RAIDING THE TRUST FUND

FRAMEWORK FOR ANSWERS:

- **Unified Balance is Traditional Measure Used to Evaluate Budget.**

  - The unified balance is the same measure that has been used by all administrations going back to the Johnson Administration. The unified budget is the simplest and clearest measure of how much the government is taking in and how much the government is spending and it allows us to look out into the future to see if the government will be able to meet all of our obligations, including Social Security.

- **If A Dollar Comes Into Social Security, It Goes To Pay Current Benefits or If There Is Extra In Any Year, It Is Invested in Treasury Bonds And Is Paid Back To Social Security When The Money Is Needed. This Investment Is Backed By A Legal Commitment And The Full Faith and Credit of the United States Government That It Will Be Repaid.**

  - Every dollar received by Social Security is either used to pay current benefits or helps pay future benefits by being invested in special-purpose Treasury bonds, which represent a legal commitment *now* to finance Social Security later. Under the law, if Social Security requires funds and the Trust Funds have assets in them, the Treasury must make the funds available.

  - The special-purpose bonds held by the Trust Funds have the same legal standing as regular Treasury bonds, which are the benchmark of reliability in the world's capital markets.

- **Five Years Ago, When We Had $300 Billion Deficits, I Could Understand The Concern That We May Have Been Unable To Repay Meet Our Commitment -- But With Surpluses, That Concern Should Be Gone.**

  - When President Clinton took office, the deficit was $290 billion and there were real questions about whether the government would be able to meet its commitments in the future. Because of the fiscal discipline of the past five years -- instead of the $357 billion deficit in 1998 projected when we took office -- we will have a budget surplus for the first time since 1969. And over the next 10 years, we are projecting $1.8 trillion of surpluses.

BACKGROUND:

- According to OMB, the budget surplus will total <u>$1.8 trillion</u> over the next 10 years; CBO projects the surplus to be $1.55 trillion.

- In January 1993, the Congressional Budget Office projected the <u>deficit to be $357 billion</u> this year. In fact, this past year we had a $70 billion surplus.

- When President Clinton took office, the deficit was projected to be <u>$579 billion in 2002</u>. Today, we are projecting <u>a surplus of $148 billion</u>. That means that our fiscal situation in 2002 will be <u>$727 billion better than projected in January 1993</u>.

- In 2013, Social Security tax revenue will not meet Social Security expenditures. However, Trust Fund continues to expand until 2021 because of interest revenue earned on existing bonds. In 2021, the Trust Fund will gradually shrink as its bonds are redeemed. In 2032, the Trust Fund will be exhausted.

TAXES

FRAMEWORK FOR ANSWER:

- **Should Not Have to Increase the Payroll Tax Rate as Part of a Comprehensive Plan.** As I said in the Kansas City forum, we should not have to increase the payroll tax rate as part of a comprehensive plan. From looking at the proposals that have been put forth so far, it seems clear that it is possible to design a comprehensive solution that does not include an increase in the payroll tax rate.

- **Many Ideas Have Been Proposed -- We Must Give Every Idea a Fair Hearing.** As part of an overall plan, many ideas are on the table. Ultimately, though, what we must consider is whether a comprehensive reform package meets the principles I set forth at the last conference.

- **Bipartisan Process for Fair and Workable Solution.** We are confident that through a mutually agreeable bipartisan process, we can come up with a fair and workable solution to strengthening Social Security for the future.

POTENTIAL QUESTION:

ARE YOU FOR RAISING THE MAXMIUM EARNINGS LIMIT OR EVEN COMPLETELY ELIMINATING IT?

- **As I Have Said Before, Completely Eliminating the Maximum Earnings Limit May Not Be Necessary as Part of Social Security Reform and Could Break the Link Between What a Worker Puts into Social Security and What He or She Gets Out.**

    - Currently, Social Security taxes are assessed on earnings up to $68,400. This level increases every year with inflation.

- **However, I Do Not Want to Put On or Take Off the Table Any Proposal at This Time.**

    - At the Kansas City conference, you said that a modest increase in the cap is among the options that should be debated this year.

BACKGROUND:

- Some have argued for raising or even eliminating the cap. Currently, 6 percent of workers earn above $68,400. Some proposals would gradually raise the cap by between 15 and 25 percent. For example, under Senator Moynihan's proposal, the taxable maximum in 2003 would reach $97,500 instead of the $82,800 it is expected to reach under current law. Others have proposed phasing in the increase more slowly -- for example by 2015.

FOLLOW-UP QUESTION:

SPEAKER GINGRICH HAS PROPOSED REPEALING THE 1993 INCREASE IN THE PERCENTAGE OF BENEFITS SUBJECT TO TAXATION. DO YOU SUPPORT THIS PROPOSAL?

- **I Believe We Must Resist the Temptation To Say Something About A Social Security Proposal Now That Would Help 10-15 Percent of Retirees And Goes Against Our Efforts To Maintain Fiscal Discipline.**

- **I Am Also Concerned That This Proposal Would Help 10-15 Percent of Social Security Recipients While Moving The Insolvency Date of the Medicare Trust Fund Closer For Everyone.**

BACKGROUND:

- The partial tax on Social Security benefits does not apply to seniors with income below $25,000 if single or $32,000 if married. In 1997, only 25 percent of beneficiaries were subject to taxes on their Social Security benefits.

  - For those with income above $25,000 if single and $32,000 if married, up to 50 percent of benefits are taxable. The fund are credited to the Social Security Trust Funds.

  - For those with income above $34,000 if single and $44,000 if married, up to 85 percent of benefits are taxable. The *additional* revenue from this provision is credited to the Medicare Trust Fund.

- One common proposal would extend the tax on Social Security benefits to all persons subject to Federal income tax by phasing out the current income thresholds. Even if the thresholds were completed phased out, other provisions in the tax code (e.g., standard deduction and exemptions) would ensure that 30 percent of beneficiaries (those at the lowest income levels) would still not have to pay taxes on their benefits.

- Other proposals would also tax Social Security benefits like other pensions. The proposal would tax benefits -- on an individual-by-individual basis -- to the extent that benefits exceed what workers had paid in. This treatment would mirror the tax treatment of other defined-benefit pension plans.

- Making *both* changes would *reduce* the long-run imbalance in the Social Security system by 0.36 percent of payroll -- relative to the current gap of 2.19 percent.

MEANS TESTING

FRAMEWORK FOR ANSWERS:

- **The President Believes That Social Security Reform Must Be Fair for All Americans -- But We Most Look At How Fair and Progressive Is A Comprehensive Plan, Not Any One Provision.**

- **For Example, The President Is Certainly Not In Favor Of Comprehensive Reforms That Put An Undue Burden On Lower-Income Americans.** The President believes that the Social Security system must be progressive and fair to those who need it most. This is one of the principles he announced at the Kansas City forum earlier this year.

- **The President Also Believes That Social Security Should Be A Universal Program.** This is also one of the five principles he put forth in Kansas City. Everyone pays in to the system, and everyone benefits.

Additional Point to be used ONLY IF NECESSARY:

- **In 1983, President Reagan and Congress Addressed These Concerns -- and We Did the Same Thing in 1993 for Very High Income Beneficiaries.** In 1993, as part of our economic plan, we did ask the top 13 percent of Social Security beneficiaries to include more of their benefits in taxable income, while protecting the vast majority of beneficiaries from any such increase.

BACKGROUND:

- Currently, Social Security benefits are not means-tested. Some proposals would means test the benefits by reducing them by a given amount for every $1 of income over some threshold.

- Subjecting benefits to income tax accomplishes many of the goals of means-testing benefits. For those with income above $34,000 if single and $44,000 if married, our 1993 Economic Plan made up to 85 percent of Social Security benefits taxable. The additional revenue from taxing benefits at 85 percent rather than 50 percent is credited to the HI Trust Fund, not the Social Security Trust Funds.

- At various times, we have showed openness to means testing the premium subsidy for high-income beneficiaries in the Medicare program. In *Putting People First*, we supported means testing of Medicare -- raising Part B premiums for those earning more than $125,000. We included a similar proposal in the 1994 Health Care plan and we showed openness in 1997 as long as the provision was administratively feasible and did not fully eliminate the premium subsidy which would have given incentives for higher-income individuals to withdrawal from the system.

COVERING STATE AND LOCAL WORKERS

FRAMEWORK FOR ANSWER:

- **Clearly An Idea That Is On The Table, But Pros and Cons Need to Be Weighed.** This proposal has been included in many reform plans. But before we reach any conclusions, we need to study carefully the pros and cons.

Advantages of This Proposal Are:

- **Social Security Coverage Has Expanded Significantly.** Since the Social Security Act of 1935, coverage has expanded from workers in business and industry to almost all Americans.

- **State and Local Government Workers Are Final Group Not Covered.** Many people have argued that state and local government employees are the final sizable group of workers not universally covered (nonetheless, about 70 percent of state and local workers receive benefits for various reasons). Being covered under Social Security would allow state and local workers to move from one job to another without losing coverage. Proposals are to cover newly hired state and local workers, not existing workers.

Disadvantages of This Proposal Are:

- **But Impact on Existing State and Local Programs Needs to Be Carefully Examined.** I know that the impact of the proposal would vary greatly across the nation, and that some people are concerned about its effect on existing state and local retirement programs. So we will need to look carefully at this and other proposals over the coming year, to figure out which changes are best as part of a comprehensive Social Security reform.

BACKGROUND:

- Since the Social Security Act of 1935, coverage has expanded from workers in business and industry to include the self-employed, nonprofit groups, agricultural and household workers, the Armed Services, Congress, and all other Federal employees hired after 1983. In 1998, 96 percent of all workers are covered under Social Security -- up from 55 percent in 1939.

- State and local government employees are the final sizable group of workers not universally covered by Social Security. If such workers are mandatorily covered under a state or local public pension system, they are not mandatorily covered under Social Security. Roughly 25 percent of state and local workers are not covered under Social Security. Many of these workers are in California, Ohio, New York, and Texas. In New Mexico, about 17 percent of state and local government employees are not currently covered by Social Security.

- Many proposals would expand mandatory Social Security coverage to state and local government workers hired after a certain date. Such proposals would close roughly 0.2 percent of the current 2.19 percent gap. Moving newly hired workers out of the state and local programs that would otherwise cover them could put financial pressure on some state and local programs -- although a gradual phase-in could attenuate any such pressures.

REDUCING COST OF LIVING ADJUSTMENTS

FRAMEWORK FOR ANSWERS:

- **We Are Committed to The Most Technically Accurate Index.** The issue of whether we should change the COLAs in order to better reflect inflation is a legitimate one, but one that needs to resolved by experts. The administration is strongly committed to using the most technically accurate index.

- **COLAs Affect Millions of Americans.** The COLAs affect 44 million Americans through the Social Security program, and millions more through other programs (including the tax code). Any change in the COLAs should be carefully considered to assure that the most vulnerable elderly and lowest-income retirees are not put in jeopardy.

- **BLS is Making Improvements.** The Bureau of Labor Statistics is continuing to make improvements in the CPI, and many economists believe that they are making good progress. Alan Greenspan recently testified that the "BLS has done such a good job recently...I must say -- they have done really an excellent job over the last couple of years." According to Janet Yellen, recent and planned changes will reduce the CPI inflation rate by about 0.33 percentage point per year more than was previously anticipated.

