May 13, 1999

MEMORANDUM TO: GENE SPERLING
LARRY SUMMERS

CC: DAVID WILCOX

FROM: JON GRUBER
PETER ORSZAG

SUBJECT: Earnings test

We understand from news reports that following your meeting with Ways and Means Democrats today, a bill will be drafted implementing the President's Social Security reform proposals. Since that proposal includes elimination of the earnings test in some form, we wanted to highlight the conclusions that we have reached after studying the issue.[1]

Our main conclusion is that the earnings test should be eliminated at and above the full benefit age. But eliminating the earnings test for those below the full benefit age would be unwise because (1) it could increase widow poverty, (2) it is not obviously politically necessary, (3) it involves additional short-run budgetary costs, and (4) there is no evidence that it will produce a significant increase in labor supply.

Increased widow poverty

- Eliminating the earnings test below the full benefit age could result in *increased* widow poverty. It would thus pose additional challenges for ensuring that the overall Social Security reform package reduces such poverty.

- The earnings test results in higher Social Security benefits for survivors and thus provides some protection against poverty among widows. The earnings test results in such widow protection in two ways:

  -- Directly, through the subsequent benefit increase for working beneficiaries who have their benefits reduced under the earnings test; and

  -- Indirectly, through the effect of the earnings test on delaying when beneficiaries claim initial benefits.

- The indirect effect is likely to be more important. Many analysts believe that the earnings

[1] We have already sent you a longer paper that we wrote about the earnings test. The purpose of this memorandum is to provide a brief summary of our main conclusions.

test is an important reason why 40 percent of beneficiaries delay initial receipt beyond age 62. Elimination of the earnings test below the full benefit age could therefore induce increased early election of benefits. And increased early benefit election would reduce subsequent survivor benefits (in addition to annual retiree and spousal benefits), thus exacerbating widow poverty.[2]

- The effect of additional early claiming on widow poverty could be substantial: *average benefits for widows who have had their benefits reduced for early retirement are significantly <u>below</u> the poverty line, whereas average benefits for widows whose benefits are not reduced for early retirement are significantly <u>above</u> the poverty line.* More specifically:

  -- Among nondisabled widows and widowers aged 80 and over in 1996 with benefits reduced for early retirement, the mean annual benefit was $7,009, or $516 *below* the poverty line of $7,525 for a single elderly person.

  -- Among other beneficiaries (those whose deceased spouses did not claim early retired worker benefits, and who did not claim early survivor benefits themselves), the average benefit was $9,174,or $1,649 *above* the poverty line.

  Differences in Primary Insurance Amounts explain only about half of the mean difference across these groups. These figures are suggestive rather than conclusive, but we find them troubling nonetheless.

- In 1996, a significant portion of those who delayed receiving benefits until the full benefit age or thereafter had relatively low Primary Insurance Amounts.[3] If the removal of the earnings test below the full benefit age induced even a modest share of such retirees to elect benefits earlier, the adverse consequences in very old age (either for the workers, or their spouses, or both) could be significant. Again, further research is required on this important topic, but the potential magnitude of the effect is sufficiently large to warrant concern.

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[2] Beneficiaries could save enough of their early benefits to ensure that income in very old age remained constant. But we doubt that such saving is likely to occur: recent research strongly suggests that higher Social Security benefits will simply lead to higher consumption levels.

[3] For example, one-third of new retirees electing benefits at or after age 65 in 1996 had Primary Insurance Amounts below $650 per month, and a similar proportion had benefits below that level. Social Security Bulletin, *Annual Statistical Supplement 1997,* Table 6.B3, page 263, and Table 6.B4, page 264. Some of these beneficiaries are officials formerly employed by state and local governments or the Federal government who were not covered by Social Security for at least part of their careers and have other pension income for those years.

Politically unnecessary

- Complete elimination of the earnings test (above and below the full benefit age) may appear to have political advantages. But numerous proposals with broad bipartisan support on the Hill only eliminate the earnings test at the full benefit age, not below it. They thus provide bipartisan support for retaining the earnings test below the full benefit age, while removing it at and above the full benefit age. The bipartisan proposals include H.R.5, S. 279, and the National Commission on Retirement Policy plan.

Additional short-term costs

- While eliminating the earnings test has roughly zero long-term actuarial cost, it does have short-term costs. And eliminating the earnings test only at or above the full benefit age costs only about half as much in the short run -- about $15 billion less over 5 years -- as eliminating it both above and below the full benefit age.

Unclear labor supply effect below the full benefit age

- The traditional view of the labor supply effect of the earnings test was that it had little impact.

- A recent study for those above the full benefit age, however, has reached a somewhat different conclusion, suggesting that eliminating the earnings test at age 65 would produce a 5.3 percent increase in work activity among elderly beneficiaries aged 65 and over.[4]

- There is no similar evidence regarding the labor supply effect below the full benefit age. In other words, unlike the questions that the recent study raises about the traditional view of the labor supply effect above the full benefit age, we are not aware of any credible evidence suggesting that the labor supply effect for those below the full benefit age is significant.

Eliminating the earnings test at and above the full benefit age

Despite our arguments against removing the earnings test below the full benefit age, there is a much stronger case to be made for removing it at that age. (A brief appendix discusses whether it should be removed at the full benefit age, at age 65, or at age 67 -- which differ because of the scheduled increase in the full benefit age.)

- First, we have less concern about poverty among widows whose spouses waited until the

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[4] Leora Friedberg, "The Social Security Earnings Test and Labor Supply of Older Men," in James Poterba, ed., *Tax Policy and the Economy* (MIT Press: Cambridge, 1998).

full benefit age before claiming benefits, so there is less need for protection in this regard.

- Second, the actuarial adjustment that compensates individuals for the delayed benefits receipt that is embodied in the earnings test is less fair after age 65 than before.[5]

- Third, the new evidence on the labor supply disincentives of the earnings test does apply to those in this age range.

Other policy suggestions

We have three further suggestions for reform that could complement our major policy suggestion of removing the earnings test for those at or above the full benefit age, but not below it:

- **Education:** Concerns about keeping the earnings test in place for those age 62-64 could be alleviated by a campaign by the Social Security Administration to make older persons aware that the earnings test is not a tax. Even popular tax guides do not mention the subsequent benefit increase under the earnings test. A clear and concise mailing to all 61-year olds about how the earnings test really works, with simple examples, could substantially improve understanding of the system. Similarly, beneficiaries whose benefits are reduced because of the earnings test should be told how much their subsequent benefits will be increased as a result.

- **Spousal benefits:** Benefit reductions under the earnings test are pro-rated between the worker and the spouse. But spouses above the full benefit age do not have their subsequent benefits increased as a result. For a couple with a spouse past the full benefit age, this provision partially converts the earnings test from a forced savings program to a true lifetime tax.[6]

  One possibility is therefore to apply the benefit reduction under the earnings test exclusively to the worker's benefits, rather than pro-rating it between the worker's benefits and the spouse's benefits. That approach would obviate the need to adjust the spousal benefit subsequently, thus removing the quirk.

- **Medicare coverage and election of Social Security benefits:** When workers register for Medicare benefits at age 65, they are encouraged (but not required) to elect Social

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[5] Even after the delayed retirement credit reaches 8 percent in 2005, it will still not fully compensate those who are 68 or 69.

[6] It should be noted, however, that widow benefits *are* increased by the delayed retirement credit. Therefore, the spouse may receive a higher benefit as a survivor (but not as a spouse) because of the benefit reductions under the earnings test. In other words, she only receives the higher benefit after her spouse (the worker) dies.

Security benefits as well – even if they plan to continue working, in which case their benefits would be reduced through the earnings test until they reach age 70 – to ensure that they do not later forget to elect Social Security benefits. This practice should be ended. Indeed, if anything, 65-year olds should be presented with a table showing how much higher their Social Security benefits would be if they waited to elect initial benefits. Encouraging those 65-year olds working full-time to elect Social Security benefits – only to have those benefits eliminated through the earnings test -- only increases frustration with the perceived tax and exacerbates the administrative burden of operating the system. Changing the current practice will become even more important as the full benefit age increases above 65.

Conclusion

We hope you find these suggestions helpful in drafting your legislative language -- especially the concerns we have regarding elimination of the earnings test below the full benefit age. Please let us know if you would like another copy of the full paper, which we will be presenting at a conference in Washington on May 20.

Appendix: Elimination at the full benefit age versus elimination at age 65 or age 67

We concluded that the earnings test should be eliminated at and above the full benefit age, but not below it. Some analysts have expressed concerns about linking the age at which the earnings test no longer applies to the full benefit age:

- First, it would cause the earnings test to apply to older and older workers as the full benefit age increases from 65 to 67 under current law;

- Second, it could create a political disincentive to increasing the full benefit age further or faster, since it would impose a "tax" on those then falling below the full benefit age.

One twist on our proposed reform is therefore to eliminate the earnings test at either age 65 or age 67, so that the age at which the earnings test no longer applies is not linked to increases (currently scheduled or otherwise) in the full benefit age. While these proposals deserve careful scrutiny, our initial reaction is that either is inferior to elimination at the full benefit age itself:

- Since one of our primary concerns is the impact of the earnings test removal on early claiming and therefore on widow poverty, and since the actuarial reductions for early claiming are tied to the full benefit age, we believe that tying the earnings test removal to the full benefit age is more appropriate than simply eliminating it at age 65. Elimination at age 65, in other words, could encourage early claiming as the full benefit age rises above 65.

- We do not believe that it is politically feasible to remove the earnings test only at age 67 effective immediately. That view is shared by many sophisticated observers of Social Security reform, and is consistent with the fact that several legislative proposals eliminate the earnings test above the full benefit age – but none simply eliminate it at age 67.

Therefore, while we are open to alternative formulations, we believe that eliminating the earnings test at the full benefit age is the most auspicious approach.

The Future Way

New Ideas to create good Qualities in your life. In present time 350 wealthy have 45% from all monies on the earth, They created Deficit every where in all most the countries include the united Nations. The wealthy new system destroyed the middle class level, increasing Bribes, Corruptionon on the earth to stop justice from being served and whole the truth will be made known. The wealthy new system try to bring slavery oldest system back again in different ways.

I have simple ideas to create better life forever to all human being, the middle and upper middle class continue but the poor and wealthy levels end forever automatically peacefully.

My ideas are very good for any system:

A - Capitalist with full freedom with out cartel or gangs using the power of money to control the government and the population with natural resources.

B - Socialist with out bad control.

C - Independent people try to live with peace and justice following the general role of the human rights in the international communities to test the justice role in every single step in the responsibility or the rights.

In this way the better life on the earth become soon, **Easier**, **Smarter**, **Cheaper**, and in good **Qualities**, with out inflation or unemployment.

In my ideas Jobs and Educations Available to every single person on the earth at anytime and any where forever. Every one can know his rights and duties and enjoy Freedom in pure direct Democratic government system with out election.

Sincerely

Saleh Mohsen Hassan AL-Mhamad

P.O. Box 1282, Station B
Ottawa, Ontario
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The Future Way

Wealthy	Upper middle class	Middle class	Poor
The wealthy created an enormous deficit resulting in the collection of vast amounts of interest from the government, the middle classes and the poor using the power of money to steal by putting the law under the control.	The middle and upper middle class those who looking for better life and they did positive jobs to the country.		Those who didn't find good jobs to live normal and all ways need help with subsidy.

I have good idea to find a job
for every body on the earth.
I am ready to help all
The International Communities

Upper Middle Class	Middle Class
←	→

When the wealthy stop stealing the money or control the right of the government and the 99% of the population the middle with upper middle class and the poor. The wealthy automatically came upper middle class.

When the poor find good jobs or small business they will be came automatically middle class.

Sincerely
Saleh Mohsen Hassan AL-Mhamad

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FAX COVER SHEET

TO: Gene Sperling
Larry Summers (cc. David Wilcox)

FROM: Peter Orszag

DATE: 5/13

SUBJECT: Admin. legislative language & the earnings test

PAGES: Cover + 6

May 20, 1999

TO: Gene Sperling
FROM: Jeff Liebman
SUBJECT: Breaux-Gregg plan appears to have integrative features

- According to the paper they are circulating on the hill, under the Breaux-Gregg plan, people's Social Security benefits will be reduced by the value of the annuity provided by accumulating individual account contributions at the bond rate of return.

- This is similar to our old add-on proposal that would have been designed to ensure people that their traditional benefit (after cuts) plus a safe return on their individual account will be at least as large as current law benefits.

- My guess is the Breaux-Gregg's variant doesn't ensure current law benefits -- it ensures a modified current-law benefit after the CPI cuts and retirement age cuts.

JL

Would like to know more. Are there more detailed version of Breaux-Greggs than T.P. I saw?

GS 5/22/99

cc: Natalie B.

THE WHITE HOUSE

WASHINGTON

May 21, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING
LARRY STEIN

SUBJECT: SOCIAL SECURITY BACKGROUND FOR SENATE DEMOCRATIC RETREAT

You are scheduled to make a statement at the annual Senate Democratic Retreat on Saturday, May 22, in Irvington, Virginia. Afterward, you will take questions on issues of interest to Senate Democrats, some of which may relate to Social Security. This memorandum provides you with a discussion of goals you might seek and background on recent Congressional Social Security activities.

Your goals for this session should be as follows:

1. **Let Senate Democrats know that you want to advance Social Security reform and that working for Social Security reform is good for Democrats.**

   - We need to fight the desire some seem to have to declare the effort to achieve Social Security reform dead. The worst scenario is the one where Democrats appear simply to have blocked real reform.