- **COLA for this Year Will Be 1.3 Percent.** Recent COLAs have been relatively small because inflation has been low. The COLA payable in the January 1999 benefit check will be 1.3 percent for OASDI benefits.

BACKGROUND:

- The cost-of-living adjustment within Social Security is set each year on the basis of the increase in the CPI-W over the year ending in the third quarter of the previous year.

- In December 1996, **the Boskin Commission** concluded that the CPI was overstating increases in the cost of living by 1.1 percentage points per year. Most of the President's economic advisers believe that the CPI does overstate increases in the cost of living, but that the Boskin figure was too high.

- Since the Boskin Commission report was issued, the BLS has been working to address many of the biases in the CPI. According to Janet Yellen, recent and planned changes would reduce even the Boskin estimate by about 0.33 percentage point per year -- to about 0.8 percentage point per year.

- Reducing the COLA by 1 percentage point per year reduces lifetime benefits for the average retiree by roughly 10 percent, and reduces the long-run actuarial imbalance in the Social Security system by 1.4 percent of taxable payroll (out of current gap of 2.19 percent).

RATES OF RETURN

FRAMEWORK FOR ANSWERS:

- **Rates of Return on Social Security Are Positive, Even after Accounting for Inflation, for Almost All Workers.**
    - Although rates of return to Social Security are lower than they once were, they remain positive, even after accounting for inflation, for almost all workers.
- **Rates of Return Could Be Raised Either Through Individual Accounts or Through Investing Some of the Trust Funds in the Stock Market.**
    - A key question in this year's national discussion is whether it will be possible to achieve higher rates of return in the future using individual accounts or trust fund investments in equities. Both approaches need to be explored carefully in the context of a comprehensive plan, to see whether they meet the principles the President have put forward. In particular, Social Security must remain a program that everyone can depend on.
- **Must Not Forget about Transition Costs.**
    - Sometimes people argue that if they could opt out of Social Security and invest on their own they could do better than they do in Social Security. But this ignores the fact that 90 percent of today's payroll tax goes to pay benefits for current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirement, we will need to come up with some other way to pay retirement benefits for people who are entitled to Social Security benefits. Rates of return that ignore this cost are misleading when compared to Social Security rates of return that include this cost.
- **Social Security Is More than a Retirement Program.**
    - It provides disability insurance and survivors' insurance -- each is equivalent for the average young family of four to an insurance policy worth about $300,000 ($600,000 in total). And it is low risk; its benefit is always there for you, no matter what happens to stocks, interest rates, or inflation. But most importantly, it reflects our fundamental values and a social compact.

REAL RATE OF RETURN TO SOCIAL SECURITY CONTRIBUTIONS
(Percent per year)

Year born/ year age 65	Single male earner			One-earner couple		
	Low earnings	Avg. earnings	High earnings	Low earnings	Avg. earnings	High earnings
1920/1985	4.4	2.8	2.5	8.1	6.6	6.3
1930/1995	3.1	1.9	1.5	6.1	5.0	4.7
1964/2029	2.4	1.3	0.7	4.7	3.7	3.1
2004/2069	1.5	0.8	0.2	4.0	3.0	2.4

ELIMINATE THE EARNINGS TEST

KEY POINTS:

- **This Is One of the Important Issues That Needs to Be Discussed Because There Are Serious Arguments on Both Sides.**

- **Some Say Social Security Benefits Should Go Only to People Who Are Retired.** Some believe that it makes sense to reduce Social Security benefits for people who continue working because FDR's Committee on Economic Security recommended that no benefits be paid before a person had "retired from gainful employment." Various forms of earnings limits have always been part of the program.

- **Others Argue That This Is An Outdated Provision That Provokes Unnecessary Confusion and Prevents People from Doing Part Time Work That Would Be Good for Them.** While retirees get back these lost benefits, on average, through the delayed retirement credit which provides them with increased benefits once they stop working, many elderly workers perceive the earnings test to be unfair and an impediment to work. They argue that removing the earnings test would help people make the right choice about whether or not to work. In addition, they say it would make the system more understandable and easier to administer.

- **In 1996, Working Closely with Members of Congress from Both Parties, I Signed Legislation That Will Gradually Double the Earning Limit for People Between 65 and 70.**

KEY FACTS:

- Currently, Social Security recipients who are between the ages of 62 and 69 have their benefits reduced if their earnings exceed a certain amount. Recipients under 65 lose $1 of benefits for every $2 of earnings above $9,120. Recipients between 65 and 69 lose $1 of benefits for every $3 of earnings above $14,500. (The benefits of recipients who are aged 70 or above are not affected by the limit.)

- In 1996, working with both Democrats and Republicans in Congress, you signed into law annual increases in the earning limit for those between 65 and 70. Between 1998 and 2002, the limit for workers in this age range will increase from $14,500 to $30,000.

- Because benefits foregone are given back through the delayed retirement credit, eliminating the earnings limit would have almost no effect on the long-run actuarial balance of the OASDI program. Such a change would have significant short-run budget effects, however. Removing the earnings limit for those aged 62 and above would raise Social Security expenditures by roughly $12 billion in 2001 *alone*.

- **The Chilean privatization has influenced Social Security debates across the world.** The Pinochet dictatorship established the current system in 1981. Benefits are based on either (a) a general-revenue-financed minimum benefit, or (b) the proceeds of an individual account. To cover the transition costs (paying workers for the benefits they had accrued entitlement to under the old system), the government issued new debt, known as recognition bonds.

  -- The minimum benefit is set at either 75 percent of the poverty rate or 25 percent of the worker's average pay over 10 years, whichever is greater. The minimum benefit is paid only if the individual account generates an annual benefit below the minimum. A worker cannot collect from both tiers: if a retiree collects the minimum benefit, he or she surrenders the proceeds from the individual account.

  -- The individual account is financed by a mandatory employee contribution of 10 percent, supplemented by additional voluntary contributions of up to 20 percent of wages.

- **Advocates of Social Security Privatization hail Chile as a success.** Supporters attribute Chile's 7 percent growth rates directly to social security privatization and they also credit the new system with increasing national saving. Projected benefits are 40 to 50 percent above those under the old system, and the funds realized real rates of return that averaged 10 percent during the decade of the 1980s (Chile's stock market performance has been much weaker recently). In addition, supporters argue that the new system has de-politicized the setting of benefits, because benefits (other than the minimum) are tied to the performance of the individual accounts.

- **There are reasons why the Chilean experience is not applicable to the U.S.** Many economists have argued that Chile's economy has improved because the economic reforms accompanying privatization have enhanced the appeal of Chilean capital markets and improved their efficiency. The U.S. already has well developed financial markets, and has little to gain along these lines from reform. In addition, the low-level of benefits under the old system and the relatively small fraction of the Chilean population that was old, meant that transition costs in Chile were much smaller than they would be in the United States.

- **The big drawback of the Chilean system has been high administrative costs.** The accumulation of administrative costs over a worker's career results in retirement income in the Chilean system that is 20 percent lower than it would be if there were no administrative costs.

  -- In Chile, fund management companies appear to compete on factors other than price. The funds are highly regulated in the types of allowable investments, and offer very similar portfolios. Individuals are allowed to switch portfolios every 4 months. This has caused fierce competition. The funds spend huge amounts on advertising, have increased their sales forces, and offer incentives such as televisions or trips to lure individuals to their particular fund. This non-price competition has driven up costs.

  -- In Chile there are 3.5 salespeople per 1,000 contributors. In the United States, there are 0.5 SSA employees per 1,000 insured workers.

- **Reforms over the past decade have greatly reduced the UK's long term financing problem.** In the mid-1980s, Prime Minister Margaret Thatcher's Conservative government introduced a series of reforms partially privatizing the existing state pension system. As a result of these reforms, the British system does not face the same type of looming financing problem that the U.S. and many other European nations are currently confronting. Although the number of workers per beneficiary in the U.K. is expected to fall from its current level of just over 2 to about 1.6 by 2030, the cost of promised benefits is actually expected to *fall* as a percentage of GDP, from 4.2 percent currently to 3.3 percent in 2030.

- **The UK now has a two-tiered system.** The first tier provides a basic flat-rate pension. The second tier provides a benefit based on an individual's earnings history and workers can choose whether to take the state provided benefit or to opt-out of the state system in favor of an employer or individual pension.

  -- *The Basic State Retirement Pension.* The first tier consists of the basic state retirement pension (BSP), a flat-rate benefit that pays most beneficiaries approximately \$105 per week. The BSP is funded on a pay-as-you-go basis through a portion of the payroll tax. The BSP provides about one-third of total income for retirees, and costs roughly 4 percent of GDP.

  -- *The State Earnings-Related Pension Scheme.* The most basic of the second tier options available to workers is the State Earnings-Related Pension Scheme (SERPS). At present, about one-fifth of British workers are enrolled in this program, which provides a publicly-funded pay-as-you-go benefit based on earnings history. When it was first introduced in 1975, SERPS was based on a worker's highest 20 years of earnings, indexed to average earnings. Subsequent changes, however, have made the program less generous. These changes, which were introduced in the mid-1980s, were intended to reduce the state's financial obligation and to encourage participants to switch to either employer- or individual-based privatized systems.

  -- Contracted out options. Workers who opt out of SERPS have two other second tier options available to them: an employer-based system and an individual-based system. Those who choose either of these options (or "contract out") have a payroll tax rate that is 4.6 percentage points lower than the contracted-in rate.

  Employer-Based Pension. One option available to those who wish to contract out of SERPS is to participate in an employer-sponsored pension plan (often referred to as an "occupational pension"). About half of all workers choose this option. Occupational pensions can be either defined-benefit or defined-contributions plans; at present DB plans are more common. In order to qualify for the lower contracted-out tax rate, occupational DB pensions must meet certain standards; most plans are more generous than SERPS.

  Personal Pension The other way to achieve contracted-out status is through a personal pension, which is similar to an IRA. About 17 percent of workers are enrolled in personal pensions. Workers enrolled in a personal pension must deposit the contracted-out rebate of 4.6 percent into their account.

- **While the financing problem has been solved, their are serious concerns about the adequacy of retirement benefits in the UK.** The size of the basic state benefit is indexed to inflation. Since real wages have been increasing, however, the benefit has fallen from about 20 percent of average earnings in 1977-78 to about 15 percent currently. By 2030, the ratio of BSP to average earnings is expected to drop to 9 percent. This presents a particular problem for low earners, since the BSP is likely to account for a large portion of their benefits once they retire. Similarly, reductions in the generosity of SERPS has resulted in some workers having low retirement income.

- **Administrative costs in the early years of the UK individual account system have been high.** A recent paper by Professor Peter Diamond reports that the charges for these individual accounts are large, complicated, and often not visible to the workers. He calculates that the total administrative costs in the typical UK account reduce retirement income by more than 24 percent. The lesson from the Chilean and UK two examples is not that individual account systems are necessarily expensive, but rather that it is important to design systems in a way that provides the desired services at a reasonable cost.