2. **Let them know that you still believe that the best chance for consensus lies with: (1) extending solvency without elements that could be perceived as privatization, while (2) passing a progressive individual savings account outside or adjunct to the system.**

   - At the end of the day, a significant constituency will want some form of individual accounts that people can control.

   - On the other hand, a large number of Democratic Members, particularly in the House, will not go along with any solvency plan that runs the risk of privatization.

   - Whether or not there are improvements to our plan, we feel that the plan we laid out with debt reduction for solvency and USA accounts could be a promising framework from which to start.

3. **Let them know that you push strongly for Democrats to be involved whenever you discuss Social Security reform with Republicans.**

DESCRIPTION OF BREAUX-GREGG PLAN

Senators Breaux, Bob Kerrey, and Robb (along with Senators Gregg, Grassley, Thompson, and Thomas) introduced their Social Security reform plan on Thursday, May 20. The sponsors stated that their plan does achieve 75-year solvency.

Key Provisions in Breaux-Gregg

Significant COLA Decrease with Tax Revenue Increase Dedicated Back to Social Security. The COLA would be redefined as the CPI minus 0.5 for all government programs, except SSI. This will provide cost savings to Social Security. The extra income tax revenue from this provision (due to slower indexation of tax brackets) would be used to provide permanent annual general revenue financing to the OASDI trust funds that would ultimately exceed 1 percent of payroll. Current workers aged 62 or older will not be affected by this change.

Two Percent Carve-Out Individual Accounts. The plan diverts 2 percent of the existing 12.4 percent payroll tax into individual retirement savings accounts that are modeled after the Federal Thrift Savings Plan. The account would be owned by workers and therefore could be passed on to the worker's heirs at death.

Individual Accounts Include Progressive USA-type Provision. Progressive matches, similar to those in USAs, would be available to lower earners who make additional contributions of their own. The matches would be funded by the budget surplus.

Social Security Benefit Reduced by an Amount a Conservatively-Invested Individual Account Would Earn. Upon retirement, the worker's Social Security benefit will be reduced by the amount that the account would have yielded if it grew at the Treasury Bill rate and was annuitized at retirement.

Traditional Solvency Measures. Other provisions include:

- Speeding up the currently scheduled increase in the retirement age to 67
- Reducing benefits for people who retire before the normal retirement age
- Eliminating the earnings test for those 62 and older
- Maintaining the taxable wage base at 86 percent of total wages.

If Senators Breaux, Kerrey, or Robb ask you what you think about their proposal, you can:

- Praise them for coming forward with a serious plan and for working to keep Social Security reform alive.
- Commend them for thinking in the same way as we have by introducing a progressive provision like USAs in their individual account.

Without criticizing their plan, you should avoid any indication that we would support a carve-out individual account or a major COLA cut as their plan suggests.

- You still believe that the best foundation for securing Social Security on a bipartisan basis is the framework you set out in your State of the Union address: relying on fiscal discipline to strengthen the solvency of Social Security and protect its traditional guaranteed benefit, while simultaneously creating USA accounts outside of the Social Security system so as to allow for progressive individual savings accounts without the risk of privatization.

- You are strongly committed to using the most technically accurate inflation index. BLS is continuing to make improvements to the CPI and many economists believe that they are making good progress. The COLA affects millions of Americans through Social Security and other government programs. Any change in the COLA should be carefully considered to assure that the most vulnerable elderly are not put in jeopardy.

SOCIAL SECURITY LOCK BOX LEGISLATION

- As you recall, Senators Domenici and Abraham offered a Social Security "lock box" amendment on April 20th that would periodically reduce the debt limit to ensure that Social Security surpluses are used only for debt reduction or legislation designated as Social Security reform. Republican leaders hope that the lock box debate will protect them from having to actually carry out anything on Social Security.

- We have advocated for our own lockbox that locks away the Social Security surpluses for debt reduction. The Senate Republican Lock Box is flawed because of its use of the debt limit and because it does not extend Social Security solvency. While we want to work constructively with Senate Democrats on devising an acceptable budget resolution alternative that includes the use of general revenues for Medicare solvency and Social Security lock box that doesn't rely on the debt limit, Senate Democrats have not been willing to come forward with any measures to use debt reduction from their lockbox to extend the solvency of Social Security (the House Budget Resolution, designed by Spratt, did use debt reduction to extent solvency in a way similar to our plan).

- The Republicans in the Senate twice failed to invoke cloture. The House leadership hopes to move its lock box bill, perhaps as soon as next week. There, Chairman Kasich has a proposal almost identical to Senator Domenici's, while Congressmen Herger, Shaw, Archer, and others have a more reasonable (if still flawed) proposal that works through points of order.

- Senator Lott hopes to revive the Senate debate in June. Senators Lautenberg and Conrad have offered separate amendments that would prevent spending of the Social Security surplus using mechanisms that do not involve the debt limit. Senator Lautenberg's amendment prohibits any action that would increase spending until Congress enacts legislation to ensure the long-term solvency of Social Security and extends the solvency of Medicare. Senator Conrad's amendment reserves an amount equal to the Social Security surplus for Social Security and 15 percent of the unified surplus for Medicare (with an annual adjustment to the Medicare reserve to extend solvency by at least 12 years).

- None of these amendments extend the solvency of the Social Security system.

THE WHITE HOUSE

WASHINGTON

May 21, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING
LARRY STEIN
BRUCE REED
CHRIS JENNINGS

SUBJECT: KEY MEDICARE ISSUES AND LEGISLATIVE UPDATE

Breaux-Thomas Proposal and the Medicare Commission. Despite failing to receive the endorsement of the Medicare Commission, Senator Breaux and Congressman Thomas have committed to introducing their Medicare reform proposal and may do so as early as next week. Their proposal's centerpiece is a premium support option that changes the way that Medicare pays health plans, including traditional Medicare. It includes a limited, although inadequate prescription drug benefit. And, most notably, it does not include your surplus proposal or any explicit commitment to add needed new financing for the Medicare program to deal with the doubling of the beneficiary population -- from 40 to 80 million over the next 35 years.

Our major criticism of the premium support proposal is that its design, according to the Medicare actuary, would explicitly increase Medicare premiums for the traditional program by between 10 and 20 percent. This would have the effect of financially coercing Medicare beneficiaries into HMOs -- not encouraging them through lower premiums for private plans. Although the Breaux-Thomas proposal maintains the current premium for beneficiaries who live in counties with no private plan options, this exemption would, for the first time in Medicare history, create different premiums for traditional Medicare based on where a beneficiary lives. Moreover, it creates a false sense of security -- should even one small HMO plan enter an area, the premium protection would end. This would leave some beneficiaries the "choice" of joining the new plan or paying 10 to 20 percent more to stay in traditional Medicare. Other criticisms of the Breaux-Thomas plan include: the lack of any new financing, raising the age eligibility to 67 percent without any policy to protect against increasing uninsured, and a Medicaid rather than Medicare prescription drug benefit that only helps beneficiaries whose income is below $11,000 (single), and, while some limited copays may deserve consideration, they have an open-ended 10 percent home health copay that could impose significant costs on the sickest beneficiaries.

Publicly, we have praised Senator Breaux for tackling such an important challenge and thanked him for including certain policies like the modernizing the traditional program and recognizing the importance of prescription drugs. However, as we commend Senator Breaux for his constructive contributions, we also point out the shortcomings in his plan. As we do this, we reiterate your statement that it is incumbent upon us to put forward an alternative that: (1) makes Medicare more efficient and competitive; (2) maintains and modernizes Medicare's guaranteed benefits, including a prescription drug benefit; and (3) assures adequate financing by dedicating part of the surplus for Medicare.

Status and Timing of Reform Plan. While we have been careful to not commit to any specific release date for your proposal, we have said that you wish to get it out with enough time left for the Congress to act this year. With this in mind, we are working toward having a plan available for public presentation as soon as mid-June. We are scheduled to meet with you in early June to review options and present recommendations.

If asked about timing, we would recommend that you say that it is your hope to get the proposal out early this summer and preferably in June. However, you should reiterate that you do not think it is wise to commit to a specific date; it is far more important that we get the policy work done right, have all the provisions scored by the Medicare actuary, and develop and implement an effective roll-out of the policy with the Democratic Leadership and others.

Provider Concerns about Balanced Budget Act. Provider savings will not be easy to come by this year, since all major provider groups have launched a campaign not just against additional savings for reform, but to support "give backs" from the Balanced Budget Act itself. Even conservative Democrats like Senators Conrad, Moynihan, Baucus and Bingiman are considering "fixing" or undoing BBA '97 reductions, especially for academic health centers, rural hospitals, nursing homes, home health care providers and others.

Our goal is to have some fixes where clearly well justified while still getting some moderate new savings. As such, we are proactively seeking administrative interventions that could moderate the effects of the BBA. Administrative actions would be the priority since, pending OMB approval, this spending would neither require legislation nor offsets. Moreover, acting administratively rather than legislatively could avert, or at least postpone, opening up the Balanced Budget Act which could drain away the resources necessary to help fund a prescription drug benefit. We are examining legislative options for your consideration, bearing these risks in mind. If we conclude that administrative actions are inadequate, limited legislative fixes could help avoid a negative response to your Medicare reform proposal.

In response to questions, we would recommend that you acknowledge the many serious concerns being raised by providers about their financial status. You can advise the members that we are reviewing these concerns carefully to evaluate whether there is justification for administrative and/or Medicare interventions. If there is, we believe that we should include them. You should advise them, however, that it would be dangerous to open up the BBA in the absence of detailed evidence that Medicare is the problem and should be the solution. If we over-react or act prematurely, we risk starting a bidding war that could seriously undermine our recent successes in strengthening the Medicare program and balancing the budget.

SPECIFIC POLICY ISSUES:

1. **Competitive Alternatives to Premium Support.** Modernization can be divided into two categories: modernization of the traditional Medicare program and competition among managed care plans. One of the positive contributions of the Medicare Commission was to unanimously support making the traditional Medicare program more competitive (e.g., allow for more competitive pricing; greater ability to contract out for services; high-cost case management). Your Medicare advisors also think that these ideas are worth pursuing.

Most of the controversy, however, surrounds whether there can be competition in managed care that avoids the downside (higher traditional Medicare premiums) of the Breaux-Thomas plan. We are reviewing policies for price competition in managed care that meet several criteria: the traditional Medicare premium is protected to avoid financial coercion into managed care; Medicare's benefits are clear and strongly guaranteed; and competition is based on price and quality, not benefits which are easier to manipulate to attract healthy beneficiaries. Although these options do not produce large savings, they have the potential to bridge the differences between advocates of premium support and the traditional program. Supporters could view this as a step in the right direction since, for the first time, beneficiaries could get lower premiums for choosing low-cost plans. Opponents could be assured that their major concern about premium support – that it undermines traditional Medicare – has been addressed. Conversely, conservative Democrats could argue that it does not go far enough, while base Democrats could continue to fear that Republicans will hijack the proposal to set us on the path towards a capped voucher system that privatizes Medicare.

Given the sensitivity of this issue, we recommend that you simply state that you are examining all options, but will not veer from your principles. Specifically, you will reject competition that results in higher traditional Medicare premiums but you are also open to new ways to inject more competition into the Medicare program. You can stress the importance of choice, not coercion.

2. **Drug Benefit: Design.** All health care providers and experts agree that a plan to reform Medicare for the twenty-first century must include prescription drug coverage. Prescription drugs have become an essential part of health care. They complement medical procedures (e.g., anti-coagulents with heart valve replacement surgery); substitute for surgery and other interventions (e.g., lipid lowering drugs that lessen need for bypass surgery) and offer new treatments where there previously were none (e.g, drugs for HIV/AIDS). Their importance will grow as the understanding of genetics increases. The potential for health improvements and possibly lower health care costs is greatest for the elderly and people with disabilities, whose health conditions often can be effectively managed through drugs.

Although the Breaux-Thomas plan acknowledges the importance of prescription drug coverage, it provides an affordable option only for beneficiaries with incomes below 135 percent of poverty ($11,000 for a single beneficiary). Moreover, the current sources of coverage for Medicare beneficiaries – retiree health insurance and Medigap – have become more expensive and less accessible. Those beneficiaries with coverage have seen the amount of this coverage decline. Less than half of beneficiaries enrolled in Medicare managed care have coverage for expenses above $1,000 or 2,000. This makes targeting only the uninsured or low-income inefficient and inequitable. As such, we are examining options that provide a voluntary, affordable Medicare insurance option for all beneficiaries.

The challenge is to design a drug benefit that is meaningful and affordable to both the program and its beneficiaries. We are also contemplating an option to provide for catastrophic coverage once the cap is met. It is important to note that, whatever design we chose, beneficiaries can use the 10 to 15 percent discount that the private contractors or pharmacy benefit managers (PBMs) get through negotiation before, during and after the coverage ends. This is a big advantage for beneficiaries who now buy drugs at retail prices. Medicaid would pay for the premiums and cost sharing for low-income beneficiaries through the QMB and SLMB programs.

A number of Senators have strong opinions on how the drug benefit should be designed. Senators Kennedy and Rockefeller proposed a more costly benefit that includes both some up-front coverage (20 percent coinsurance after a $200 deductible, up to $1,500 in spending) and some catastrophic coverage (0 percent coinsurance after $4,200 in total expenses or $3,000 in out-of-pocket spending). This reflects the desire to ensure that beneficiaries with low to moderate costs are helped while protecting the sickest. You should praise them for their leadership on this issue. Senators Graham and Wyden suggest that costs should be reduced by either raising the deductible, limiting the types of drugs covered, or restricting the coverage to low-income beneficiaries only. We have concluded that these are unworkable or flawed approaches, but would also recommend that they be acknowledged for their interest in this issue.

We feel it is important to not signal the direction of our benefit, but you should know that we are currently exploring an option with no deductible, where we would pay half of the costs of prescription drugs up to $5,000.

3. **Drug benefit: Costs and Offsets.** The options that we are considering have 10-year costs that fall between $150 and 200 billion, significantly less than Kennedy-Rockefeller legislation whose costs are at least $300 billion over 10 years (note: we do not advise that you discuss numbers with Senators since they are not public). These costs are net of beneficiary premium payments.

Your advisors have been striving to fully fund the prescription drug benefit from savings from competition, providers, and beneficiaries. However, the constraints on these savings options make it clear that only a very limited drug benefit can be financed in this way. As such, we are examining options for additional financing that include an additional tobacco tax, a portion of the surplus dollars dedicated to Medicare, and/or additional provider and beneficiary contributions.

Some Congressional Democrats (mostly the base) have advocated for using either part of Medicare's 15 percent, or an extra amount from the surplus, for prescription drugs. The primary rationale is the enormous contribution that Medicare has made to the balanced budget and surplus; the Medicare Trustees and the Congressional Budget Office project that Medicare spending is over $200 billion lower than originally projected when the BBA was passed. It also appears possible that the trust fund could still be extended to 2025 or so with approximately one-third of the surplus used for the drug benefit. Others, particularly the moderate Senators and the Blue Dogs, have expressed concerns that this would undermine your surplus framework. Instead, they recommend proposing additional tobacco tax revenue for the benefit as well as larger beneficiary and provider cuts. Some within your economic team would advocate taking this approach as an opening position, recognizing that the surplus would likely be used to fund the benefit in the bill that gets signed. We are examining these options' policy or political viability. Since there is a clear split in Congress, and differences of opinion among your budget advisors as well, we suggest that you avoid any comments on financing sources at this point, but reassure the Senators that our plan will be fully, credibly financed.

4. **Surplus for Medicare Solvency**. A few Senators (Breaux, Kerrey, Hollings) and some conservative House members continue to express concerns over dedicating 15 percent of the surplus to Medicare. In Senator Hollings' case, it stems from a belief that this is more of a budget game than a serious approach buying down debt. Senator Breaux adopts the same IOU criticism, but the primary reason for his current opposition is that he believes that it fractures his bipartisan coalition for his reform package, since Republicans are adamantly opposed to the surplus dedication. Only Senators Breaux and Kerrey voted against using the surplus for Medicare in the budget resolution.

   Clearly, major structural reform, program savings and beneficiary contributions combined cannot offset the costs associated with the doubling of Medicare enrollment that will occur when the baby boom generation retires. In fact, if reductions in growth alone were used to extend the life of the Medicare Trust Fund, spending growth per beneficiary would have to be limited to below inflation, 3 percent per year -- in every year -- to get to 2025. Every independent Medicare expert affirms that greater revenue is needed to fund the program into the future (note: 15 percent of the surplus gets to 2027 on the 1999 trustees' baseline). This rate is well below projected private health insurance spending per person (7.3 percent). Moreover, since this growth rate is below general inflation, the value of Medicare spending per beneficiary would erode.

   Senator Kerrey argues as if the general revenues going to Medicare would somehow be reserved for non-defense discretionary if they were not dedicated to Medicare. Most feel, however, that without a "Medicare block," the general revenue would go to a fiscally irresponsible tax cut as opposed to a fiscally responsible plan to pay down debt and to help Medicare solvency.

5. **Income-Related Premium.** We are contemplating an income-related premium in our policy review. You have supported this policy in the past (1992, 1993, and 1997) as a progressive form of increasing beneficiary contributions in the context of an acceptable package of broader reforms. In the past, our support has been conditional on several parameters. First, the 75 percent premium subsidy would not be fully phased out, in order to keep high-income beneficiaries in the program. Second, it should target truly high-income beneficiaries and be indexed to keep up with inflation (an earlier version of the Commission plan began at $24,000 for single beneficiaries, $30,000 for couples, affecting about 30 percent or 12 million beneficiaries, which is problematic). And, third, it should be administered by Treasury since it can collect this premium more efficiently than HHS, thus producing more revenue.

   Large numbers of moderate/centrist Democrats and Republicans strongly support the income-related premium as do elite validators (other than those who consider Medicare a pure social insurance program). Interestingly, the far left of the Democratic party (Gephardt, Waxman, Kennedy) and the far right of the Republican party (Senator Gramm) oppose this proposal. The Democrats' main arguments are that the income-related premium opens the door to means-testing since it could easily be lowered in the future, and if it only hits the highest income, it does not raise enough revenue to justify the policy. In contrast, Senator Gramm insisted that the income-related premium be dropped from the final Breaux-Thomas proposal because he believes it to be a tax that affects one of the Republican core constituencies.

Given your past support for this policy and the need to come up with beneficiary as well as provider savings, you probably should indicate an openness to the income-related premium if asked. Almost all of your advisors support this. The base Democrats concerns can be allayed somewhat if you reassure them that it will be targeted truly at the higher income beneficiaries. More importantly, it is useful to remind them that it is much more progressive than an across-the-board premium increase or aggressive cost sharing increases, which would be needed to raise comparable contributions.

6. **Cost Sharing.** The Breaux-Thomas proposal includes reforms intended to rationalize Medicare's patchwork of cost sharing. In some cases, this means adding copays where none exist, and other, it is reducing excessive or unnecessary cost sharing. Specifically, it would eliminate preventive service cost sharing and hospital copays after 60 days, and create one, combined, budget-neutral deductible of $400 (today, the Part A deductible is $768 per hospitalization and $100 for Part B). It would also add an unlimited home health copay of 10 percent and 20 percent lab and nursing home coinsurance. Finally, it would prohibit Medigap from covering the new $400 deductible. Although the intent was to produce a budget-neutral package, it ended up saving $20-40 billion over 10 years.

   Centrist Democrats are inclined to support beneficiary cost sharing because they believe it has a positive impact on excess utilization of services. Base Democrats argue that it will not affect utilization since most beneficiaries have supplemental coverage, and for those without coverage, it will significantly increase costs.

   Your advisors are reviewing options with the primary goal of simplifying Medicare's cost and making it more similar to that of private health plans. We are contemplating eliminating cost sharing for preventive services (since cost sharing discourages use); rationalizing the nursing home copay (from nearly $100 per day for days 21 to 100 to a straight 20 percent coinsurance); and adding a new Medicare option to purchase (without subsidies) lower cost sharing (a Medicare version of Medigap). This last option, of eliminating the need for supplemental coverage by offering better coverage within Medicare, is widely recommended by experts like Bob Reischauer and Laura Tyson. Additionally, we are reviewing options to add copays where there currently are none: a reduced, capped home care copayment and 20 percent coinsurance on clinical lab services. This package of cost sharing savings could either be budget neutral or save money, which may be justifiable in the context of adding a new prescription drug benefit. If asked, we would recommend that you be non-committal in this area, but acknowledge that cost sharing options are being considered.

7. **Age Eligibility Increase.** The Breaux-Thomas proposal would increase the Medicare age eligibility from 65 to 67. Some support this policy, arguing that it conforms Medicare to Social Security. However, Social Security provides the option for a partial benefit at age 62 and through age 67. In contrast, the Breaux-Thomas proposal provides for no such option for people at age 62 and no specific coverage option for people ages 65 to 67.

   Per your guidance, we are opposing this policy for several reasons. First, people in their early 60s are already at risk of becoming uninsured. The fastest growing number of uninsured Americans are those between the ages 55 and 65. One recent study projects that the number of uninsured ages 61-64 will increase by over 40 percent by 2005 (from 3 million to 4.25 million). As a consequence, people ages 55 to 65 are twice as likely as younger people to purchase individual private health insurance -- despite the fact that, in virtually all states, it is the most expensive and inaccessible insurance option for older Americans. It was for these reasons that you proposed allowing certain people ages 55 to 65 to buy into Medicare. As a note, Senator Daschle feels strongly that you include this budget proposal in your Medicare reform plan as well.

These problems would be worse for people ages 65 to 67 if they did not have Medicare. Nearly one in ten or about 4 million Medicare beneficiaries are age 65 to 67. If they were to lose Medicare and their uninsured rate is the same as that of 64 year olds, it could be assumed that nearly 600,000 people would become uninsured. This would likely be higher since more people in this age group have health problems and would be unable to access or afford private individual health insurance. This policy would also likely increase employer and state Medicaid costs, since these payers would continue to be the primary insurer for these beneficiaries.

Some proponents of raising the age eligibility have suggested that these problems can be avoided if coupled with a Medicare buy-in for people ages 66 and 67. It is true that, relative to the coverage options facing people ages 55 to 65, it is an affordable, attractive option, even without a subsidy. However, it is not designed to be a substitute for Medicare. According to the Congressional Budget Office, about 9 percent of the uninsured and 5 percent of the total eligible population ages 62 to 65 would participate in the buy-in. If similar take-up rates occurred in the 65 to 66 year old population, only a small number of those who would lose Medicare would opt for coverage through the buy-in. The Medicare buy-in proposal could be subsidized to encourage low-income people to participate. However, since about over half of people ages 65 and 66 have income below 300 percent of poverty (about $27,000 for a single), the cost of subsidies would be high.

There appears to be a growing recognition of the shortcomings of increasing Medicare's eligibility age. As a consequence, although the Finance Committee supported this provision in 1997, it is unclear whether this policy could pass today. In fact, Senator Breaux has recently indicated that he would likely drop this provision from his package. We would therefore recommend that you reiterate your strong opposition to this policy, particularly since there is no viable policy to address the problems that recent studies affirm will occur.

THE PRESIDENT HAS SEEN

THE WHITE HOUSE

WASHINGTON

May 24, 1999

cc: Sperling Reed Jennings Lambrew Podesta

INFORMATIONAL MEMORANDUM TO THE PRESIDENT

FROM: Gene Sperling, Bruce Reed, Chris Jennings, and Jeanne Lambrew

SUBJECT: Medicare Policy Development Update

NEC and DPC continue to develop Medicare reform policy options for your consideration. We will soon be meeting with you to discuss these options and to receive your guidance. In the meantime, we thought that you might be interested in reviewing some of the attached background information that has been prepared for internal and, in some cases, external briefings for Members of Congress and their staffs. It addresses most, but not all, of the topics under review. As we continue to address policy issues and options, we will forward you additional information.

Policy Development Status. Following the conclusion the Medicare Commission and the recently-released Medicare Trustees' report, we have been working intensively to evaluate the strengths and weaknesses of the Breaux-Thomas reform proposal and the advantages and disadvantages of various alternatives to it. Your White House, OMB, HHS, and Treasury Medicare advisors are reviewing numerous reimbursement and structural reform concepts, drug benefit designs, and offset options to strengthen the financial status of the program and to help pay for benefit improvements. Cost estimates are being run and re-run to reflect the Trust Fund's new baseline (which is now scoring reduced savings for individual policies), new design options of interest to your advisors, and evolving reform positions of key Members of Congress, aging advocates, and health care providers. In preparation for our upcoming policy discussions, you will find:

- Tab 1 contains our Medicare "walk-through" document that is being used for Members of Congress and their staff to detail the strengths and weaknesses of both the Medicare program and the recommendations made by Senator Breaux and Congressman Thomas.

- Tab 2 includes the memo that we gave you in advance of the Senate Democratic retreat that highlights the major issues.

- Tab 3 provides an update of Congressional interest in and action on Medicare, which was produced in collaboration with Larry Stein.

- Tab 4 encloses a background briefing document on premium support and options to inject more competition in the Medicare program. We are closely examining alternatives that meet our objectives of making Medicare more efficient and reducing costs while not undermining the traditional fee-for-service program. (Also attached is the original premium support concept article by Robert Reischauer and Henry Aaron.)

- Tab 5 provides a summary of our talking points on the use of the surplus for Medicare – in particular the common myths and our responses to them.

- Tab 6 includes detailed background information on the status of prescription drug coverage for older and disabled Americans as well as a discussion of the major moving pieces of any drug benefit design.

- Tab 7 includes some background facts on options involving beneficiary contributions to Medicare. These include the income-related Part B premium as well as fact sheets on various services for which cost sharing changes are being considered.

- Tab 8 provides specific back-up facts and trends that strongly support your contention that an increase in the eligibility age without an explicit policy that assures there is not an increase in the uninsured ill advised and flawed policy.

- Tab 9 explains the issues confronting rural beneficiaries under the Breaux-Thomas proposal -- a critically important issue in the Senate and amongst the conservative Democrats most willing to be open to broader Medicare reforms.

- Tab 10 includes your response to the March 30th, 1999 Trustees report on the status of Medicare, and our general talking points supplementing your comments. It also contains your comments responding to the Breaux-Thomas proposal and the general talking points on the topic, your State of the Union comments on Medicare, your AARP speech outlining your principles for reform, and the back-up paper that was released around the speech.

We hope that you will find this information to be useful in preparation for our upcoming meeting with you on Medicare reform options.

May 24, 1999

MEMORANDUM FOR GENE SPERLING

FROM: BILL DAUSTER

RE: HOUSE LOCK BOX BILL UPDATE

At 5:00 this afternoon, the House Rules Committee will consider the Herger-Shaw lock-box bill, which seeks to prevent using the *off-budget* surplus until enactment of Social Security and Medicare solvency legislation. The House itself will likely consider it tomorrow. House Democrats will likely say that they would do more to protect Social Security and will probably offer an amendment or a motion to recommit that would call for protecting both the *off-budget* and the *on-budget* surpluses until enactment of Social Security and Medicare solvency legislation. Having said that, they will probably vote for the Herger-Shaw bill in the end.