- **The mis-selling scandal shows that careful regulation of privatized systems is necessary.** Overly aggressive marketing techniques by providers of personal pensions in the UK have misled a large number of workers into choices that were not in their own best interest. For example, although occupational pensions turn out to be better investments than private pensions in most instances, there are numerous and repeated examples of the banks and insurance companies advising workers to drop out of more beneficial occupational pensions to purchase personal pensions instead. In what has been dubbed the "Mis-selling Scandal," at least 600,000 cases of pension mis-selling have been identified, and the final total may be 2 million. Regulators have already levied fines on insurers and financial advisors of more than $7 million, and Scotland Yard is conducting a criminal investigation related to the scandal. In order to fend off lawsuits, many insurers are voluntarily reimbursing investors for the losses they suffered based on the bad information they received; one insurer has set aside $1 billion for this purpose. When all is said and done, this scandal is expected to cost British insurers roughly $18 billion.

SOCIAL SECURITY REFORM IN CANADA

Canada has recently decided to invest the assets of its Social Security system in private securities beginning in early 1999. This will provide an important test of the feasibility and desirability of a policy of trust fund investments in private securities.

Draft investment regulations have been proposed, and final regulations are expected to be issued soon.

- Investment decisions will be taken by a 12-member Investment Board (yet to be named). Each member of the Investment Board will serve a three-year term, can be reappointed, and will receive pay similar to that in the private sector.

- The members of the Investment Board will have a fiduciary responsibility to the fund; specifically, the Board members are to "manage any amounts transferred to it . . . in the best interests of the contributors and beneficiaries" of the CPP. They will be held to a "prudent person" standard, and members with special knowledge or skill will have a higher level of responsibility.

- By law, the fund will be prohibited from investing more than 20 percent of CPP funds in foreign markets (equities and bonds). However, there has been much speculation that this limit will be raised or eliminated.

- The draft regulations covering the first three years of operation call for all investment in equities to be undertaken passively (that is, via one or more indexes).

- The Investment Board will be prohibited from investing more than 10 percent of the fund in any individual company, and from owning more than 30 percent of the voting shares of any one firm. Some real estate holding would be permitted.

- After three years, the investment regulations will be reviewed by the Finance Minister and the provinces.

12-12-98

EYES ONLY

SPECIAL ANALYSIS

The Swedish Approach to Social Security Reform

Sweden made sweeping changes to its public pension system this summer. The most novel reform is the creation of defined-contribution individual accounts as part of a traditional pay-as-you-go (PAYGO) system.

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The new program. Key aspects of the reforms include the following:

- Notional accounts. The lion's share of future payroll taxes will be used to finance contemporaneous benefits, as in the old PAYGO system. But these taxes will be recorded in individual "notional accounts" that will earn an imputed rate of return based on the growth of average covered earnings in the economy. Contributions will also be made to the notional accounts of some people without current market earnings (such as the disabled, the unemployed, and those caring for children). In addition, the system will maintain substantial redistribution through minimum guaranteed pensions financed by general revenue.

- Annuitization. Upon retirement, which can be at any age after 61, individuals' notional accounts will be automatically converted by the government into annuities. The size of the annuity will depend on the individual's account balance and the average life expectancy of men and women that age. With rising life expectancy, the monthly benefit associated with any given retirement age will decline over time. Put the other way around, successive cohorts will have to work longer in order to receive the same monthly benefit. Thus, the system may generate a naturally rising retirement age.

- Prefunded private accounts. A second and smaller arm of the system provides for individual accounts with claims on real assets. Taxes will be invested initially by the government in low-risk assets until precise individual pension rights can be tallied (about 18 months later, on average). At that point, individuals can direct their balances to any certified investment fund, or by default to a public fund. To reduce administrative costs, individuals will interact only with a central public agency; this agency will hold one account with each investment fund equal to the aggregate of all individuals' balances.

Analysis. The new system has several interesting implications:

- As a defined-contribution system, it will more closely link benefits to contributions than did the old system. This may be viewed as more fair, and the perception that payments are retirement contributions rather than taxes may reduce labor supply distortions. The unavoidable tradeoff is that redistribution will be more transparent.

- Individuals will bear limited financial-market risk. Officially, people will bear the full risk of their investment choices in the prefunded private accounts. However, if someone's total benefit from the notional and prefunded accounts falls below a given threshold, he or she will receive additional payments. Still, this minimum guarantee is indexed over time to inflation rather than wages, so it will decline in relative importance if real wages grow unless future changes are made.

- The system is less vulnerable to demographic shifts than traditional defined-benefit PAYGO systems. The key innovation is the way that annuitizing notional accounts *automatically* adjusts benefits to changes in life expectancy. At the same time, the chosen rate of return on notional accounts will not be sustainable if the Swedish labor force declines over a long enough period. Total contributions are determined by both average earnings and the number of workers making contributions, but the rate of return is indexed only to average earnings. Thus, a shrinking labor force would drain the system, while an expanding labor force would lead to surpluses. Swedish analysts recognize that changes in the rate of return may be necessary over time, but they expect that these changes can be buffered by the public pension trust funds.

EDWARD M. KENNEDY
MASSACHUSETTS

12-23-98

Sperling/Reed
Legislative agenda re: tobacco
BR

United States Senate

WASHINGTON, DC 20510

December 18, 1998

MEMORANDUM FOR THE PRESIDENT

FROM SENATOR EDWARD M. KENNEDY

"PROPOSED DEMOCRATIC PRIORITIES FOR THE 106th CONGRESS"

The November elections reaffirmed the key Democratic priorities on which you have worked so effectively over the past two years. As a result, we are poised to move forward on a number of popular issues, especially:

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-- The Patient's Bill of Rights;

-- The increase in the minimum wage;

-- Education reforms to reduce class size and facilitate school construction;

-- Aid for disabled Americans who are able to work and want to work;

-- Medicare "buy-in" for the near-elderly; and

-- Saving Social Security.

I encourage you to include in the Democratic agenda three new ideas that will help millions of Americans and expand our base of support for the year 2000.

1. Prescription Drug Coverage under Medicare:

We should help seniors by guaranteeing this coverage under Medicare. In 1965, when Medicare was enacted, most private insurance plans did not offer this coverage. Today, 99 percent of private insurers provide it -- but Medicare does not. Millions of senior citizens struggle to afford the expensive prescription drugs needed to maintain their health and avoid hospitalization.

In 1994 and 1996, Democrats received 48 percent of the senior citizen vote. This year, that support dropped slightly, to 44 percent. The elderly represent 28 percent of the voting public. We cannot afford as a party to lose this powerful and growing voting bloc. There is no better way to attract these voters than to fight for their health care. Providing prescription drug coverage is expensive -- which is why seniors are struggling so hard to afford it. But the need is great, and the long-term benefit for the Democratic Party is great too.

2. A Well-Qualified Teacher in Every Classroom:

You deserve great credit for directing the national education debate to the all-important issues of quality and standards. Your two key proposals to reduce class size by funding 100,000 new teachers and to modernize schools have resonated throughout the country. To fill out the education picture, we must also assure that teachers are well-trained to meet high standards and raise student achievement.

You are already providing funds to hire new teachers. I propose that we help existing teachers, too. We need mentoring programs for novice teachers as they adjust to the classroom. We need more resources for teacher training, for professional development, and for appropriate recertification requirements -- while avoiding the divisive issue of teacher testing. With your leadership, we can assure parents and students that we are doing all we can to guarantee a well-trained teacher in every classroom in America.

3. Ready to Learn:

We must do a better job of enabling children to start school ready to learn. Experts agree that the attention given children in their formative years often determines their ability to learn and succeed over their lifetime. You have led the way on child care. We need to expand Headstart, Early Start, pre-K, and other programs with a proven record of preparing children for school, and we also need to focus these programs more effectively on early learning.

I believe that tobacco funding can provide the resources needed to pay for these initiatives, and that the iniatives will have widespread support from the American people and strengthen your hand in dealing with the tobacco companies.

For example, the governors could be permitted to keep the federal share of the state tobacco settlement, provided that the funds are used to prepare children to start school ready to learn.

In addition, the federal government should insist on compensation from the tobacco companies for the costs to the federal government of treating tobacco-related illnesses under Medicare, veterans' health programs, and other public health programs. The compensation could be pursued both in court and through legislation. To strengthen these approaches, we should earmark every cent collected from the tobacco companies for prescription drug coverage for our senior citizens under Medicare. I believe this linkage would receive broad support.

Thank you for your continued leadership on so many issues of vital importance to the nation. As always, I look forward to working with you to bring greater opportunities for working families.

TOBACCO TALKING POINTS -- DECEMBER 17, 1998

1) The Administration should renew its effort to substantially raise the federal tax on cigarettes. The budget should propose increasing the cigarette tax by at least 70 cents per pack. A majority of the Senate -- 58 members -- supported a $1.10 per pack increase in the last session. The cost of the state settlement is approximately 40 cents per pack. This leaves 70 cents per pack -- approximately $40 billion over five years -- to finance our initiatives.

2) Raising the price of cigarettes produces a double benefit -- it is an important deterrent to youth smoking and it produces badly needed revenue.

3) The federal government incurs enormous costs each year to provide health care for those suffering from tobacco-induced disease. Estimates place the federal cost at approximately $22 billion per year, of which roughly half is incurred in Medicare.

4) The successful state lawsuits already established the principle that the tobacco industry is liable for the costs which government incurs treating sick smokers. Whenever people ask me about tobacco issues, they want to know why the federal government has not filed suit.

5) The best way, probably the only way, to get Congress to enact a substantial cigarette tax increase is for the federal government to file suit against the industry. That is our leverage to bring the industry to the table and negotiate a strong legislative package.

6) I know you are hearing from the Justice Department that the federal government does not have a good case. Many of the foremost experts in the country disagree.

7) I (along with Senators Conrad and Bob Graham) have had several meetings about this issue with Attorney General Reno. She personally is very favorably disposed to bringing a suit, but the staff keeps raising obstacles to going forward.

8) At her invitation, I have put together a group of experts -- both legal academics and trial lawyers -- who believe the federal government has a strong case and who are willing to meet with the Attorney General and her staff on an ongoing basis to persuade them to file suit and to help them put the case together. It includes Larry Tribe, Robert Blakey (the RICO expert), Einer Elhauge (an anti-trust expert from Harvard), Mike Ciresi (the lead trial counsel in the Minnesota case) and Dick Scruggs (the lead counsel in the Mississippi case). We've already been meeting with them, and the first meeting with the Attorney General is scheduled for early in January.

9) They have identified four viable courses of action -- 1) civil RICO, 2) the Medical Care Recovery Act, 3) the federal common law of nuisance (used successfully in environmental cases prior to EPA), and 4) antitrust.

10) Such a lawsuit would clearly give us enormous leverage to negotiate strong tobacco legislation including a substantial price increase and FDA regulatory authority.

11) I believe we could further strengthen the legislative argument for a 70 cent per pack price increase by proposing that the money be spent to provide prescription drug benefits for seniors through Medicare. You know how popular that issue is, but we've never been able to fund it. Since much of the tobacco-related cost the federal government incurs is in Medicare, this would be a particularly appropriate use of the money. It is a much more potent message than spreading the money over a number of different programs.

12) I would try to use the federal share of the tobacco money which the states recovered in their Medicaid suits to address our child care and child development initiatives. We should only agree to waive the federal claim to those Medicaid dollars if the states agree to use the federal share for children's programs. The states are worried about losing that money, and an agreement along these lines can be negotiated.

Health and Human Services

		FY 2000			
FY 1998	FY 1999	OMB Passback	Appeal	Potential Settlement	Proposed Final
36,119	40,309	40,552	3,300	850	41,402

OMB recommended level

Our most recent offer to settle HHS funds the Department at $1 billion or 6% over program levels for 1999. The funded level allows for significant increases in many operating divisions, and a reasonable level of funding for initiatives including long term care, bio-terrorism, mental health, and many other areas. We have also directed $3.6 billion in out-year tobacco revenues to fund mandatory initiatives in HHS, including $1 billion for the Secretary's public health initiative, an outreach program for uninsured Americans.

Outstanding issues

- Indian Health Service — where we have already granted a $175 million increase in BA, the most generous funding increase in the history of the program.
- Bio-terrorism — where the COS and OMB believe that we have funded credible increases, but NSC and HHS disagree; and
- NIH — where constraints have compelled us to recommend a $49 million increase, a level of funding consistent with the path we established in the 1999 budget, but dramatically less than expectations created by the $858 million increase granted by the Congress last year.

The Secretary may also appeal our funding $1.3 billion in discretionary spending through Medicare program integrity offsets.

The Secretary will probably focus much of her appeal on the politics of tobacco. HHS is disappointed that they were not able to garner more of the revenues from the tax and recoupment. The Secretary will propose the acceleration of our recoupment policy to the year 2000 (it is currently deferred until 2001 to improve our chances of bringing the states to the negotiating table) to generate $2 billion for HHS to spend. As we discussed last week, Bruce Reed believes that attempting to spend recoupment funds in FY 2000 would seriously undermine our efforts to pass tobacco legislation. Secretary Shalala believes equally strongly that failing to show recoupment revenues in FY 2000 will have the same negative effect.

The Secretary will propose FY 2000 emergency designations for several activities that were funded as emergencies in FY 1999 (Y-2K, bio-terrorism).

Proposed settlement

We are currently reserving $200 million to settle the HHS appeal. While this level is clearly less than the Department wants, it should be more than adequate to address the non-NIH policy concerns.

State Department/International Affairs

		FY 2000			
FY 1998	FY 1999	OMB Passback	Appeal	Potential Settlement	Proposed Final
19,494	20,044	20,633	4,217	602	21,235

New Embassy & Consulate Construction. The State Department seeks $1.4 billion in FY 2000 to construct new embassies and consulates, with similar amounts in future years. State and OMB have agreed in principle to a long-term capital planning process, but have been unable to settle upon funding levels. The proposed OMB settlement offers initial funding for design costs plus $1.35 billion in advanced appropriations over the next three years. The OMB offer, combined with existing funds, would fund a highly ambitious construction schedule that would fully pay for six new embassies and posts, and begin design and/or site acquisition of 13 new posts in FY 1999 and 2000, roughly two to four times the level of State's building program at its highest tempo over the last 20 years. In addition to Security concerns, State continues to seek immediate funding for major protects that are not immediate security risks, such as the Beijing embassy.

State Department Operating Programs. The State Department seeks $250 million to fund the follow-on costs of security upgrades made with FY 1999 emergency funds and $300 million more for regular agency operations. As part of the potential settlement, OMB proposes to fund fully the $250 million in follow-on security upgrades. For other operating expenses, OMB's original passback provided the State Department with a 2.8 percent increase above FY 1999 enacted levels, including $90 million for continued modernization of information technology.

International Affairs Programs. The State Department seeks $1.8 billion on appeal for a wide range of programs, including more assistance for Asia, Central America, Eastern Europe and the New Independent States.

For the NIS, the proposed OMB settlement provides $867 million for assistance, $20 million above last year's enacted level of $847 million (which includes $46 million in emergency spending). Moreover, DoD and DoE will also spend over $760 million in the NIS. The proposed OMB settlement also fully funds the State Department request for Bosnia, Bulgaria and Romania, and provides $25 million in economic assistance for Kosovo. It would also provide over $225 million more for the Economic Support Fund, development assistance, and other State and NSC priorities.

The Wye Agreement will be funded above the level of the general State appeal, as will relief for Hurricane Mitch.

If you want to raise the level of funding for international programs, we have reserved $50 million which could be made available for embassy construction in FY 2000 and $40 million for other programs.

MOVING THE PRESIDENT'S AGENDA FORWARD: FUNDAMENTALLY IMPROVING AMERICAN EDUCATION

We need to continue to create a new sense of direction in America's schools.

A $2.2 billion increase over FY1999 ($2.4 billion over passback) is the minimum required to make fundamental improvements in education such as getting high standards and accountability into schools and classrooms. This investment, along with our school construction proposal in the tax arena, would demonstrate our continued support for creating real momentum for school change and accelerating serious education reform (reauthorization of ESEA and the redesign of Title I with more rigorous accountability this coming year).

Our new initiatives, such as Class Size Reduction, After-School, Reading, Teacher Quality and Recruitment, and GEAR-UP require a second installment in FY2000 in order to ensure permanency beyond the first year. Otherwise, our legacy will be nothing more than a series of small, one-time programs.

Also, because many of these initiatives are forward funded, this FY2000 budget will literally hit the schools in the Fall of 2000.

Our proposal basically has four parts:

- A $700 million package to support high standards and improving the basics tied to stronger accountability in schools and classrooms. This includes such items as putting in place report cards rating public schools and action to encourage improvement of poor schools through Title I, improving reading and the basics and support to raise standards through Goals 2000 expansion.

- $300 million to accelerate school change and serious education reform – including the expansion of new initiatives like the doubling of GEAR-UP and After-School, continued efforts to improve Safe and Drug-Free Schools, expanding charter schools, and turning around schools through expansion of Obey-Porter.

- $500 million to provide leadership to help address the massive need for quality teachers that measure up to high standards – including the second installment for Class Size Reduction; more than doubling funds to recruit new teachers to the neediest schools, strengthen State teacher certification standards, and hold teacher education schools accountable for preparing high-quality teachers; improving math instruction; and strengthening the ongoing professional development of current teachers.

- $600 million to create high hopes and access to college by expanding Pell Grants, TRIO, College Work-Study and Tech-Prep Vocational Education.

The Department's alternative proposal would provide a $2.2 billion increase over the FY1999 level – down from our original requested increase of $3.8 billion.

Additional measures we want to take would urge schools take a more active role in encouraging more parents and families to get involved in their child's education.

	1999	2000 Proposal	Change	
SUPPORT HIGH STANDARDS AND THE BASICS AND STRONGER ACCOUNTABILITY IN SCHOOLS AND CLASSROOMS				
Title I Grants to LEAs – (includes report cards to rate schools on their progress)	$7,676.0	$8,026.0	+$350.0	
Reading Excellence Act	$260.0	$310.0	+$50.0	
Even Start	$135.0	$185.0	+$50.0	
Goals 2000	$491.0	$541.0	+$50.0	
Tough Courses in High School	$4.0	$20.0	+$16.0	
Earlier Identification to Help Young Children with Reading and Behavioral Problems	----	$50.0	+$50.0	
Special Education – Preschool, Infants and Toddlers, State Improvement	$779.2	$841.4	+$62.2	
Research to Improve Early Reading and Mathematics Instruction	----	$75.0	+$75.0	
ACCELERATE SCHOOL CHANGE AND SERIOUS EDUCATION REFORM				
GEAR-UP	$120.0	$200.0	+$80.0	
21st Century Community Learning Centers	$200.0	$350.0	+$150.0	
Safe and Drug-Free Schools	$566.0	$613.0	+$47.0	
Charter Schools	$100.0	$110.0	+$10.0	AGREE
Comprehensive School Reform Demonstrations (Obey-Porter)	$145.0	$195.0	+$50.0	
ADDRESS THE MASSIVE NEED FOR QUALITY TEACHERS THAT MEASURE UP TO HIGH STANDARDS				
Class Size Reduction (40,000 teachers)	$1,200.0	$1,450.0	+$250.0	
Teacher Quality and Recruitment	$75.0	$150.0	+$75.0	
Eisenhower Professional Development	$335.0	$410.0	+$75.0	
Improving Math Instruction	----	$50.0	+$50.0	
Bilingual Professional Development	$50.0	$65.0	+$15.0	
Technology Teacher Training	$75.0	$75.0	----	AGREE
Middle School Teacher Training	----	$30.0	+$30.0	AGREE
CREATE HIGH HOPES AND PATHWAYS TO COLLEGE				
Pell Grants	$7,704.0	$8,109.0	+$405.0	
Pell Grant Maximum Award	*$3,125*	*$3,225*	*+$100*	
Perkins Loans Capital Contributions	$100.0	$100.0	----	
TRIO	$600.0	$650.0	+$50.0	
Tech-Prep and Vocational Education	$1,154.2	$1,179.7	+$25.5	
College Work Study	$870.0	$934.0	+$64.0	AGREE

TOTAL INCREASE OVER FY1999 **+ $2.2 BILLION**

NOTE: School Construction cost in FY2000 is $215 million, thus the total Education increase over FY1999 would be $2.4 billion, the same as the decrease in cost for student loans in FY2000.

Education

		FY 2000			
FY 1998	FY 1999	OMB Passback	Appeal	Potential Settlement	Proposed Final
29,559	33,119	32,943	3,407	1,000	34,143

OMB recommended level

The Education Budget is $1.2 billion over the Passback level, or $1 billion above the FY 1999 level. While smaller relative to Education budget increases you proposed over the past several years, it funds Administration top priorities. The recommended level includes a new emphasis on accountability for results in elementary and secondary programs, resources to help end social promotion, investments in computer centers in low-income communities, and significant expansions for adult literacy and programs for Hispanics.

The recommended level makes progress toward reaching Administration goals stated in past budgets to provide federal work study opportunities to 1 million college students, reduce class sizes ($1.3 billion for the second year of funding), invest $2 billion in education technology by 2001. It could also finance an increase to the Pell grant maximum award.

The Policy Councils have proposed the following Education Initiatives which total $709 million above Passback:

- Adult Literacy, **$197 million** would expand the State Grants Program ($100 million), establish ESL/Civics ($50 million) demonstration projects, establish applied Technology grants programs ($25 million), expand workplace literacy programs ($20 million), and establish a community mobilization campaign ($2 million).

- Social promotion/After School, **$350 million** would expand the 21st Century/After School program to fund extended learning time including summer schools for that have a policy to end social promotion.

- Urban/Rural Computing, **$60 million** would expand the Community-Based Technology Centers program, began in FY99, which provides access to the Internet and computers in low-income communities.

- Charter Schools, **$19 million** to promote public school choice and make progress toward the Administration's goal of helping establish 3,000 Charter Schools by 2002.

- Stay in College, **$25 million** would establish competitive grant program to improve college persistence of low-income students.