The Herger-Shaw bill would:

- create a point of order against any budget resolution or legislation that would cause or increase an on-budget deficit;
- authorize a waiver of this point of order in the Senate only with a three-fifths majority;
- require any official Federal statement of the budget surplus or deficit to exclude the outlays and receipts of Social Security, and require Social Security outlays and receipts to be submitted in separate Social Security budget documents;
- except from the point of order Social Security or Medicare reform legislation (defined as legislation that specifies that it is reform legislation); and
- terminate the point of order upon enactment of Social Security and Medicare reform legislation.

The Herger-Shaw bill thus contrasts with the Abraham-Domenici debt-limit lock box amendment that the Senate considered last month. Secretary Rubin warned that the Abraham-Domenici debt-limit lock box could trigger periodic debt crises that would threaten the stability of our economy. Chairman Kasich has introduced a lock box very similar to the Abraham-Domenici lock box, but it is unclear whether the Rules Committee will make it in order.

While the Herger-Shaw lock box avoids the pitfalls of the Abraham-Domenici debt-limit lock box, it still raises some concerns:

- It fails to do anything to strengthen the solvency of Social Security or Medicare, and thus distracts Congress from the debate we should be having.

- It provides weaker protections than the Budget Enforcement Act's discretionary spending caps and pay-as-you-go requirements, which protect both off-budget and on-budget surpluses from being spent.

- It fails to provide adjustments for emergencies, recessions, or other contingencies, irrationally tightening constraints on appropriations when such exceptions apply.

While Ways and Means staff earlier appeared to indicate that they would prefer that the Administration not issue a SAP, it now appears that House Democrats simply do not want the Administration to take a position inconsistent with their amendment. Chuck Konigsberg is thus back to revising his draft SAP.

THE WHITE HOUSE

WASHINGTON

May 29, 1999

MEMORANDUM TO THE PRESIDENT

FROM: Gene Sperling and Chris Jennings

SUBJECT: Briefing Memorandum for Medicare Meeting

On Tuesday, you will have a Medicare meeting in which we will review key elements and several packages of reforms, seeking your guidance as we develop a plan. Our goals for this plan include: (1) significant dedication of the surplus for Medicare, which will extend the life of the Medicare Trust Fund as well as reduce debt; (2) serious modernization of Medicare, including making it more competitive; (3) substantial prescription drug benefit; and (4) sufficient savings to make our prescription drug benefit fiscally responsible. These goals conform to your principles for reform articulated at the AARP in February.

Below, we describe the major elements of reform, key parameters of a prescription drug benefit, and illustrative packages. Ultimately, your primary decisions about the Medicare plan will hinge on how the prescription drug benefit is designed and financed. Packages showing options for drug benefits and financing options are shown at the end of the memo.

KEY ELEMENTS

Modernizing Traditional Medicare. One of the positive contributions of the Medicare Commission was to unanimously support making the traditional Medicare program more competitive (e.g., allow for more competitive pricing; greater ability to contract out for services; high-cost case management). Your Medicare advisors also unanimously agree that these policies are worth including in the plan. They save an estimated $14 billion over 10 years.

Competitive Managed Care Payments. A more controversial issue is whether to allow competition to determine Medicare premiums and government payment rates. Premium support, the centerpiece of the Breaux-Thomas proposal, would set all Medicare premiums competitively, including that of the traditional program. Because it would result in a lower government contribution for traditional Medicare, the actuary projects that the traditional program premiums would rise by 10 to 20 percent, effectively driving people into managed care. Your advisors are recommending an option that is fundamentally different because it would protect the traditional Medicare premium, assuring that competition is based on choice, not financial coercion. Although this option does not produce as much savings as does the Breaux-Thomas premium support model ($10 versus $50 billion over 10 years), it would be considered structural reform since it gives incentives to encourage beneficiaries to choose low-cost plans. There is a risk, however, that base Democrats will view it as a "voucher" or something akin to Breaux-Thomas and conservative Democrats and many Republicans may think that it does not go far enough. Regardless, all of your advisors are in favor of including this proposal.

Income-Related Premium. An income-related premium is a progressive form of increasing beneficiary contributions. You have supported this policy in the past (1992, 1993, and 1997) so long as it is designed well. All of your advisors recommend that it begin at $80,000 for singles, $100,000 for couples, which produces about $25 billion over 10 years and affects about 2 million beneficiaries. Some are willing to go lower to avoid the use of surplus funding to help finance the drug package.

Cost Sharing. Changes can both make Medicare's cost sharing more rational and help fund the prescription drug benefit. The following is the list of options under review:

- Eliminate preventive cost sharing: Cost sharing can inhibit beneficiaries from using their new Medicare preventive benefits. Eliminate all cost sharing would cost $3 billion over 10 years and is unanimously recommended by your advisors.

- Add lab 20% copay: Only lab and home health services do not have any copays, and most experts agree that a lab copay could decrease excess use (the typical 20% copay would be about $5-10). It would save about $9 billion over 10 years and is supported by your advisors.

- Change nursing home copay to 20% coinsurance: The nursing home benefit's current cost sharing structure is not rational. Beneficiaries pay nothing for the first 20 days, but then pay nearly $100 per day (about 33%) for days 21-100. This proposal would apply a 20% copay (about $60 per day) for all covered days. This helps sicker beneficiaries, but applies a new copay to short-term nursing home residents. While we aimed to make this cost neutral, it actually saves $4 billion over 10 years. It is possible to lower the copayment to make it budget neutral.

- Index the Part B deductible to inflation: The $100 Part B deductible has not been updated since the 1980s, and is lower than most private fee-for-service insurance plans. This proposal would simply index the current deductible to general inflation (by 2010, it would be $135) and save about $2 billion over 10 years. Most advisors recommend this, particularly if it eliminates the need for a home health copay. Some are willing to increase the deductible (to $150) if it would avoid the need for surplus spending.

- Add $5 home health copay. Most experts agree that a carefully designed home health copay can reduce excess use without harming beneficiaries. At the same time, home health users are among the most vulnerable (older, sicker); increasing this benefit's cost sharing has the appearance of being inconsistent with your long-term care initiative; and the new prospective payment system will reduce use without copays. Although a number of your advisors agree that this is good policy, they believe that it is not necessary in the context of the other beneficiary cost sharing proposals outlined above (saves $7 billion over 10 years).

Provider Payment Reductions. Provider savings are difficult to find given (a) our FY 2000 budget used the limited options for the next few years; (b) the BBA of 1997 package relied heavily on providers savings; and (c) all major provider groups have launched a campaign not just against additional savings but in support of increased spending to offset the Balanced Budget Act in the near term. Even conservative Democrats like Senators Conrad, Moynihan, and Bingaman are considering "fixing" or undoing BBA '97 reductions, especially for academic health centers, rural hospitals, nursing homes, and other providers. Our goal is to have some fixes where clearly well justified while still getting some moderate new savings. As such, we are proactively seeking administrative interventions that could moderate the effects of the BBA. If we conclude that administrative actions are inadequate, targeted legislative fixes could help avoid a negative response to your proposal. However, because of the limited availability of on budget surplus dollars in 2000, finding early-year savings to offset these costs would be extremely difficult. Your advisors believe that a credible Medicare reform plan, taking into account provider constraints, could achieve about $40 billion over 10 years (more or less depending on the degree of fixes).

PRESCRIPTION DRUG BENEFIT. The part of your Medicare plan that will receive the most attention is its prescription drug benefit. The base Democrats will judge your plan in large part by how generous this benefit is. Many of them have signed onto the Kennedy-Rockefeller plan, which provides for 20 percent coinsurance up to a cap, and then provides 100 percent coverage after the beneficiary has spent $4,200 on drugs. This bill costs over $300 billion over 10 years. On the other hand, conservative Democrats are interested in the least costly benefit that can be validated, even minimally, as meaningful. The following table shows our major options.

PRESCRIPTION DRUG BENEFIT OPTIONS ($ BILLIONS -- Preliminary -- Excludes State Maintenance of Effort)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	00-09
$5,000 LIMIT	Cap:	$2,000	$2,000	$3,000	$4,000	$5,000	indexed			
50% Premium	0	5.6	10.7	12.5	15.0	17.3	19.1	20.6	22.3	123.0
Premiums		***$24***	***$25***	***$31***	***$36***	***$41***	***$43***	***$45***	***$48***	
67% Premium	0	7.4	14.3	16.7	19.9	23.0	25.4	27.5	29.7	164.1
Premiums		***$16***	***$17***	***$21***	***$24***	***$27***	***$29***	***$30***	***$32***	
$10,000 LIMIT *	Cap:	$4,000	$4,000	$6,000	$6,000	$8,000	$8,000	$10,000	indexed	
50% Premium	0	7.2	13.8	15.6	17.2	19.0	20.8	22.9	25.1	141.6
Premiums		***$31***	***$33***	***$38***	***$40***	***$45***	***$47***	***$51***	***$55***	
67% Premium	0	9.6	18.4	20.8	22.9	25.4	27.8	30.5	33.5	188.8
Premiums		***$21***	***$22***	***$25***	***$27***	***$30***	***$31***	***$34***	***$36***	
NO LIMIT:	Cap:	$2,000	$3,000	$3,000	$4,000	$5,000	None			
50% Premium	0	5.6	12.0	13.3	15.1	17.3	21.0	24.1	26.5	134.8
Premiums		***$24***	***$30***	***$31***	***$36***	***$41***	***$51***	***$54***	***$58***	
67% Premium	0	7.4	15.9	17.7	20.2	23.1	28.0	32.1	35.4	179.9
Premiums		***$16***	***$20***	***$21***	***$24***	***$27***	***$34***	***$36***	***$39***	

** Note: The policy with the $10,000 cap is more expensive than the catastrophic option only because it offers more generous coverage in the early years of its design (00 to 06); the catastrohpic option is more expensive in the out-years*

All of your advisors support a policy in which we cover 50 percent of the costs of prescription drugs up to at least $5,000. We believe that this will have a simple, clear message: if you choose to pay a modest premium, we will pay half of your prescription drug costs up to $5,000. Another reason that your advisors support this is that every year, every beneficiary will see a benefit every time that they buy a prescription drug because there is no deductible. The two issues of difference among your advisors are how much the premium (and overall benefit) should be subsidized and whether or not there should be catastrophic coverage.

On the subsidy issue, the Medicare actuary has concluded that 50 percent is the minimum subsidy amount that is necessary to attract enough healthy beneficiaries to avoid adverse selection. Some of your advisors think that a 50 percent premium is the most that we should do because anything higher will create too large of an entitlement that will be too hard to restrain in the future. Other advisors feel, however, that unless the premium subsidy is closer to 67 percent (and under $20 to start), the premium will be too high and the overall attractiveness of the plan could be hampered.

A second, major issue is whether the benefit is capped or covers catastrophic costs. Most policy experts believe that "true insurance" should not have caps and are concerned about capped options that leave the sickest beneficiaries unprotected. The Kennedy-Rockefeller bill, for this reason, includes catastrophic coverage. However, capped drug benefits have the advantage of constraining costs because the government's maximum spending growth is limited while the catastrophic coverage has the potential for more unconstrained growth in the out years.

FINANCING GAP. If all of the advisors' recommendations on key elements were adopted, there would be Medicare savings of about $100 billion over 10 years. This is about $30-90 billion below the cost of the drug benefits being considered. Options to fund this shortfall include one or more of the following:

- <u>Making the drug benefit less generous</u>. The level of the subsidy could be reduced from 67 to 50 percent, raising the premium by roughly $10 per month. One could also reduce the benefits, but most of your advisors believe that further diminishment of the base drug coverage package would be unappealing to beneficiaries and their advocates.

- <u>Increasing provider and/or beneficiary savings</u>: Most of your advisors are loathe to consider additional provider and/or beneficiary savings for fear that it would undermine the political support for the package. However, some would argue that it might be advisable, at least as an initial positioning strategy, to increase these savings (primarily by maximizing the BBA extenders and minimizing the BBA fixes) to avoid using the surplus.

- <u>Including an additional tobacco tax</u>: Because the tobacco tax in our budget is unlikely to be used by the Congress, an additional tobacco tax may not be viewed as a credible financing source. It is also unpopular with the House Democratic leadership. However, the Senate Finance Committee may be more supportive of the tobacco tax than the surplus as a source of funding. A $0.50 tax (on top of your budget's $0.55 tax) would generate about $45 billion in revenue from 2000-09.

* Using the surplus: Using a portion of the surplus dedicated to Medicare solvency for prescription drugs could be justified given the tremendous drop in the Medicare baseline ($240 billion over 10 years from 1998 to 1999). While there are credible arguments for using the surplus, it clearly has to be considered in the broader Social Security / surplus context. Some fear that without more progress on Social Security solvency, tapping any portion of the surplus for prescription drugs before the solvency of Social Security and Medicare has been addressed could strengthen the Republicans' argument for using the surplus to finance a large tax cut.

ILLUSTRATIVE PACKAGES. On the following page, you will find illustrative options that show combinations of drug benefits and additional offsets. Every option includes our recommended "base policy" which reflects the preliminary recommendations of your advisors. It assumes that each drug benefit design has a zero deductible and a 50 percent copayment. The elements of the drug benefit options that affect its cost are: (1) the degree to which it is subsidized (and therefore what the premium would be) and (2) the level to which the benefit is capped or alternatively, whether it provides for any catastrophic protection. It is likely that we will use some version of these options to help focus our discussion with you during the Tuesday Medicare reform meeting.