- Technology for Disabled, **$23 million** would fund several rehabilitation services projects to expand and promote the use of assistive technology for people with disabilities.

- Native Americans, **$10 million** would provide 4-year scholarships to Native American students who commit to teaching in regular school districts (not BIA) which primarily serve Native American children.

- Education Research, **$25 million** would fund Education's share of a joint Education/NSF collaborative research partnership to explore ways of improving teaching in reading, mathematics and science.

Outstanding issues

The Department argues our proposed Budget, in total, is inadequate to support your education agenda; the increase is too small to either sustain your leadership position on education. Education constituency groups may also feel that an increase of this size could make it possible for Republicans to get credit for raising the level of education funding. The Department wants to convince you of the need for an increase comparable to the $3 billion increase you requested in FY 1998 and the $2.8 billion increase you requested in FY 1997.

The recommended level would be the lowest increase you have proposed, but it is not significantly lower than your FY 1999 proposal, which was $1.6 billion over FY 1998 (excluding Class Size, then a mandatory program), or your FY 1995 proposal, also a $1.6 billion increase.

The offsets for education funding are likely to be controversial in Congress. We propose reducing excess costs in the student loan programs by $4.3 billion over five years, primarily by reducing funding for State and non-profit guaranty agencies. These cost savings should have no material effect on students or schools, though these agencies would argue otherwise.

Proposed settlement

If you want to raise Education's Budget above our proposed level, we have reserved up to +$200 million, which would bring the total increase to $1.2 billion over FY 1999 enacted. Alternatively, these funds could be used to resolve other appeals.

EDUCATION DEPARTMENT FY 2000 BUDGET APPEAL
December 21, 1998

FY99 Final	FY 2000 OMB Passback	FY2000 ED Appeal	Increase Over FY99
$33.1 B	$32.9 B	$35.3 B	$2.2 B

- ED's appeal includes funding for further class size reduction.
- Our school construction proposal is included on the tax side and costs $215 million in FY2000.
- ED's appeal also includes $2.4 billion in mandatory student loan savings in FY2000 alone. *Thus, in FY2000 there would still be no increased costs from education.*

Education Appeal	FY2000
Discretionary increase	+$2.2 billion
School construction (tax proposal)	+$0.2 billion
Mandatory student loan savings	-$2.4 billion
Net increase in education	**$ 0**

TO: Melissa Green
FROM: Jeff Liebman

Ken Apfel wants Gene to see this. It would be good if Gene is aware of this before the 2pm meeting.

FACSIMILE SHEET

SOCIAL SECURITY ADMINISTRATION

Office of the Commissioner
500 E Street, SW
Washington, DC 20254
Telephone: (202)358-6016
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Date: Dec 21, 1998

Pages: eight

From: Commissioner Kenneth S. Apfel

TO: Gene Sperling thru Jeff Leliman

Telephone number: 456-5358

Fax number: 456-2223

Messages:

Bob Ball

SOCIAL SECURITY AND BUDGET SURPLUSES

In recent months there have been several proposals, including one from Martin Feldstein, that would come close to balancing Social Security for the long run by using projected budget surpluses. The proposals appear politically attractive because they largely avoid cuts in benefits or increases in taxes.

However, they all use not only the build-up in Social Security funds -- which make up the only budget surpluses for the next two or three years -- but also the substantial surpluses in the non-Social Security budget which are estimated to begin appearing about 2006. There are major problems with committing these surpluses to Social Security -- problems that are of sufficient gravity, in my view, to make this "painless" approach to the Social Security deficit entirely unacceptable.

1. It ties the future financing of Social Security to a very uncertain source. These surpluses may not develop at all or may be much less than predicted either because the estimators are off the mark or because the government's income and outgo is modified by legislation. If in a few years the Social Security program is once again predicted to be in long-range deficit, the effect on public confidence would be devastating.

2. For the first time future Social Security benefits would depend on money raised for general purposes. Up until now benefits have been paid for by money raised specifically for Social Security and earmarked for that purpose by law. When deductions have been made from workers' earnings for Social Security with employers matching these deductions the purpose has been clearly stated. To use such funds for another purpose would betray a long standing agreement as expressed explicitly in law.

These non-Social Security budget surpluses, on the other hand, grow out of the fact that taxes, primarily income taxes, are now estimated at present rates to be more than enough to cover the costs of general government as defined by present law. Other programs from defense to education have just as big a claim to these surpluses as Social Security, claims that may be recognized by future Congresses if not by the Congress that embraces a "painless" solution to the Social Security deficit problem. The point is simply that Social Security does not automatically have a superior moral claim to general budget surpluses and would be in competition for them year by year with every other program of the Federal government. The proposal, in effect, would finance a significant part of Social Security's future out of the income tax, with all the accompanying instability that this implies.

3 As a matter of public policy it seems to me undesirable that all estimated future budget surpluses should be commited now to Social Security. Of course, all surpluses in the Social Security account should go to Social Security, but they are already counted toward Social Security's long-run financing. The rest of the Social Security deficit should be made up for by specific Social Security changes, in my view, particularly by partial advance funding and a mix of investments including not just low-yielding long-range government bonds, the only investment now allowed by law, but also corporate bonds and common stocks. Thus, the principle is maintained of financing Social Security entirely by dedicated taxes raised specifically for this purpose, keeping the funding of this uniquely long-term program separate from the shorter term year-to-year considerations that necessarily drive general budgets supported by general revenues.

If surpluses in the government's general account start to appear in 2006 as predicted, there are unmet needs in American society that, in my view, should be addressed. There is not only the estimated shortfall in the financing of Medicare, but the lack of any kind of health insurance for millions of younger Americans. There is the need to improve education and in other ways contribute to a future of greater worker productivity and, among many other needs, there is the need to protect the environment and the obligation to address the national disgrace of having a fifth of our children growing up in poverty.

The Feldstein proposal has additional disqualifications. Overall it goes beyond making Social Security whole and increases the Federal government's commitments to additional retirement benefits. In view of Medicare's need for additional funding and the other needs referred to above, I think this is unwise. Moreover, this plan and some others cut back on Social Security and use the budget surplus to establish individual compulsory savings accounts. All such compulsory savings plans have huge administrative problems because as a substitute for Social Security they need to cover all the same workers as Social Security including part time and temporary employees and the employees of very small employers, household employers, and the employers of seasonal workers generally including migratory agricultural workers. The Feldstein plan also provides offsets in Social Security benefits as income from the individual savings part of the plan grow so that down the road many workers will continue to pay the present level of Social Security taxes but get very little in the way of a Social Security benefit in return, a situation which would be certain to undermine support for continuing Social Security.

There are two actions that would help avoid the trap of a "painless" Social Security solution:

(1) Maintain a complete separation of Social Security financing by maintaining a Social Security budget and a general purpose budget; and,

(2) Adopt an acceptable plan for bringing Social Security into long-range balance.

With the non-Social Security budget in balance, estimated for 2002, we could realistically put Social Security on a permanent path of partial advance financing without any confusion about whether a Social Security build-up contributes to national savings or whether what Social Security saves is just spent elsewhere in the Federal budget.

With the non-Social Security budget balanced, we should drop the unified budget concept of the last several decades and return to a budget presentation that treats Social Security financing entirely separately. The combination of balancing the non-Social Security budget and completely separate financing for Social Security would make it clear that partial advance funding of Social Security is adding to national savings. With Social Security trust funds purchasing Treasury securities or investing the funds in other ways, more money would be available for individuals in the private sector to invest in plant and equipment. In other words, surpluses in Social Security would clearly be leading to real savings and investment. States separate their financing of retirement systems from the rest of their budgets and the Federal government should do this, too.

Building up such a reserve in Social Security would not only be good for the economy but also for the program. Although advance funding would require workers to pay more than under a pay-as-you-go system at first, they would pay less for any given level of benefits later on. Partial advance funding would prevent very high pay-as-you-go rates down the road or, alternatively, very large benefit cuts.

The separation of Social Security from the non-social Security budget may need to be reached gradually over a period of five-years or so to avoid the dislocations from a sharp deviation from past practice, but it would be important to reach the goal by the time sizeable non-Social Security surpluses begin to appear, now estimated to be 2006.

The other condition necessary to avoid the appeal of a "painless" solution is to have an acceptable solution that keeps the pain to a minimum. There are several that could be considered but I think the best one is the one I have put forward as Social Security Plus (revised December 15, 1998).

THE WHITE HOUSE

WASHINGTON

MEETING ON SOCIAL SECURITY OPENING BID

December 22, 1998

The Cabinet Room; 2:30pm

AGENDA

I. CRITERIA FOR DECISION

II. REVIEW OF THREE OPTIONS

Option #1: Maintain Strong Social Security Benefit by Transferring 50 Percent of Surplus to Social Security Trust Fund and Investing the Trust Fund in Equities, establish individual accounts, extend Medicare solvency, and fund other priorities.

Option #2: Allocate 67 Percent of the Surplus for Social Security While Leaving Open the Allocation Between Collective Investment and Individual Accounts, extend Medicare solvency, and fund other priorities.

Option #3: Take Social Security Off Budget, invest trust fund in equities, and make transfers from on-budget surplus to Social Security trust fund.

CRITERIA FOR DECISION

1. Will it help maintain support of Democrats?

2. Will it reach out a hand to Republicans and show them that you are serious about bipartisanship?

3. Will the public see you as showing bipartisan leadership?

4. Will the elite media and Concord Coalition types feel that the proposal demonstrates fiscal courage?

5. Will the proposal lead the process to get polarized, or will it help move things forward?

6. Considering where you would like to end up, does the proposal represent an opening bid that is likely to lead there?

OPTION #1: MAINTAIN STRONG SOCIAL SECURITY BENEFIT BY TRANSFERRING 50 PERCENT OF SURPLUS TO SOCIAL SECURITY AND INVESTING THE TRUST FUND IN EQUITIES

PART #1: INVEST 50 PERCENT OF SURPLUS TO MAINTAIN STRONG SOCIAL SECURITY BENEFIT

- Continue to use all 12.4 percent of the Social Security payroll tax to fund the traditional benefit.
- Transfer 50 percent of the unified budget surplus to Social Security and invest a portion of the Social Security trust fund in equities -- possibly enough to assure 100 percent of currently promised benefits.
- Call for a bipartisan effort to make additional tough choices on reforms. This could reduce the reliance on equity investments and the surplus, and free up resources that could be used to strengthen Medicare.

  -- *Progressivity*
    - Make change in widow allotment to reduce the poverty rate for widows. Possibly include other anti-poverty proposals such as an enhanced minimum benefit.

  -- *Corporate Governance*
    - Independent board hires private investment managers: none of them would control more than 1-2 percent of the stock market.
    - Investments in passive index funds commingled with investments of private individuals.
    - Two-thirds rule with both Houses to affect investment choices.
    - Diffuse voting rights by keeping the amounts with any one manager small.
    - Ask for bipartisan process to ensure independence and non politicization.
    - Open to all ideas.

PART #2: INVEST 17.5 PERCENT OF SURPLUS FOR FAIR AND SAFE SOCIAL SECURITY ACCOUNTS (POSSIBLY TARGETED FOR LONG-TERM CARE)

- Set principles that any individual account must make Social Security more progressive and fair.
- Start with \$200-\$300 individual accounts for 25 years with some voluntary individual/employer match. Provide additional incentives for poorer Americans.
- Ensure safe accounts that have TSP structure with three choices, and a guarantee of a minimum real return.

  -- *New Idea*: Possibly allow two uses: retirement or long-term care costs.

PART #3: INVEST 17.5 PERCENT OF SURPLUS TO EXTEND MEDICARE TO 2020

PART # 4: RESERVE 15 PERCENT OF SURPLUS FOR MILITARY READINESS AND PRESSING NATIONAL DOMESTIC PRIORITIES

- Detailed blue print for Military Readiness over the next 6 years
- Set aside block for Education and Research

VARIATION: GIVE ADDITIONAL DETAILS TO ASSURE 100 PERCENT OF BENEFITS

Proposal: You could put forth a specific proposal showing that 100 percent of currently promised benefits can be provided by investing 50 percent of the trust fund in equities and transferring roughly 50 percent of projected future surpluses to the Social Security trust fund. The proposal might also include some small traditional reforms such as covering state and local new hires or raising the maximum level of earnings subject to taxation so as to hold constant the percentage of all earnings that are subject to taxation.

Advantages:

- Will reassure Democratic base that the full Social Security benefit can be protected, and reduce criticism for lack of specifics.

Disadvantages:

- By disclosing specifics of trust fund investments, this option will open us up to attacks over the share of the stock market owned by the government. Critics could credibly argue that the trust fund would own between 13 and 20 percent of the stock market.

Maintaining Support of Democrats

- Could hold core Democrats and progressive interest groups by meeting test of not cutting benefits to fund individual accounts. Assures them that we oppose plans that carve out revenue from existing payroll tax to fund individual accounts.

- Democrats may still be nervous that the proposal opens the door to individual accounts without creating certainty that traditional Social Security benefits will be sufficiently protected.

Reaching Out to Republicans

- Establishes good faith and brings some Republicans to the table by proposing individual accounts in our opening bid.

- Ruling out carve outs will alienate some Republicans who favor that approach.

- Because the plan relies on collective investing, it may lead to major attacks over government ownership.

- Existence of individual accounts may blur the attack on government ownership in the market.

Public Display of Bipartisan Leadership

- Public may initially judge the plan as a reasonable middle approach that reaches out to all sides, both preserving a strong traditional Social Security benefit and encouraging private wealth accumulation.

- Asking both sides to focus on savings for long term retirement needs and to forego short term spending and tax cut desires will be seen as responsible, especially when combined with the specific commitment to addressing the Medicare problem.

Elite Media/ Concord Coalition

- Will receive credit for allocating 85 percent of surpluses to long term fiscal challenges, and making more difficult the impulse for irresponsible tax cuts.

- Will receive credit for the surprise announcement that we are tackling Medicare.

- Will be criticized for not making tough choices on the benefit cuts and tax increases necessary to reduce national spending on elderly entitlements. However, if we open the door to traditional revenue options, this critique may be somewhat muted.

- May face some criticism for transferring Social Security surpluses to the trust fund a second time.

- May receive severe criticism for allocating surpluses for many years into the future (although Gramm and Dominici are doing the same thing).

Will Opening Bid Avoid Polarization and Lead to an Acceptable Final Result?

- Proposal includes strong public statement of bipartisanship, and an attempt to include what matters most to both sides. Thus, it could make even dissatisfied players want to come to the table and participate in the process.

- While the proposal includes the benefits of both collective investment and individual accounts, the proposals could produce the worst of both worlds -- attacks on both individual accounts and on collective investing.

OPTION #2: USE 67 PERCENT OF THE SURPLUS FOR SOCIAL SECURITY WHILE LEAVING OPEN THE ALLOCATION BETWEEN COLLECTIVE INVESTMENT AND INDIVIDUAL ACCOUNTS

PART #1: USE 67 PERCENT OF THE SURPLUS TO STRENGTHEN SOCIAL SECURITY WHILE LEAVING OPEN THE ALLOCATION BETWEEN COLLECTIVE INVESTMENT AND INDIVIDUAL ACCOUNTS.

- Sets aside sufficient funds to save Social Security.
- Explain that the main debate is over whether prefunding and higher returns should occur through individual accounts or through an independent government board contracting with private investment companies on behalf of the trust fund.
- Call for a bipartisan process to reach consensus on this and other remaining issues.

PART #2: ANNOUNCE THAT THE ENTIRE 12.4 PERCENT PAYROLL TAX SHOULD CONTINUE TO BE USED TO FUND THE TRADITIONAL SOCIAL SECURITY BENEFIT AND THAT A SUBSTANTIAL PORTION OF THE PREFUNDING SHOULD BE USED TO STRENGTHEN THE TRADITIONAL SOCIAL SECURITY BENEFIT.

- The 12.4 ensures only 72 percent of benefits in 2032 and 66 percent in 2072. There are different mechanisms for getting additional resources for the traditional benefit, including trust fund investments in equities, traditional revenue sources, and integrative plans. This proposal would insist that a mechanism be found to get additional resources into the traditional benefit.

PART #3: ANNOUNCE ADDITIONAL PRINCIPLES FOR COLLECTIVE INVESTMENT

- Independent board hires private investment managers: none of them would control more than 1-2 percent of the stock market.
- Investments in passive index funds commingled with investments of private individuals.
- Diffuse voting rights by keeping the amounts with any one manager small.
- Ask for bipartisan process to ensure independence and non politicization.

PART #4: ADDITIONAL PRINCIPLES FOR INDIVIDUAL ACCOUNTS

- Any individual account must have a guarantee that no matter what happens, people have a basic guaranteed benefit -- equivalent to current law benefits.
- Individual accounts must make the system more progressive for those who rely on Social Security the most -- older women, the disabled, low wage workers.
- An individual account plan must keep administrative costs as low as possible.

PART #5: ANY REFORM PLAN MUST COMBAT POVERTY AMONG THE ELDERLY, PARTICULARLY AMONG WIDOWS.

- Plans must include increased survivor benefits, or other anti-poverty measures.

PART #6: INVEST 17.5 PERCENT OF SURPLUS TO EXTEND MEDICARE TO 2020

PART # 7: RESERVE 15 PERCENT OF SURPLUS FOR MILITARY READINESS AND PRESSING DOMESTIC PRIORITIES

PART # 8: OFFER TO PARTICIPATE IN BIPARTISAN PROCESS TO ACHIEVE SAVINGS FROM SOCIAL SECURITY IN ORDER TO MAKE MORE RESOURCES AVAILABLE FOR MEDICARE

intaining Support of Democrats

- Some Democrats may feel that the door to individual accounts has been opened without a clear formula for protecting the traditional Social Security benefit.

- Allocating 12.4 and more to preserve the traditional benefit may reassure Democrats that we will accept individual accounts only if they are on top of the existing system.

Reaching Out to Republicans

- Proposal brings Republicans to table by opening door to individual accounts and by not committing to collective investment.

- Strong conditions on individual accounts and lack of specifics may leave some Republicans wary that we are avoiding "going first" and unsure of whether we really want to get a deal done.

- By ruling out carve out proposals, we alienate Republicans who favor such an approach.

Public Display of Bipartisan Leadership

- Wins points for clear statement of current consensus and determination to resolve remaining disagreements in a bipartisan process.

- Lack of specifics and tough choices may be seen as failure in leadership.

Elite Media/ Concord Coalition

- May face criticism for lack of specifics.

- Will receive credit for allocating 85 percent of surpluses to long term fiscal challenges, and particularly for the surprise announcement that we are tackling Medicare.

- Will be criticized for not making tough choices on benefit cuts and tax increases. However, because we are opening door on traditional revenue options and to the possibility of a bipartisan agreement to reduce the share of GDP spent on entitlements for the elderly, this critique may be somewhat muted.

- May receive severe criticism for allocating surpluses for many years into the future (although Gramm and Dominici are doing the same thing.)

- Possibility of getting some credit for avoiding irresponsible tax cuts.

Will Opening Bid Avoid Polarization and Lead to an Acceptable Final Result?

- By not laying out a specific plan and by leaving open the decision about collective investment versus individual accounts, we avoid attacks and maintain maximum flexibility to work with all sides.

VARIATION: ANNOUNCE DATE THAT YOU WILL UNVEIL A COMPLETE PLAN

Proposal:

For either of the two options above, you could give fewer details in the State of the Union, and instead:

1. Call for everyone to focus on saving the surplus to meet future retirement needs.
2. Make a strong call for bipartisanship and for hard work over the next 4 to 6 weeks to put together a plan.
3. Announce basic principles on progressivity, corporate governance, and on dealing with Medicare.
4. Announce that after a few weeks of consultation, you will put forth a plan by a specified date (February 25 or March 10 for example).

Advantages:

- This option may solve our time trap. At the moment there is pressure for immediate leadership, and for you to put out a plan. Yet Democrats are not sufficiently engaged in the issue to know what options are acceptable to them. By giving them more time, and forcing them to reach a consensus in the period immediately following the State of the Union, we will encourage them to confront the difficulties in plans that they may currently think that they favor, give them the opportunity to move toward the center, and give us the opportunity to obtain more information about where they really stand.

- Shows leadership while still giving Democrats significant time to get up to speed and to work with you on specific proposals.

Disadvantages:

- Locks you into going first at a specific time without knowing what the future political environment will look like.

- While it may make some people work hard to engage in the process and advise you, it may encourage others to sit back and wait to see what you come up with.

VOLUNTARY INDIVIDUAL ACCOUNTS

There are different ways to have a voluntary individual accounts plan or a component of an individual account plan that is voluntary. For example:

- We could provide a tax-favored investment option with incentives for low-income people to contribute, such as a government match (similar to an IDA).

- The government could make an annual $100 contribution to every worker's account, and then give individuals the option to make additional contributions on their own.

- Budget surpluses could be used to get the accounts started with 10 years of contributions, with the notion that it would be up to individuals to make their own contributions thereafter.

THESE OPTIONS CAN BE APPLIED TO ALL OF THE PLANS

OPTION # 3: PHASE IN TAKING SOCIAL SECURITY OFF BUDGET

PART #1: CREATE A NEW "REAL" SOCIAL SECURITY REFORM BUDGET

- Announce that we are taking Social Security off budget over the next 10 years, and that every dollar of the $1.7 trillion dollars in Social Security surpluses will be invested in real assets in a new trust fund.
- Phase in would allow us to maintain balanced budget, and to come up with additional funding for defense and discretionary priorities.
- Would not need to describe the phase-in to Social Security being off budget as replacing a "sham" trust fund. Instead, we could say that the fiscally responsible President is moving on to tackle an even more ambitious goal.

PART #2: INVEST TRUST FUND IN EQUITIES

- Announce that the new Social Security trust fund would be partially invested in equities.

--Corporate Governance

- Independent board hires private investment managers: none of them would control more than 1-2 percent of the stock market.
- Investments in passive index funds commingled with investments of private individuals.
- Two-thirds rule with both Houses to affect investment choices.
- Diffuse voting rights by keeping the amounts with any one manager small.
- Ask for bipartisan process to ensure independence and non politicization.
- Open to all ideas.