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THE WHITE HOUSE

WASHINGTON

March 19, 1999

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MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: NEC WEEKLY REPORT

cc: JOHN PODESTA

Agriculture Policy Meeting: On Friday (3/19) we convened an NEC principals meeting to provide a framework for policy options and decisions to assist those farmers and ranchers in need. There was an extended discussion of the budgetary implications of major new initiatives, both in the short term (the need for offsets even for emergencies) and the longer term competition for very limited resources. We are committed to developing a limited range of options very quickly to present to you.

Capital Budget Commission: Next Tuesday (3/23) your Capital Budget Commission, chaired by Kathleen Brown and Jon Corzine, will present its final report to the NEC. The Commissioners are coming to the White House to present the report to Jack Lew, Secretary Rubin and myself. The Commission is not recommending that the government adopt a capital budget. However, they do make a series of specific recommendations aimed at improving the budget process in setting priorities, making budget decisions, reporting the decisions and subsequently evaluating the decisions. For example, they recommend that one or more agencies adopt a "capital acquisition fund" (CAF) for the construction or acquisition of large capital projects. The CAF would receive appropriated funds for capital assets and it would rent these funds out to various programs throughout the agency and charge the equivalent of debt service. The idea would be to charge programs the true cost to improve efficient use of capital and to smooth budget funding spikes. I will make sure that you receive a copy of the report, along with the NEC's analysis of the commission's recommendations.

Social Security: Your economic team continues to meet both internally and with Congressional Democrats to discuss responses to the Republican budget resolutions and overall budget strategy. On Monday, Larry Stein and I met with Congressman Spratt and House Budget staff to discuss a Democratic budget resolution. The House budget resolution follows your Social Security plan in making sufficient transfers to extend the trust fund exhaustion dates of Social Security and Medicare. Later that afternoon, Jack Lew, Larry Stein and I met with a number of Senators, including Senators Daschle, Lautenberg, Conrad, Sarbanes, to discuss amendments Senate Democrats planned to introduce to the Republican budget resolution. The Senate Democratic approach sets aside the Social Security surpluses but does extend the trust fund exhaustion date. It does, however, make transfers to the Medicare Trust Fund from the on-budget surpluses thereby extending the Medicare trust fund to 2020. We will continue to meet and talk with Democratic members to figure out our best possible strategy over the weekend and on Monday; Larry Stein expects legislation to be introduced on Tuesday (3/23).

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EU Aircraft Noise Standard: The NEC held two interagency meetings, including a deputies meeting on Friday (3/19), on the proposed EU noise regulation that would limit the operation of U.S. aircraft equipped with hushkits and re-engineered engines in violation of internationally a standards. Secretary Slater will meet next Tuesday (3/23) and Wednesday (3/24) Kinnock and other EU officials to urge them not to approve the regulation the fol (3/29) as scheduled. The Germans told us privately that they believe they can del somewhat. (Fearing passage of the bill to ground the Concorde, France and the U hard for delay.) In exchange, we will agree to discuss possible "hollowing out" c opposed to its complete withdrawal. Although many in U.S. industry want to ma believe the industry coalition would dissolve if the EU imposed counter-sanction industry would accept a good compromise if we can reach one, which it could tal months to determine. In addition to the interagency meetings, NEC staff met wi British Airways on this issue.

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IT Research Initiative: You should know on Tuesday (3/16) 36 CEOs and senior executives endorsed your call in the State of the Union for a 28 percent increase in long-term information technology research. They also said that the government could continue these increases in 2001 - 2004 -- (doubling IT research over a 5 year period), given that government-supported research has led to say many of the advances that are now driving the U.S. economy.

Bankruptcy Reform: Senators Torrecelli and Biden joined Senators Grassley and Sessions in introducing a bankruptcy reform bill that is modeled after last year's conference report (which the Administration threatened to veto). Torrecelli sent a letter to Grassley that said he cosponsored the bill "because I believe that it is important to begin moving the bill forward in good faith and in a bipartisan manner." He thinks that last year's conference report had abandoned important principles which the new bill "goes far" in restoring. However, he says, there remain "a number of areas in which I think the bill must be improved and will work in the coming weeks to address those areas in further discussion with you, as well as in Committee and on the Floor." His list of concerns include the bulk of our concerns as well.

Apparel Industry Partnership: Since the announcement in October of the agreement to create the new Fair Labor Association (FLA), the AIP has been buffeted by criticism from labor, on the one hand, and competition from less demanding industry sponsored plans. As a result, they have not been able to enlist any new companies thus far. This week, however, AIP got a major shot in the arm when 17 colleges and universities announced that they would join the FLA. The AIP announced that they would amend the by-laws to better incorporate schools as members and to expand the goods covered beyond apparel and footwear to other kinds of collegiate merchandise. Secretary Herman issued a statement praising the schools. The American Council on Education also sent a letter to 1800 universities describing the new arrangement and including a letter from human rights groups urging the schools to join the FLA. The 17 colleges already on board are: University of Arizona, Brown, Columbia, Cornell, Dartmouth, Duke, Florida State, Harvard, Marymount University, Notre Dame, U Pennsylvania, Princeton, Rutgers, Smith College, Tufts, Wellesley, and Yale. We expect many more to join.

THE PRESIDENT HAS SEEN
3-22-99

Don't slow-walk this. it's important.

Oil Producer Meeting: On Tuesday (3/16) the Chief-of-Staff hosted a meeting attended by 20 oil CEOs, myself, and Secretaries Rubin and Richardson to discuss the effect of low oil prices on the domestic oil industry. The oil representatives requested targeted tax relief, relief from expensive environmental regulations and the increased use of cost benefit analysis in the regulatory decision making process. They also expressed concern about the effect of Iraqi oil production on the world market. The NEC committed to running an interagency process to address the proposals brought forward by the Department of Energy and the industry in order to determine what type of assistance to the industry is appropriate. We will keep you informed of the progress of the interagency working group.

Steel: The Visclosky quota bill passed 289-141 (R's 128 no, 91 yes; D's 197 yes, 13 no), however it is not at all clear that it will move in the Senate. On the other hand, Levin- Houghton introduced their legislation Tuesday (3/16), although it is not expected to move in the House they think it might move in the Senate. On Tuesday (3/23), there is the Senate Finance Hearing at which Ambassador Barshefsky and Secretary Daley will testify. You should know that Sandy Levin has asked that they be very forward leaning in support for his and Houghton's legislation. Some of your advisors are concerned about being forward leaning so early, especially having no guarantee that steel legislation of any sort will pass. Instead they think it would make more sense to wait until we discover if possible steel legislation could help to move Fast track.

China WTO Accession: The negotiators are close to being ready to present you and your advisors with some strategic decisions. As you know the foreign policy and economic consequences of completing such a deal are enormous. A small group of your international economic advisors-- Podesta, Barshefsky, Berger, Daley, Rubin, Summers, Albright, Brainard, and Sperling -- have been meeting to develop options for you which we will present to you in a memo early next week. You should know that Congress has already begun to take a position on this issue. Rep. Hutchinson introduced an amendment to the bill that would have required Congress to vote on whether we can support China's accession to the WTO -- this is well beyond the scope of permanent China MFN and we oppose this. It is worth noting that although the ultimate vote was in our favor (69-31) and we were successful in tabling the amendment, however only thirty Republicans voted with us and Rep. Mel Watt voted against us.

International Debt Relief: You should know that reaction to the new debt plan has been mixed. The Africans, NGOs, and Congressional advocates of debt relief have uniformly praised your proposal as a step in the right direction while criticizing it for not going far enough. They are pleased insofar as they view your speech as evidence that you wish to play a leadership role on the subject. However, they are disappointed that the proposal as it now stands a) relaxes the Heavily Indebted Poor Country program's criteria only "in exceptional circumstances" rather than for all countries with unsustainable debts meeting the program's current policy conditions; and b) fails to modify more fundamentally the criteria for determining when a country's debt is unsustainable through consideration of how much of its budget is being devoted to external debt service payments. Rep. Leach has introduced a bill (HR 1095), drafted in cooperation with the NGO community, that offers far broader and deeper relief by taking a different approach in these two respects. However, it is unclear how much Republican support his bill is capable of attracting, particularly in light of its estimated $1 billion cost (over many years).

NEW

March 22, 1999

TO: Gene Sperling
FROM: Jeff Liebman
SUBJECT: Next steps on Social Security

I recommend that we try to do two principals meetings this week on Social Security strategy followed perhaps by a meeting with the President next week.

Meeting 1: Social Security Budget Strategy (Wednesday?)

The attached tables (along with some revised ones that build off of the Senate Democratic plan's pure off budget framework that I hope will be ready sometime tomorrow) show:

1. Even if we charge the on-budget only for the interest on trust fund transfers and not for the transfers themselves, it will be difficult to stay within on-budget surpluses if we want to do anything on the discretionary or tax cut front.

   Implication: we need to have a serious discussion of whether we want to go along with the trend toward taking Social Security off budget. Such a position may be inevitable, but it may also set us up for a train wreck later in the year when Medicare, Social Security, military spending, and tax cuts collide.

2. The pure approaches (tables 4 and 6) get us only to 2038 and 2039 on solvency. (The Liebman/Summers approach might get us a bit further. I'm still waiting for the numbers.)

   Implication: Do we want to risk going with one of the impure approaches and taking a second round of hits on hocus-pocus accounting?

Meeting 2: Social Security Commission Options (Friday?)

Now that the budget resolution process is in full swing, perhaps it is time to start thinking about ways to structure a process that would lead to serious bipartisan negotiations on Social Security reform.

Among the issues to consider are:

- How to send signals to Republicans that we are serious about reform and not simply setting them up.
- How to convince Congressional Democrats that it is better to do reform this year with a Democratic President and budget surpluses than to wait until later.

Table 1:	Take credit for post-2014 fiscal responsibility. "Impure" interest transfers.
Table 2:	Take credit for post-2014 fiscal responsibility. "Pure" interest transfers and truncate in 2014.
Table 3:	After 2014, pay off-debt with portion of interest savings that is due to debt reduction achieved in first 15 years, spend rest of surpluses. "Impure" interest transfers.
Table 4:	After 2014, pay off-debt with portion of interest savings that is due to debt reduction achieved in first 15 years, spend rest of surpluses. "Pure" interest transfers.
Table 5:	After 2014, spend all surpluses. "Impure" interest transfers.
Table 6:	After 2014, spend all surpluses. "Pure" interest transfers.

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TABLE 1
Transfer of Interest Savings Relative to Spend-It Baseline for Social Security
Framework With Continuation of Discretionary and USAs
(Transfer NOT reduced for Trust Fund Interest)
(In billions of dollars)

	Transfer of Interest Savings			On-budget surplus/deficit(-)		Medicare	
	Amount of interest savings	Transfer to OASDI	Cumulative increase in OASDI	Reduced for transfers and interest	Reduced for interest only	transfer from Senate Dem. plan	CBO Delta on-budget
2000	2	2	2	(29)	(27)	0	7
2001	7	7	10	(51)	(44)	3	11
2002	12	12	22	(35)	(23)	18	15
2003	18	18	42	(53)	(35)	15	20
2004	24	24	68	(45)	(21)	20	18
2005	31	31	103	(54)	(24)	32	21
2006	39	39	149	(33)	6	46	13
2007	49	49	207	(25)	24	54	3
2008	60	60	280	(16)	44	58	-10
2009	73	73	370	(7)	66	66	-23
2010	87	87	479	(4)	83	70	-31
2011	103	103	610	(3)	99	73	-37
2012	119	119	766	(7)	112	76	-40
2013	137	137	947	(15)	122	72	-44
2014	155	155	1,157	(31)	124	72	-42
2015	173	173	1,396	(51)	122		
2016	191	191	1,668	(66)	125		
2017	210	210	1,973	(84)	126		
2018	228	228	2,314	(105)	124		
2019	247	247	2,691	(128)	119		
2020	265	265	3,108	(154)	110		
2021	282	282	3,564	(177)	105		
2022	299	299	4,062	(201)	98		
2023	315	315	4,604	(234)	81		
2024	330	330	5,191	(269)	61		
2025	344	344	5,824	(306)	38		
2026	357	357	6,504	(342)	15		
2027	369	369	7,232	(379)	(10)		
2028	380	380	8,010	(416)	(36)		
2029	391	391	8,842	(456)	(65)		
2030	403	403	9,731	(500)	(98)		
2031	414	414	10,679	(540)	(125)		
2032	427	427	11,691	(579)	(152)		
2033	439	439	12,771	(621)	(182)		
2034	452	452	13,922	(667)	(215)		
2035	466	466	15,148	(722)	(256)		
2036	479	479	16,454	(773)	(294)		
2037	493	493	17,845	(821)	(328)		
2038	507	507	19,325	(871)	(364)		
2039	522	522	20,900	(925)	(403)		
2040	537	537	22,575	(988)	(451)		
2041	553	553	24,356	(1,053)	(501)		
2042	568	568	26,249	(1,122)	(553)		
2043	585	585	28,260	(1,196)	(612)		
2044	601	601	30,397	(1,278)	(676)		
2045	618	618	32,666	(1,371)	(753)		
2046	636	636	35,074	(1,472)	(836)		
2047	654	654	37,631	(1,581)	(927)		
2048	672	672	40,343	(1,699)	(1,027)		
2049	691	691	43,221	(1,842)	(1,151)		
2050	710	710	46,274	(1,982)	(1,272)		

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TABLE 2
Transfer of Interest Savings Relative to Spend-It Baseline for Social Security Framework With Continuation of Discretionary and USAs
(Transfer NOT reduced for Trust Fund Interest)
(In billions of dollars)