PART #3: TWO OFF BUDGET VARIATIONS

Option A: Make generous use of surplus to maintain full benefits. Transfer nearly all of the on-budget surplus for as long as it lasts in order to preserve full benefits without relying on traditional revenue increases or benefit changes.

Option B: Combine traditional reforms with surplus transfers and equity investments to achieve 75-year actuarial balance. Close one-third of the solvency gap with equity investments (invest 35 percent of the trust fund), one-third with transfers from the on-budget surplus (transfer an amount equal to about 1 percent of payroll), and one-third with traditional reforms. Even without the traditional reforms, this proposal moves the trust fund exhaustion date to 2050 (from the current 2032).

ALTERNATIVE OFF-BUDGET APPROACH: LEAVE OPEN THE FORM OF INVESTMENT
Take Social Security off budget and announce principles but not a complete plan. • Announce that Social Security should be taken off budget over the next ten years. • Leave open the allocation between collective investment and individual accounts. • Give principles for accomplishing the rest of Social Security reform similar to those in option 2. For example, the full 12.4 percent payroll tax must continue to fund the traditional benefit, collective investment must be accomplished by contracting with private managers, and individual accounts must be progressive.

Maintaining Support of Democrats

- By creating a "real" trust fund with marketable securities rather than IOUs, we strengthen the credibility of Social Security within the context of the traditional program.

- Proposal provides big Democratic victory since the plan virtually shuts down the possibility of unpaid-for tax cuts for at least the next 7 years.

- In combination with the President's principle that the full 12.4 must go to the traditional benefit, makes it unlikely that individual accounts will be a major part of the plan. However, absence of add-on individual account options may displease some Democrats, and by removing add-on option, the proposal may make a carve-out plan more likely.

- May limit resources available for other Democratic priorities. Even if a phase in that allows for defense spending and NDD priorities can be accomplished, such a plan leaves little room for Medicare spending, or other priorities that might arise before 2008

Reaching Out to Republicans

- Key Republicans including Archer have argued that Social Security should be off budget. Some Republicans think this proposal will help them meet their goal of shrinking government.

- Republicans may support a phase in so as to allow for defense spending.

- With Social Security off budget, the system will appear more independent. This may reduce concerns about trust fund investment in private securities.

- Republicans might respond to the phase-in proposal by trying to take Social Security off budget immediately. This has the following potential political downsides:

  -- The President would no longer be seen as having balanced the budget.

  -- Previous statements about fiscal accomplishments may now appear to have been deceptive.

- Republicans might respond to phase-in proposal by trying to take Social Security off budget immediately. This has the following potential **policy** downsides:

  -- Perceptions of deficits instead of surpluses could fuel new pressure to achieve immediate balance by cutting discretionary spending and shrinking the role of government.

- Draws significant attention to the current practice of using Social Security surpluses to finance general spending at a time when we are likely to be proposing additional spending on defense and domestic priorities. Republicans may criticize us for using the phase in in order to accomplish new spending.

- The difficulty of funding individual accounts in an off-budget world may dampen Republican enthusiasm for reform. While it would be possible to wait to start individual accounts until after there are large on-budget surpluses (perhaps 2008), this delay would reduce the appeal of the proposal, and would make it hard to design a package in which the build up of individual account assets matches the phase-in of benefit cuts.

Public Display of Bipartisan Leadership

- Appeals to people who are concerned that the current trust fund is not real. Off-budget proposal has enthusiastic supporters on both sides of the aisle.

Elite Media/ Concord Coalition

- Attitude of elite media will depend on the degree to which the proposal relies on traditional reform options rather than on surplus transfers and higher returns.

- Plan is immune to arguments about double counting.

- Easier to argue that tough choices on Social Security benefits and revenues are helping solvency, rather than simply increasing the general budget surplus and the likelihood of tax cuts.

- Does not leave much cushion in case of an economic downturn. Risks return of significant deficits.

Will Opening Bid Avoid Polarization and Lead to an Acceptable Final Result?

- Because the proposal will be seen as having bipartisan support on both sides, it could generate momentum for bipartisan reform.

- Tighter resources, at least in early years, could make it hard to provide wins for both sides.

- If Republicans think the proposal has ruled out individual account and tax cuts, they may decide not to participate in the process unless we are willing to consider a carveout.

- If Democrats decide that this approach will create new pressure for cuts in education and health care, this proposal could also lose their support.

December 22, 1998

TO: Gene Sperling
FROM: Jeff Liebman
SUBJECT: Three new plans devised by Ken Apfel

Ken wants you to see these three new plans. They have a fair amount of pain and only a moderate amount of equity investment and surplus transfers.

SSA Props: Unified Budget Transfers Needed for OASDI Solvency

Basic Provisions:	Change in Actuarial Balance
Raise NRA from 67 to 68 for age 62 in 2034-39 (after addl 11-yr hiatus).	0.17
Raise taxable maximum to tax 90 percent of covered earnings by 2021.	0.49
Increase benefit computation period to 36 in 2006, 37 in 2010, 38 in 2014.	0.19
Cover all State and local govt employees hired in 2011 and later.	0.18
Pay aged surviving spouse beneficiaries 75 percent of couple benefit, if higher, but limit this option to the amount payable to survivor as a retired worker if had PIA equal to average retired worker PIA in year of surv eligibility. Phase in by 2040.	-0.12
Specify the COLA as change in CPI less 0.2% starting December 1999.	0.31
Total for Basic Provisions	1.16

Plan A Achieve OASDI Actuarial Balance with Redeem for stock, transfer on-budget surp, benefit cut

a) Basic provisions (above)	1.16
b)Redeem OASDI special issue securities at an amount equal to 1 percent of taxable payroll for the purchase of stock beginning 1999 so that the percent of the TF invested in stock never exceeds ***35%***.	0.72
c)For years 2002 through 2013, transfer up to 1 percent of payroll from the GF to the TF (limited to size of on-budget surplus projected under FY99MSR D@CPI+POP) Where on-budget surplus is less than 1 percent of payroll, redeem (b).	0.20
d)Gradually reduce the PIA benefit factors by ***3.5*** percent (phase in 2001-2040). Reduction does not apply to disabled (DI) and young survivor benefits.	0.12
Change in OASDI actaurial balance for a), b), c), and d)	2.19

OASDI trust fund ratio at end of 2072 is 103 percent and is declining by 20 percent per year.

Plan B Achieve OASDI Actuarial Balance with Redeem for stock, transfer on-budget surp, benefit cut

a) Basic provisions (above)	1.16
b)Redeem OASDI special issue securities begin 1999 at an amount equal to 1 percent of payroll for stock, limiting stock holdings to ***25%*** of Trust Fund Assets.	0.52
c)For years 2002 through 2013, transfer up to 1 percent of payroll from the GF to the TF as in Plan B above.	0.20
d)Gradually reduce the PIA benefit factors by ***9.0*** percent (phase in 2001-2040).	0.31
Change in OASDI actaurial balance for a), b), c), and d)	2.19

OASDI trust fund ratio at end of 2072 is 99 percent and is declining by 17 percent per year.

Plan C Achieve OASDI Actuarial Balance with Redeem for stock, Benefit Cut

a) Basic provisions (above)	1.16
b)Redeem OASDI special issue securities at an amount equal to 1 percent of taxable payroll for the purchase of stock beginning 1999 so that the percent of the TF invested in stock never exceeds 25%.	0.52
d)Gradually reduce the PIA benefit factors by ***14.6*** percent (phase in 2001-2040). Reduction does not apply to disabled (DI) and young survivor benefits.	0.52
Change in OASDI actaurial balance for a), b), and d)	2.19

OASDI trust fund ratio at end of 2072 is 100 percent and is declining by 13 percent per year.

NOTES:
Transfers to Trust Funds as percent of payroll are limited to On-Budget Surplus (OMB FY99 MSR D@CPI+POP)
Transfers are used to purchase **stock** up to a prescribed limit, and then are used to purchase special bonds
All UB surplus under MSR assumptions that is not transferred is assumed to be spent.

OCACT/SSA 12/22/98

SSA Props: Unified Budget Transfers Needed for OASDI Solvency

Estimated Trust Fund assets held in the form of stock with the market aggregate value at $9.3 Trillion at the beginning of 1998, with growth at either the rate of growth in GDP or the expected total yield on stock (3.84% equity premium over LT US Bond)

Trust fund Assets Held in Stock at beginning of Year (BOY)

	Plan A	Plan B	Plan C
	(billions of current dollars)		
2000	38	38	38
2010	865	746	663
2020	2,581	1,743	1,467
2030	4,337	2,817	2,312
2040	6,188	3,837	3,000
2050	8,842	5,347	4,146
2060	11,094	6,692	5,355
2070	9,305	5,818	5,131

Trust Fund Stock BOY as % of Market (Market grows with GDP)

	Plan A	Plan B	Plan C
2000	0.4	0.4	0.4
2010	5.2	4.5	4.0
2020	9.7	6.5	5.5
2030	***10.3***	***6.7***	***5.5***
2040	9.1	5.6	4.4
2050	8.2	4.9	3.8
2060	6.5	3.9	3.1
2070	3.4	2.1	1.9

Trust Fund Stock BOY as % of Market (Market Grows at GDP+1.6%)

	Plan A	Plan B	Plan C
2000	0.4	0.4	0.4
2010	4.3	3.7	3.3
2020	***6.8***	***4.6***	***3.9***
2030	6.2	4.0	3.3
2040	4.7	2.9	2.3
2050	3.6	2.2	1.7
2060	2.4	1.5	1.2
2070	1.1	0.7	0.6

OCACT/SSA 12/22/98

MEETING ON SOCIAL SECURITY
JANUARY 4, 1999

I. Criteria for decisions
II. How new budget projections change the on-budget/off-budget calculus

III. On-budget option
IV. Off-budget option

CRITERIA FOR DECISIONS

1. Will it help maintain support of Democrats?

2. Will it reach out a hand to Republicans and show them that we are serious about bipartisanship?

3. Will the public see the President as showing bipartisan leadership?

4. Will the elite media and Concord Coalition types feel that the proposal demonstrates fiscal courage?

5. Will the proposal lead the process to get polarized, or will it help move things forward?

6. Considering where we would like to end up, does the proposal represent an opening bid that is likely to lead there?

HOW THE NEW BUDGET PROJECTIONS CHANGE THE ON-BUDGET/OFF-BUDGET CALCULUS

	MSR Projections			New Baseline Projections (12/28/98)		
	On-budget	Off-budget	Unified Budget	On-budget	Off-budget	Unified Budget
1998	-63	102	39	-29	99	70
1999	-64	113	49	-25	118	94
2000	-65	123	58	2	128	130
2001	-48	131	83	10	134	144
2002	7	141	148	55	143	198
2003	4	152	156	42	152	194
2004	23	159	182	59	157	216
2005	39	176	215	72	172	244
2006	61	184	245	95	179	274
2007	101	196	297	133	190	323
2008	138	205	343	166	198	364

Ways in which the new projections make taking Social Security off budget more appealing

- **Under the new numbers, it is possible to take Social Security off-budget and still have a balanced budget in FY2000 (assuming no new spending).**

- **New Numbers May Create a Stampede in favor of taking Social Security Off-budget.** *If CBO projections are similar to OMB projections*, the numbers could lead to overwhelming support for taking Social Security off budget.