	Transfer of Interest Savings			On-budget surplus/deficit(-)		Medicare
	Amount of interest savings	Transfer to OASDI	Cumulative increase in OASDI	Reduced for transfers and interest	Reduced for interest only	transfer from Senate Dem. plan
2000	2	2	2	(29)	(27)	0
2001	7	7	10	(51)	(44)	3
2002	12	12	22	(35)	(23)	18
2003	18	18	42	(53)	(35)	15
2004	24	24	68	(45)	(21)	20
2005	31	31	103	(54)	(24)	32
2006	39	39	149	(33)	6	46
2007	49	49	207	(25)	24	54
2008	60	60	280	(16)	44	58
2009	73	73	370	(7)	66	66
2010	87	87	479	(4)	83	70
2011	103	103	610	(3)	99	73
2012	119	119	766	(7)	112	76
2013	137	137	947	(15)	122	72
2014	155	155	1,157	(31)	124	72
2015	173		1,219	127	127	
2016	191		1,284	140	140	
2017	210		1,353	152	152	
2018	228		1,426	163	163	
2019	247		1,503	173	173	
2020	265		1,584	181	181	
2021	282		1,669	195	195	
2022	299		1,758	208	208	
2023	315		1,853	213	213	
2024	330		1,952	218	218	
2025	344		2,057	222	222	
2026	357		2,168	227	227	
2027	369		2,285	233	233	
2028	380		2,407	240	240	
2029	391		2,537	247	247	
2030	403		2,673	252	252	
2031	414		2,817	265	265	
2032	427		2,968	282	282	
2033	439		3,128	299	299	
2034	452		3,296	315	315	
2035	466		3,473	327	327	
2036	479		3,660	347	347	
2037	493		3,856	373	373	
2038	507		4,064	402	402	
2039	522		4,282	431	431	
2040	537		4,512	456	456	
2041	553		4,755	485	485	
2042	568		5,010	515	515	
2043	585		5,280	546	546	
2044	601		5,563	575	575	
2045	618		5,862	598	598	
2046	636		6,178	622	622	
2047	654		6,510	644	644	
2048	672		6,859	664	664	
2049	691		7,228	668	668	
2050	710		7,617	682	682	

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TABLE 3
Transfer of Interest Savings Relative to Spend-It Baseline for Social Security Framework
With Continuation of USAs and Discretionary at Maximum of Plan and Spend-It Baseline
(Transfer NOT reduced for Trust Fund Interest)
(In billions of dollars)

	Transfer of Interest Savings			On-budget surplus/deficit(-)		Medicare transfer from Senate Dem. plan
	Amount of interest savings	Transfer to OASDI	Cumulative increase in OASDI	Reduced for transfers and interest	Reduced for interest only	
2000	2	2	2	(29)	(27)	0
2001	7	7	10	(51)	(44)	3
2002	12	12	22	(35)	(23)	18
2003	18	18	42	(53)	(35)	15
2004	24	24	68	(45)	(21)	20
2005	31	31	103	(54)	(24)	32
2006	39	39	149	(33)	6	46
2007	49	49	207	(25)	24	54
2008	60	60	280	(16)	44	58
2009	73	73	370	(7)	66	66
2010	87	87	479	(4)	83	70
2011	103	103	610	(3)	99	73
2012	119	119	766	(7)	112	76
2013	137	137	947	(15)	122	72
2014	155	155	1,157	(31)	124	72
2015	166	166	1,390	(323)	(157)	
2016	171	171	1,640	(327)	(155)	
2017	177	177	1,910	(327)	(151)	
2018	182	182	2,200	(326)	(144)	
2019	188	188	2,511	(323)	(135)	
2020	193	193	2,844	(318)	(125)	
2021	199	199	3,202	(312)	(113)	
2022	205	205	3,585	(309)	(103)	
2023	212	212	3,995	(303)	(92)	
2024	218	218	4,434	(294)	(76)	
2025	225	225	4,903	(284)	(59)	
2026	231	231	5,404	(289)	(58)	
2027	236	236	5,937	(316)	(79)	
2028	241	241	6,503	(342)	(101)	
2029	246	246	7,105	(371)	(125)	
2030	250	250	7,744	(403)	(153)	
2031	255	255	8,422	(429)	(174)	
2032	259	259	9,141	(453)	(194)	
2033	264	264	9,903	(479)	(216)	
2034	268	268	10,710	(508)	(240)	
2035	272	272	11,565	(544)	(272)	
2036	277	277	12,471	(575)	(298)	
2037	281	281	13,430	(601)	(320)	
2038	285	285	14,444	(628)	(343)	
2039	289	289	15,516	(656)	(368)	
2040	292	292	16,651	(692)	(400)	
2041	296	296	17,849	(728)	(432)	
2042	299	299	19,116	(765)	(466)	
2043	302	302	20,454	(805)	(503)	
2044	305	305	21,867	(850)	(545)	
2045	308	308	23,358	(904)	(597)	
2046	310	310	24,932	(963)	(653)	
2047	312	312	26,593	(1,026)	(714)	
2048	314	314	28,345	(1,096)	(782)	
2049	315	315	30,192	(1,186)	(871)	
2050	316	316	32,140	(1,271)	(956)	

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TABLE 4
Transfer of Interest Savings Relative to Spend-It Baseline for Social Security Framework
With Continuation of USAs and Discretionary at Maximum of Plan and Spend-It Baseline
(Transfer REDUCED for Trust Fund Interest)
(In billions of dollars)

	Transfer of Interest Savings			On-budget surplus/deficit(-)		Medicare
	Amount of interest savings	Transfer to OASDI	Cumulative increase in OASDI	Reduced for transfers and interest	Reduced for interest only	transfer from Senate Dem. plan
2000	2	2	2	(29)	(27)	0
2001	7	7	9	(51)	(44)	3
2002	12	11	21	(35)	(23)	18
2003	18	16	39	(51)	(35)	15
2004	24	21	63	(42)	(21)	20
2005	31	27	93	(50)	(23)	32
2006	39	33	132	(26)	7	46
2007	49	41	181	(15)	25	54
2008	60	49	241	(3)	46	58
2009	73	58	314	10	68	66
2010	87	68	401	18	87	70
2011	103	79	504	25	104	73
2012	119	90	623	29	119	76
2013	137	100	760	30	131	72
2014	155	111	914	24	135	72
2015	166	114	1,080	(256)	(142)	
2016	171	110	1,252	(247)	(137)	
2017	177	107	1,428	(234)	(128)	
2018	182	103	1,611	(219)	(116)	
2019	188	99	1,798	(200)	(101)	
2020	193	94	1,992	(178)	(84)	
2021	199	90	2,191	(154)	(64)	
2022	205	85	2,397	(131)	(46)	
2023	212	81	2,608	(105)	(24)	
2024	218	76	2,827	(74)	2	
2025	225	71	3,051	(39)	32	
2026	231	65	3,282	(19)	46	
2027	236	58	3,519	(19)	39	
2028	241	51	3,760	(17)	34	
2029	246	42	4,005	(15)	28	
2030	250	34	4,256	(14)	20	
2031	255	25	4,510	(6)	20	
2032	259	16	4,769	7	23	
2033	264	7	5,033	19	26	
2034	268	0	5,304	29	29	
2035	272	0	5,589	26	26	
2036	277	0	5,889	30	30	
2037	281	0	6,206	41	41	
2038	285	0	6,539	53	53	
2039	289	0	6,891	65	65	
2040	292	0	7,261	71	71	
2041	296	0	7,651	80	80	
2042	299	0	8,063	90	90	
2043	302	0	8,496	99	99	
2044	305	0	8,953	106	106	
2045	308	0	9,434	106	106	
2046	310	0	9,941	104	104	
2047	312	0	10,475	100	100	
2048	314	0	11,038	93	93	
2049	315	0	11,632	68	68	
2050	316	0	12,257	52	52	

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TABLE 5
Transfer of Interest Savings Relative to Spend-it Baseline for Social Security Framework
With Continuation of USAs and Discretionary at Maximum of Plan and Remaining Surplus
(Transfer NOT reduced for Trust Fund Interest)
(In billions of dollars)

	Transfer of Interest Savings			On-budget surplus/deficit(-)		Medicare
	Amount of interest savings	Transfer to OASDI	Cumulative increase in OASDI	Reduced for transfers and interest	Reduced for interest only	transfer from Senate Dem. plan
2000	2	2	2	(29)	(27)	0
2001	7	7	10	(51)	(44)	3
2002	12	12	22	(35)	(23)	18
2003	18	18	42	(53)	(35)	15
2004	24	24	68	(45)	(21)	20
2005	31	31	103	(54)	(24)	32
2006	39	39	149	(33)	6	46
2007	49	49	207	(25)	24	54
2008	60	60	280	(16)	44	58
2009	73	73	370	(7)	66	66
2010	87	87	479	(4)	83	70
2011	103	103	610	(3)	99	73
2012	119	119	766	(7)	112	76
2013	137	137	947	(15)	122	72
2014	155	155	1,157	(31)	124	72
2015	164	164	1,387	(428)	(264)	
2016	164	164	1,630	(429)	(265)	
2017	164	164	1,885	(427)	(263)	
2018	164	164	2,155	(422)	(259)	
2019	164	164	2,439	(416)	(252)	
2020	164	164	2,738	(407)	(243)	
2021	164	164	3,053	(396)	(233)	
2022	164	164	3,385	(387)	(224)	
2023	164	164	3,735	(377)	(213)	
2024	164	164	4,104	(361)	(198)	
2025	164	164	4,493	(344)	(180)	
2026	164	164	4,902	(325)	(162)	
2027	164	164	5,334	(306)	(142)	
2028	164	164	5,789	(308)	(143)	
2029	165	165	6,270	(330)	(165)	
2030	166	166	6,778	(356)	(190)	
2031	166	166	7,313	(374)	(208)	
2032	167	167	7,877	(391)	(224)	
2033	167	167	8,471	(409)	(242)	
2034	166	166	9,097	(429)	(262)	
2035	166	166	9,756	(454)	(289)	
2036	165	165	10,450	(475)	(310)	
2037	163	163	11,179	(489)	(326)	
2038	162	162	11,946	(503)	(342)	
2039	159	159	12,752	(519)	(359)	
2040	157	157	13,598	(540)	(383)	
2041	154	154	14,487	(560)	(406)	
2042	150	150	15,420	(580)	(430)	
2043	146	146	16,399	(603)	(456)	
2044	142	142	17,426	(628)	(486)	
2045	136	136	18,503	(661)	(525)	
2046	130	130	19,631	(697)	(567)	
2047	124	124	20,813	(736)	(613)	
2048	116	116	22,051	(780)	(664)	
2049	108	108	23,347	(843)	(735)	
2050	99	99	24,703	(897)	(798)	

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TABLE 6
Transfer of Interest Savings Relative to Spend-It Baseline for Social Security Framework With Continuation of USAs and Discretionary at Maximum of Plan and Remaining Surplus
(Transfer REDUCED for Trust Fund Interest)
(in billions of dollars)

	Transfer of Interest Savings			On-budget surplus/deficit(-)		Medicare transfer from Senate Dem. plan
	Amount of interest savings	Transfer to OASDI	Cumulative increase in OASDI	Reduced for transfers and interest	Reduced for interest only	
2000	2	2	2	(29)	(27)	0
2001	7	7	9	(51)	(44)	3
2002	12	11	21	(35)	(23)	18
2003	18	16	39	(51)	(35)	15
2004	24	21	63	(42)	(21)	20
2005	31	27	93	(50)	(23)	32
2006	39	33	132	(26)	7	46
2007	49	41	181	(15)	25	54
2008	60	49	241	(3)	46	58
2009	73	58	314	10	68	66
2010	87	68	401	18	87	70
2011	103	79	504	25	104	73
2012	119	90	623	29	119	76
2013	137	100	760	30	131	72
2014	155	111	914	24	135	72
2015	164	112	1,078	(361)	(250)	
2016	164	103	1,242	(350)	(247)	
2017	164	94	1,405	(335)	(240)	
2018	164	86	1,569	(317)	(231)	
2019	164	77	1,733	(295)	(218)	
2020	164	69	1,896	(271)	(203)	
2021	164	60	2,060	(246)	(185)	
2022	164	52	2,224	(219)	(167)	
2023	164	43	2,387	(190)	(147)	
2024	164	34	2,551	(156)	(122)	
2025	164	26	2,715	(119)	(93)	
2026	164	17	2,878	(79)	(62)	
2027	164	9	3,042	(38)	(29)	
2028	164	1	3,207	(17)	(16)	
2029	165	0	3,379	(22)	(22)	
2030	166	0	3,560	(30)	(30)	
2031	166	0	3,752	(31)	(31)	
2032	167	0	3,954	(28)	(28)	
2033	167	0	4,166	(27)	(27)	
2034	166	0	4,390	(27)	(27)	
2035	166	0	4,626	(31)	(31)	
2036	165	0	4,875	(30)	(30)	
2037	163	0	5,137	(22)	(22)	
2038	162	0	5,413	(13)	(13)	
2039	159	0	5,704	(4)	(4)	
2040	157	0	6,010	(0)	(0)	
2041	154	0	6,333	6	6	
2042	150	0	6,674	12	12	
2043	146	0	7,032	18	18	
2044	142	0	7,410	21	21	
2045	136	0	7,809	17	17	
2046	130	0	8,228	11	11	
2047	124	0	8,671	3	3	
2048	116	0	9,137	(8)	(8)	
2049	108	0	9,628	(38)	(38)	
2050	99	0	10,145	(58)	(58)	

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THE WHITE HOUSE

WASHINGTON

March 29, 1999

BRIEFING AND REMARKS ON ANNUAL REPORT ON THE STATUS OF THE SOCIAL SECURITY AND MEDICARE PROGRAMS

DATE: March 30, 1999
TIME: 2:15-3:00pm
LOCATION: Rose Garden
FROM: Gene Sperling

I. PURPOSE

To review and comment on the Annual Report of the Social Security and Medicare Trustees. There will be audience of approximately 60 guests (Staff from Treasury, HHS, Labor, OMB and SSA).