    -- If there is going to be a stampede in that direction, we might want to get in front of it, and take credit for it.

    -- Democrats who simply want to define Social Security as an issue for the 2000 elections may lead the stampede in order to rule out the possibility of a major Republican tax cut or of individual accounts.

- **New Numbers May Create Pressure to Use the On-budget Surplus for Tax Cuts.** Republicans are likely to propose using $68 billion of the surplus for defense and the remaining $100 billion for a tax cut

    -- We could seek to block a tax cut by arguing that Medicare deserves any additional funds that are available. However, this case is weakened by the fact that we will be spending two-thirds to three-fourths of the surplus on NDD and defense.

Downsides of taking Social Security off budget

- **<u>A phase-in is still needed to meet NDD and defense objectives, but may be more difficult politically since the spending will take us from an on-budget surplus to an on-budget deficit in the first few years.</u>**

- **<u>New NDD spending will be a large share of the on-budget surpluses</u>**. Under the on-budget plan, only 7 percent of the unified budget surpluses are dedicated to NDD spending, and this is exceeded by the 17.5 percent allocated to tax cuts in the form of universal pension contributions. With Social Security taken off-budget, nearly half of the surpluses will be used for NDD spending and there will be no tax cuts to provide Republicans with a win.

- **<u>Will be difficult to extend Medicare solvency through 2020.</u>** It would probably eliminate our chance to do something major for Medicare in the near term.

- **<u>Difficult to fund universal pensions.</u>** Reduces chance of an add-on pension that could be critical for achieving bipartisan reform. Without sufficient funds for an add-on in the short-term, we would either need to invest all 12.4 collectively (unacceptable to Republicans), do a carve out plan (unacceptable to Democrats), or wait until 2007 or so to start the universal pensions (politically unattractive).

OPTION #1: MAINTAIN STRONG SOCIAL SECURITY BENEFIT BY TRANSFERRING SOME OF THE SURPLUS TO SOCIAL SECURITY AND INVESTING IN PRIVATE SECURITIES

PART #1: STRENGTHEN SOCIAL SECURITY

USE 50 PERCENT OF THE UB SURPLUS FOR 15 YEARS TO STRENGTHEN SOCIAL SECURITY

- Transfer 50 percent of the UB surplus for the next 15 years to the Social Security trust fund. (Alternatively, we could transfer a smaller amount of general revenue for a longer period of time).
    - Could also announce principle that the entire 12.4 percent payroll tax should continue to be used to fund the traditional social security benefit
- Key question: do we explicitly call for trust fund investment in equities or do we call for a bipartisan process to resolve the best way to do the investment?
    - Could announce principles to protect collective investments from political interference.
- Key question: When we call for a bipartisan process to achieve reform, do we explicitly sayu that we need tough choices on traditional reform options to close the gap?

ANNOUNCE PROPOSALS TO REDUCE ELDERLY POVERTY

- Establish new widow benefit that provides the maximum of the current benefit or 75 percent of the benefit the married couple received with both spouses were alive. This new benefit would be capped at the PIA for the average worker. Would reduce widow poverty from 18 percent to 14 percent (tentative numbers).
- Could be more general and simply promise to release specific proposals later.

PART #2: INVEST 17.5 PERCENT OF SURPLUS TO ESTABLISH UNIVERSAL PENSIONS (TO PROVIDE RETIREMENT INCOME AND FUND LONG TERM CARE EXPENSES)

- See options at end of document.

PART #3: INVEST 17.5 PERCENT OF SURPLUS TO EXTEND MEDICARE TO 2020

- Any additional savings achieved with traditional reforms should also be used to strengthen Medicare.

PART #4: RESERVE 15 PERCENT OF SURPLUS FOR MILITARY READINESS AND PRESSING NATIONAL DOMESTIC PRIORITIES

- Detailed blue print for Military Readiness over the next 6 years
- Set aside block for Education and Research

How off budget issue would be handled

- **Continue to stress unified budget**. We would continue to argue that the unified budget is the relevant concept for budgeting, and we would defend this concept by pointing out that it has been used by every administration in the last 30 years and that it is the relevant concept for macroeconomic policy.

- **Our NDD spending is less than the on budget surpluses.** Even if you took Social Security off budget, it would be possible to fund our NDD spending out of the on-budget surpluses. Our NDD spending is just 7 percent of the unified budget surpluses.

- **100 percent of the Social Security surpluses are being allocated to retirement needs.** We are using the Social Security surpluses to strengthen Social Security and Medicare and to fund universal pensions.

- **Will face challenge preventing a tax cut.** Republicans are likely to propose spending 50 billion on defense and the remaining 118 billion on a tax cut. We will need to argue that remaining surpluses are needed for Medicare.

How Much Should We Rely on Projected Future Surpluses and Equity Investments?

With 50 percent of the trust fund in equities:

- Using 50 percent of surplus as long as it lasts achieves solvency beyond 2072.
  -- Trust fund would own between 13 and 19 percent of stock market.
- Using 50 percent of the surplus for 15 years achieves solvency through 2068.
  -- Trust fund would own between 12 and 18 percent of stock market.
- Transferring a smaller amount (0.8 percent of payroll) forever (even after surpluses end) achieves solvency through 20yy.
  -- Trust fund would own z percent of stock market.

With 35 percent of the trust fund in equities:

- Using 50 percent of surplus as long as it lasts achieves solvency through 2062.
  -- Trust fund would own between 12 and 18 percent of stock market.
- Using 50 percent of the surplus for 15 years achieves solvency through 2057.
  -- Trust fund would own between 8 and 12 percent of stock market.
- Transferring a smaller amount (0.8 percent of payroll) forever (even after surpluses end) achieves solvency through 20yy.
  -- Trust fund would own x percent of stock market.

OPTION # 2: TAKE SOCIAL SECURITY OFF BUDGET AND CREATE A NEW "REAL" TRUST FUND

PART #1: STRENGTHEN SOCIAL SECURITY

TAKE SOCIAL SECURITY OFF BUDGET

- Announce that we are taking Social Security off budget immediately -- no longer will Social Security surpluses mask on-budget deficits.

MAKE TRANSFERS FROM GENERAL REVENUES TO SOCIAL SECURITY TRUST FUND

- Any on-budget surpluses remaining after discretionary needs are met in the first five years and an amount equal to 1 percent of payroll in later years (or some similar amount) would be transferred to the Social Security trust fund.

- **Key question**: Do we explicitly call for trust fund investment in equities or do we call for a bipartisan process to resolve the best way to do the investment?

    - Since on budget surpluses will not be sufficient to fund individual accounts for a number of years, we may want to propose trust fund investments in order to prevent a carve out.

- **Key question**: Do we call for a bipartisan process to make additional tough choices on reforms or do we propose sufficient on budget transfers and equity investment to achieve solvency even without additional reforms?

ANNOUNCE PROPOSALS TO REDUCE ELDERLY POVERTY

- Establish new widow benefit that provides the maximum of the current benefit or 75 percent of the benefit the married couple received with both spouses were alive. This new benefit would be capped at the PIA for a worker with average earnings. Would reduce widow poverty from 18 percent to 14 percent (tentative numbers).
- Could be more general and simply promise to release specific proposals later.

PART #2: USE ON-BUDGET SURPLUS FOR CRITICAL DISCRETIONARY NEEDS AND TO STRENGTHEN MEDICARE

- Over first five years, nearly all of the surplus would be needed for Military Readiness and Pressing National Domestic Priorities.
- Any remaining surpluses after discretionary needs are met and after the general fund transfers to Social Security would be reserved for Medicare.

VARIATION: ANNOUNCE TIME TABLE FOR RELEASING ADDITIONAL DETAILS OR COMPLETE PLAN

Proposal:

For either of the two options above, the President could give fewer details in the State of the Union, and instead:

1. Call for everyone to focus on saving the surplus to meet future retirement needs.
2. Make a strong call for bipartisanship and for hard work over the next 4 to 6 weeks to put together a plan.
3. Announce basic principles on progressivity, corporate governance, and on dealing with Medicare.
4. Announce that after a few weeks of consultation, we will put forth a plan by a specified date (February 25 or March 10 for example).

Advantages:

- This option may solve our time trap. At the moment there is pressure for immediate leadership, and for us to put out a plan. Yet Democrats are not sufficiently engaged in the issue to know what options are acceptable to them. By giving them more time, and forcing them to reach a consensus in the period immediately following the State of the Union, we will encourage them to confront the difficulties in plans that they may currently think that they favor, give them the opportunity to move toward the center, and give us the opportunity to obtain more information about where they really stand.

- Shows leadership while still giving Democrats significant time to get up to speed and to work with us on specific proposals.

Disadvantages:

- Locks us into going first at a specific time without knowing what the future political environment will look like.

- While it may make some people work hard to engage in the process, it may encourage others to sit back and wait to see what we come up with.

DIFFERENT APPROACHES TO UNIVERSAL PENSIONS

Option # 1: One-time government contribution plus progressive subsidy.

- Make one-time contribution (perhaps $500) to give every American a retirement individual account (perhaps exclude people who already have IRAs).
- Match the contributions of low and moderate income taxpayers using a refundable tax credit. Match rate could start at 200 percent and then fall to 40 percent (40 percent is essentially the subsidy taxpayers in the 28 percent bracket receive from existing IRAs) as a taxpayer's AGI rises. Workers would have to have at least $5000 of annual earnings to qualify (so as to exclude students and pensioners) and there would be age restrictions on who could contribute to the accounts (21 to 64?).
- A worker's total contribution to traditional IRAs and the new individual account would be capped at $2000.
- Would provide default TSP account option, but permit accounts to be invested with any approved investment manager.

Advantages

- Every American will have an account with regular statements eliminating the obstacle to savings caused by the need to find a provider and learn how to set up an account.
- Most of the money is allocated to subsidies that benefit only those who engage in the desired behavior -- saving.

Disadvantages

- If people do not take advantage of the match, there will be lots of small accounts. The lowest income people may be the least likely to take advantage of the subsidies.
- If matches are too generous, people whose employers match 401k contributions may instead contribute to the new individual account system. Government subsidies would replace employer subsidies and little new saving might result.

Option # 2: Make flat contributions to individual accounts for 15 years to get them started.

- Give $250 a year to every American each year for the next 15 years to get accounts started. Thereafter, workers would be on their own.
- Could continue to give $250 for 15 years to every new cohort (for example 20 to 34 year olds).

Advantages

- Gets moderate sized accounts started for every American.

Disadvantages

- Contributions are independent of saving behavior and could even encourage additional consumption.

Option # 3: Kid-save style accounts.

- Make flat contributions to individual accounts for children ages 0-16, so that they have a $10,000 account and experience with investments when they enter the work force.

Advantages

- Every American would have a moderate sized account when they entered the work force. After observing the value of compounding, they might develop the habit of saving.

Disadvantage

- Educational value might be greater after people have entered the work force.