II. BACKGROUND

Each year, the Trustees of the Social Security and Medicare trust funds report in detail on their financial condition. The reports describe their current and projected financial condition, within the next ten years (the "short term") and over the next 75 years (the "long term.") Tomorrow morning, the Trustees vote out the report and release it to the public.

We do not receive any advance notice of the conclusions in these reports until they are made public tomorrow. The Administration Trustees will brief you on the conclusions of the report before you speak. For Social Security, we expect that the continued strong economy and the incorporation of recent BLS methodological changes in the CPI will produce a modest improvement in the 75-year actuarial imbalance and in the trust fund exhaustion date. For Medicare, based on recent CBO re-estimates, we expect a more substantial improvement. The robust economic performance has resulted in higher-than-expected payroll tax revenues. In addition, there were lower-than-expected expenditures due in part to the continuing implementation of the Balanced Budget Act of 1997 reforms, low increases in health care costs more generally, and the success of efforts to combat waste, fraud and abuse in the Medicare program.

III. PARTICIPANTS

<u>Event Briefing</u>
-Secretary Rubin
-Secretary Shalala
-Secretary Herman
-Deputy Secretary Larry Summers
-Ken Apfel

-Gene Sperling
-Jack Lew
-Sylvia Mathews
-Chris Jennings
-John Podesta
-Ron Klain
-Larry Stein
-Paul Glastris

IV. SEQUENCE OF EVENTS

- <u>YOU</u> will be briefed in the Oval Office by the Trustees on their annual report.

- <u>YOU</u> will be announced into the Rose Garden and the trustees will take their place behind you on the steps.

- <u>YOU</u> will make your remarks to the guests and press corps

- <u>YOU</u> and 4 Trustees depart.

V. PRESS COVERAGE

Open

VI. REMARKS

To be provided by speechwriting.

March 4, 1999

TO: Gene Sperling
FROM: Jeff Liebman
SUBJECT: Gensler memo on equity issues

This memo by Gary Gensler provides useful background on issues we will have to resolve to fully implement trust fund investments in equities. It would make good weekend reading.

FRAMEWORK FOR INVESTING SOCIAL SECURITY IN EQUITIES

This paper describes a possible set of rules for investing the Social Security trust funds in equities. The framework we describe is intended to promote discussion; it is not intended to represent policy prescriptions.

The Administration has already laid out five core principals for investing the Social Security trust funds in equities:

- private sector managers selected by competitive bidding
- independently managed and non-political
- limited size of equity investment
- broad-based, neutral and non-discretionary
- lowest-cost

The framework described in this paper suggests possible answers to a number of additional questions:

- What equities would be eligible for trust fund investment?
- Should the trust funds invest in foreign equities?
- How should illiquid securities be addressed?
- Should the government use a privately-published index, or develop its own equity index?
- What characteristics should an equity index have?
- How should private sector managers track an equity index?
- Should stock lending be allowed?
- How would investments and disinvestments be scheduled?
- Are dividends and the proceeds from corporate actions reinvested?
- Should investment managers' actions be transparent to the market?
- What would the independent board look like?

There are four additional issues for which we have laid out options, without suggesting a preferred path.

- Should the trust fund portfolios be rebalanced and, if so, how?
- How should proxies be voted?
- What level of discretion should be left to the independent board and private investment managers?
- How would trust fund equity investments interplay with design of USA accounts?

What Equities Would Be Eligible for Trust Fund Investment?

The eligible equities should have certain desirable characteristics. These would include being common stock and publicly-traded, and having certain liquidity characteristics. This framework rules out privately-traded equities because we do not want to force private entities to sell stock to the government. Liquidity issues will be discussed in detail below.

IPOs warrant special treatment. The trust funds should participate in IPOs, although with the understanding that managers might not be able to obtain sufficient shares in the first day. The independent board could be given discretion concerning the length of time allowed for investing in IPOs.

Should the Trust Funds Invest in Foreign Equities?

This framework suggests that the trust funds should invest only in US equities, for the following reasons:

- There may be concerns that foreign accounting standards, commercial codes, contract law, and stock market regulation are in some cases different from U.S. standards and rules.
- If a decision was made to buy any foreign equities, foreign policy considerations would require investing in every foreign stock market. This could raise both transactions costs and political issues.
- There could be increased currency risk inherent in ADRs and other foreign equities. The liabilities of the Social Security trust funds are in US dollars. Some might argue that US firms with overseas operations are subject to currency risk, but the resulting currency risk is generally smaller in proportion to the firms' size, and is often hedged by the firms.

The drawbacks to investing only in US stocks include (i) less diversification and (ii) the perception that political factors are behind the decision to invest only in US companies. Note also that political problems could arise when US firms such as Chrysler merge with foreign entities, and are dropped from an index.

How Should Illiquid Securities Be Addressed?

Liquidity problems are likely to arise with nationally-traded stocks at the lower end of market capitalization, and among regionally-traded stocks. This is because of private holdings and cross-holdings among smaller firms.

Market float is generally consistent with liquidity. Market float is the number of shares which are presumed to be available in the market for trading. It is generally calculated by excluding the largest shareholders (over 5%) and the insiders (the Ford family for Ford Motor Company, or Bill Gates for Microsoft). Although float can be used to approximate liquidity, a small float in the stocks of a large corporation might satisfy market demand more readily than a large float in the stocks of a small corporation.

The 7200 stocks in the Wilshire 5000 have an average float of 91% (the Wilshire index excludes stocks that have not traded in the past five days). This broad average hides some important detail, however. According to Wilshire, when ordered by percentage float, the highest 40% of stocks have an average float of more than 90% (these stocks account for 75% of market capitalization). The bottom 20% of stocks, ordered by percentage float, have less than 50% float (these stocks account for 4.5% of market capitalization).

We may want to develop a rule that screens out small float stocks. Such a rule could be based on estimates of market float or on trading history. For example, Wilshire screens out equities that have not traded in the past five days.

Should the Government Use a Privately-Published Equity Index, or Develop Its Own Equity Index?

We would lean against creating our own total market index. A government-sponsored index could be subject to, or could appear to be subject to, political pressures. In contrast, private indices have the benefit of distance.

Some of the same concerns about political pressure could also apply to a private index. There may also be reluctance to cede decision-making to a third party with no contractual relationship to the government. To address these concerns, we could give the independent oversight board discretion to change the index used by private managers (see below). The track record of the Wilshire 5000 to date seems fairly reassuring: Wilshire Associates have changed the parameters of the Wilshire 5000 (to exclude foreign firms) only once in the 25 years of the index' existence. We do not know the history of changes in other broad market indices.

A benefit of creating a government index would be that the government could control the qualities of the index. The qualities of a government-created index could be expressed clearly and simply in statute.

What Characteristics Should an Equity Index Have?

A widely used, total market index would appear to best meet the administration's stated goals of broad-based, neutral, non-discretionary and lowest-cost. A total market index would be market-neutral. It would also offer the least scope for political influence concerning which sector(s) or where to set the bar on market capitalization. Total market indices also offer the greatest diversification. Indices that focus on the top 500 by market capitalization do not pick up small cap firms, which at time have outperformed the large cap firms. In addition, sectoral indices may have higher turnover than broader indices as equities enter and leave the index. By requiring that the index be "widely used," we would reduce some the possibility for altering existing private indices to fit political criteria.

Among total market indices, the Wilshire 5000 includes US-domiciled, nationally-traded stock that has traded in the last five days. The Wilshire 5000 covers more than 99% of market capitalization. The Vesteck Allshares is a total market index that includes foreign firms that are also in the S&P500, but excludes stocks that have not traded in the past 30 days. The Wilshire and Vesteck indices are both weighted by market capitalization. Solomon's world equity index covers all world stock markets.

Barclays has developed its own proprietary total market index of 5300 stocks which is float-weighted (it adjusts market capitalization for cross-holdings and private holdings) and excludes REITS, stocks under $1 and pink sheet (regional) stocks.

The Russell 3000 index is a float-weighted index that represents approximately 98% of market capitalization. The bar for inclusion in the Russell 3000 is based on total market capitalization; however when the index is compiled, the market capitalization figure is adjusted for cross-holdings and private holdings (float-weighted). The Russell 3000 excludes foreign companies but not REITS. The index is updated once a year (which could require the trust funds to buy and sell substantial amounts of stock at that time) through a very transparent process.

The S&P 500 represents about 70% of market capitalization. About 85% of market capitalization is covered by the S&P "Supercomposite" index, which adds the S&P Midcap and Smallcap indices to the S&P 500. The S&P Supercomposite index, like its S&P component indices, excludes REITs and foreign stocks except for grandfathered foreign equities.[1] The equities included in the S&P indices are chosen by a committee of S&P 500 executives and analysts; while S&P has broad guidelines for market capitalization cutoffs, the committee does not always observe these guidelines. This could create political difficulties.

The principle drawback to a total market index is that there can be less liquidity among smaller firms, due to private holdings or cross-holdings.

How Should Private Sector Managers Track an Equity Index?

Managers who track an index such as the S&P 500 generally buy every stock in that index. Tracking a total market index is more difficult, however, because of higher transactions costs and liquidity problems at the lower end of the index.
This framework suggests that managers fully replicate the chosen index, for example, by buying all 7200 stocks in the Wilshire 5000. Full replication would avoid political problems that could

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[1] As a consequence of grandfathering, the S&P 500 includes about 10 foreign equities, some of which are Royal Dutch, Unilever, Seagram, Northern Telecom, McDermott and Schlumberger. The decision to exclude foreign equities was made in 1994.

attend choosing from among the equities included in an index.

Full replication may be expensive, however, due to liquidity problems at the lower end of the market, as discussed earlier. Under a policy of complete replication, it might cost roughly 5-10 bps to invest each new increment of trust fund assets into equities (the average cost for managing the entire portfolio, including specials and already-invested equities, would be lower). This estimate, which might be conservative, assumes that purchasing the last 1% of the index might push the prices of these stocks 5-10% higher.

"Optimization" is the solution used by many private managers for the liquidity problems. As one example of "optimization," Vanguard's broad index fund buys the top 1,200 of the Wilshire 5000 (95% of the market), and then uses sampling techniques to select 2000 more stocks that perform like the residual 6300 Wilshire stocks. Vanguard then buys three-plus-fold of these selected stocks.

We see a number of drawbacks, however, to this method. First, managers' models could be influenced by government or independent groups to favor a sector or region, or could be accused of doing so. Second, optimization requires doubling up (or tripling, or more) on the purchases of certain stocks. This could have a non-neutral impact on the market, and it could also raise major governance concerns at the 5% and 10% shareholding levels. Some have suggested that optimization and full replication methods have virtually identical long-term performance, because the lower transactions costs of optimization (higher ownership of selected stocks, fewer proxies to vote, fewer corporate actions) are offset by having to buy more of a more limited basket of stocks.

Should Stock Lending Be Allowed?

This framework envisages permitting private sector managers to lend out the trust fund equity holdings. Lending equities may be worth between 2-4 bps. Disadvantages of stock lending include the perception that it facilitates short-selling, and the assumption by the trust funds of some limited credit risk.

How Would Investments and Disinvestments Be Scheduled?

The independent board or government would need to project, on at least an annual basis, the size of the trust fund (based on projected equity returns, returns on the specials, new transfers to the trust funds, payroll taxes and benefit payments) and develop a plan for investing or disinvesting over the year. Equity market yield estimates should be based on long-term growth rate of equities, so that the estimates don't change from year to year. If it is anticipated that the overall size of the trust fund portfolio would go down over the year, then the trust fund would need to sell equities to help maintain the target equity allocation. These estimates would be performed by the independent board or government yearly. New transfers, investments and disinvestments then would be pro-rated equally over the twelve months. An issue would remain as to how private sector managers would then spread investments and sales within each month.

Are Dividends and the Proceeds From Corporate Actions (Mergers) Reinvested?

There would be cash return on the investments from dividends and due to mergers, acquisitions, and other corporate events. This cash would be reinvested unless the fund is already at the target asset allocation.

Should Investment Manager's Actions be Transparent to the Market?

There should be transparency in the dates and amounts invested (or disinvested), because large price swings could cause market anxiety. The rules should be clear and predictable, and planned purchases and sales should be announced and well understood by the market. The government should announce monthly investment (or disinvestment) amounts, although managers could be given discretion to smooth the investments (or equity sales) over the course of the month. As any pre-announced purchase (sales) amounts would be based on estimates, we would also need to announce any subsequent revisions and changes to the investment schedule.

Others have argued that transparency would allow the market to position itself. It is likely, however, that the market would be able to guess the amounts of investments (disinvestments) from the legislation or from payroll (equity returns) data.

What Should the Independent Board Look Like?

Members of the independent oversight board should have public stature, they should have a private sector background, and they should be presidentially-appointed and senate-confirmed. They should have long, over-lapping terms (a staggered board). Legislation creating the TSP Board could serve as a model.[2] We believe that legislation should specify that the Board's sole fiduciary responsibilities should be to Social Security beneficiaries.

One additional question is whether the Board should be given sole fiduciary responsibility to beneficiaries, similar to ERISA, or whether the responsibility should be to the trust funds. The Social Security Trust funds are a defined benefit plan, unlike the TSP plan, which is a defined contribution plan. Another question is whether current government employees or administration

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[2] The TSP board consists of 5 part-time members and 1 full-time executive director. All 5 board members who serve part-time are appointed by the President and confirmed by the Senate for overlapping four-year terms (although they serve until replaced). One board member is recommended by the Speaker, one by the majority leader, and the rest are recommended by the White House. The part-time members are only paid for days when they actually do work related to the TSP board; this includes about eight board meetings per year, which in the past have been conducted by conference calls. The Executive Director who serves full time is selected and approved by the Board by a vote with at least three members voting in favor. The Executive Director is the CEO and has an unlimited term.

officials could participate on the Board. Our framework suggests that Board members come only from the private sector.

ISSUES THAT REQUIRE FURTHER DISCUSSION

Four key questions remain. First, we will need to decide whether to rebalance the portfolio between the bond and equity allocations and, if so, how frequently the portfolio should be rebalanced. Second, should proxies be voted? Third, what level of discretion should be left to the independent board and private investment managers? Fourth and finally, we need to discuss how trust fund equity investments might interact with USA account investments.

Should the Trust Fund Portfolio be Rebalanced and, if so, How?

After the trust fund allocation to equities reaches the desired target (14.6%), stock price movements can be expected to alter the portfolio allocation between stocks and specials in the trust fund. The value of the par-based special bonds will not change, although there is some reinvestment risk. Whether to rebalance to maintain a constant allocation to equities and, if so, the frequency of rebalancing and the time allotted to managers to complete the rebalancing, will need to be discussed.

Rebalancing would ensure that the 14.6% allocation to equities in the trust funds's portfolio is closely observed. This could be especially important during periods of rising share prices, when the equity side of the portfolio could become disproportionately large and raise concerns about risk to the portfolio. Rebalancing, however, has a number of disadvantages:

- Rebalancing may increase portfolio risk, and frequent rebalancing may raise portfolio risk even higher. The trust funds could theoretically lose a value greater than its original purchases to reach the equities allocation, if the market declines slowly and the portfolio is rebalanced often.[3]
- Rebalancing may have a countercyclical influence on the market, given the size of potential government sales and purchases. In rising equity markets, the trust funds would need to sell equities to maintain a constant allocation, and vice versa.
- Rebalancing could increase transactions costs, depending on the size of the purchases and sales.
- Rebalancing could have significant implications for Treasury's debt management functions, because it would require frequent adding to or subtracting from publicly held debt.
- Rebalancing could possibly be affected by statutory debt limit.

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[3] As stock prices fall, the trust fund must sell bonds to buy stock to restore the desired allocation to stock. As stock prices fall again, the trust fund must sell more bonds to buy more stock.

These disadvantages can be mitigated to some extent by allowing managers to trade in a band around the target allocation to equities, and by allowing a longer period for rebalancing.

- Option 1: Rebalance within a band (+/- 2%) around the target allocation (14.6%) to equities, with 30 days to complete the rebalancing. Allowing managers to trade in a band around the 14.6% equity allocation would reduce the need to rebalance. The exact width of the rebalancing band would need to be calculated based on the specific characteristics of the trust funds' assets (how much the markets in question trend, and if so, how much they come back to a mean growth rate).[4] Some investment managers rebalance to the top of a band, others to the mid-point of the band, and still others to the "first quarter" of the band, viz. 13.75% of the total trust fund for a band between 13.5% and 15.5%.

- Option 2: Modest rebalancing by not reinvesting dividends and by using scheduled divestitures. Modest rebalancing could be accomplished by using cash flow to the trust funds (dividends and corporate actions). Dividends would not be reinvested if the target allocation was reached. During the disinvestment phase, rebalancing could also be addressed by scheduled sales of equities as outlined in the framework above.

  This modest rebalancing would avoid the some of the disadvantages listed above. It could, however, result in the trust funds holding more (or less) than 14.6% of assets in equities, in an environment of rising (or falling) equity prices.

How Should Proxies be Voted?

Legislation should specify how proxies will be voted. Options are:

- Proportional Voting. The trust fund investment managers could be instructed to vote proportionately to other shareholders' votes. A drawback to this approach is that we might have to change many states' laws in order to facilitate proportional voting. Further research is needed on this issue.

- Delegate to Investment Managers. Voting rights could be delegated across multiple investment managers, who would vote shares in interests of shareholders. Investment managers would be given a standard for how to vote, i.e. in the best interests of beneficiaries or an ERISA standard. This could be coupled with a rule that no manager could have more than 1% of the market.

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[4] Wilshire Associates (which publishes the Wilshire 5000) simulated different rebalancing scenarios for a fund with a target allocation of 85% in corporate bonds and 15% tracking the S&P 500 equity index. Wilshire compared the consequences of end-month rebalancing to maintain a constant 15% allocation to stocks, to bands of 1%, 3% and 5% around the target allocation. Wilshire concluded in favor of a broad trading band (+/- 5%) around the target allocation to equities (a rebalancing range between 10% and 20%). There were some differences, however, between Wilshire's simulation and the Trust Funds' circumstances that could reduce the size of the band.

What Balance Should We Strike Between Rules and Discretion in the Actions of the Board and the Independent Managers?

The independent board could have limited discretion, by giving it only minimum responsibilities for choosing investment managers and ensuring that the managers comply with all statutes. Alternatively, we could allow for some discretion in the activities of the independent board and the private sector investment managers. Various options include:

- Discretion Limited to Hiring and Monitoring Private Sector Managers. The board's responsibilities would be limited to:
  - choosing investment managers through a competitive bidding process;
  - deciding whether the TSP and USA account managers should be excluded;
  - ensuring that the managers comply with all statutes; and
  - monitoring private managers performance.
  - deciding on the number of private sector managers;
  - setting threshold requirements for private sector managers (e g., experience, minimum capital, and U.S.-domiciled);

- Discretion Also Includes Issues Related to the Index (possible middle ground): The Board could be allowed some limited additional discretion, such as:
  - choosing an index that meets requirements that are specified in legislation or regulation -- this would allow for flexibility to respond to changes to, or even the disappearance of, a published index;
  - choosing the width of the band in which managers can trade around the target allocation to equities and various other rebalancing rules;
  - resolving issues related to IPOs and divesting merger proceeds;
  - possibly setting rules for when companies join or leave the index; and
  - setting guidelines for private sector managers' commission arrangements with brokerage firms.

- Broader Discretion. Among the possibilities would be to allow the board to decide, in addition to the minimum duties listed above:
  - whether to invest in foreign stocks;
  - whether investment managers should completely replicate an index versus "optimization;"
  - if and how to create a government index; and
  - if and how to set liquidity targets.

How will equity investments by the trust funds interplay with design of USA accounts?

- Both the USA accounts and the trust funds may use the same total market equity index. This could create further competition at the lower, and more illiquid, end of the index.

- The independent boards that manage USA accounts and the Social Security trust funds will probably be very similar (same personnel qualifications, same responsibilities for hiring private sector managers). This is probably appropriate.

- Would we want to use a trust fund investment manager who was also a manager of default USA accounts?

April 5, 1999

MEMORANDUM TO GENE SPERLING

FROM: Natasha Bilimoria

SUBJECT: BRT Retirement Income Security Principals

Below you will find the key components of the Business Roundtable's principals on the 3 main sources of retirement income:

- Social Security
- Employer Pensions
- Individual Savings

Attached is a copy of the full text for your convenience.

BRT supports policies that will foster growth of employer-provided pensions, encourage personal savings and ensure the financial viability of Social Security.

BRT's general principals regarding retirement income security:

- Individuals must assume greater responsibility for their retirement.

- Government should provide a floor of financial support in retirement through the Social Security program but provide incentives for individuals to save on their own.

- Tax policy must continue to encourage employer-sponsored retirement plans as well as individual savings.

Social Security

- **Need for Reform.** Social Security must be reformed sooner rather than later so that individuals have time to adjust and plan ahead for their retirement security.

- **Social Security and the Budget.** Elimination of the federal deficit is important but must be done in conjunction with maintaining the financial integrity of the Social Security trust funds.

- **Affordable Benefits.** Social Security benefits should be reexamined to fit the demographic and economic realities currently facing the country as well as the needs of current and future retirees. Social Security should balance these sometimes competing needs.

- **Reasonable Financing.** Individuals and employers must continue to share in the financing of Social Security. Raising the payroll tax is not the answer to the Social Security problem

- **Funding the system.** The Social Security system should move from an inter-generational transfer program to one that is more fully funded. By beginning to accumulate real savings and by budgeting responsibly to meet the government's retirement commitments, economic growth can be generated making it easier to support an aging population.

- **Alternative solutions.** Creative solutions, including proposals which allow individuals to invest a portion of their Social Security taxes in the private market should be examined.

Employer-Provided Retirement Plans

- **Employer Objectives.** In order to compete effectively, employers must be able to design both DB and DC plans without costly and unreasonable administrative requirements. Such requirements restrict employer-provided plans and should be eliminated.

- **Flexibility to Adapt.** Employers should tailor their plans to meet the needs of their employees.

- **Appropriate Tax Treatments.** Government should continue to encourage employer/employee retirement savings plans though judicious use of the tax system (i.e. employer contributions are fully deductible, accumulation of benefits on a tax-deferred basis). Reform proposals must be evaluated for their impact on employer-provided retirement savings.

- **Portable Pensions.** Government should foster an environment, without mandates, that encourages employers to make their DC plans fully portable.

- **Prudent Management.** Employers must continue to have the freedom and the sole responsibility to invest retirement fund assets within their control in the best economic interest of the plan's participants and beneficiaries.

Individual Savings/Investment

- **Personal Responsibility.** Individuals and families must assume primary responsibility for their retirement.

- **Long-Term Savings.** Tax system should provide incentives for long-term retirement savings. (i.e. IRA opportunities should be expanded within reasonable budgetary constraints).

- **Appropriate Tax Treatment.** Government should encourage individual savings through the tax system (i.e. individual contributions to retirement programs should be fully deductible and accumulate on a tax-deferred basis).

- **Preservation of Retirement Savings.** Tax policy should discourage premature withdrawal of retirement savings for non-retirement purposes.

- **Financial Planning.** Government should support national campaign to promote individual responsibility to plan for retirement.

STATEMENT OF GENE SPERLING
ASSISTANT TO THE PRESIDENT FOR ECONOMIC AFFAIRS
June 9, 1998

The President is deeply committed to leading world efforts to eradicate child labor. The President applauds Senator Harkin for his persistent and urgent efforts to put this issue on the U.S. and world agenda. In his State of the Union address, President Clinton promised to ask other nations to join the United States "to fight the most intolerable labor practice of all -- abusive child labor."

This week, he took further steps to fulfill that commitment.

- First, President Clinton sent Labor Secretary Alexis Herman to Geneva to the annual meeting of the International Labor Organization with direct instructions to enlist the support of all ILO members in negotiating and adopting a convention designed to eliminate the most abusive forms of child labor -- forced or indentured work, work in hazardous conditions, and work by very young children. The United States' negotiating team, lead by Secretary Herman herself, will work with business, labor, and government representatives to the ILO to frame a targeted convention that can be widely ratified and effective in its purpose.

- Second, the President concurred in Secretary Herman's recommendation that we lead by example. Thus, we announced the Administration's support for Senator Harkin's efforts to modernize the domestic agricultural child labor laws. Secretary Herman and her team will work with Senator Harkin to find the right formula, but the goal must be clear: we will not tolerate even one child in the United States working under abusive conditions. Children should be laboring in the classroom -- not the factory or field.

These steps build on the President's earlier request that Congress: (1) increase 10-fold, to $30 million, the U.S. support for the International Programme for the Elimination of Child Labor (IPEC); (2) increase by $50 million funds for the Migrant Education Program to provide special services to migrant child and test new programs to get school age youth out of the fields; and (3) to increase the Department of Labor's budget by $4 million to enhance enforcement of child labor laws in the agricultural sector. The President will continue to call upon world leaders to join him in the fight against child labor, as he did in his remarks at the Summit of the Americas.

VI. Conclusion

Child labor is a complex problem that requires comprehensive, multi-faceted solutions. This report has described some of the major strategies that are now being undertaken by governments and nongovernmental actors to eliminate child labor. Chapter II described the nature and extent of child labor in the 16 countries studied in this report: **Bangladesh, Brazil, Egypt, Guatemala, India, Kenya, Mexico, Nepal, Nicaragua, Pakistan, Peru,** the **Philippines, South Africa, Tanzania, Thailand, and Turkey.** Chapters III and IV addressed two of the most basic and traditional governmental approaches to preventing the premature entry of children into the work force: the enactment and enforcement of child labor legislation and the provision of universal, affordable primary education. Chapter V described targeted projects, implemented or advanced by governments, that focus on removing children from exploitative work and providing them with educational opportunities. These projects, often involving partnerships among governmental and nongovernmental actors, frequently complement efforts in law enforcement and education.

A. Child Labor in the World

While poverty is the reason most often given for why children work, child labor also perpetuates poverty, since children who must begin work at an early age often compromise their future earnings potential. Today, hundreds of millions of children are working around the world, often in occupations that are clearly harmful to their health and future development. Many millions of these children work full time and in dangerous or abusive conditions, deprived of opportunities for education and the accompanying promise of a better future.

As explained in Chapter II, child laborers are seldom found in large and medium-sized enterprises, except in commercial agriculture. Child laborers most often work in small workshops, home-based operations, informal mining and quarrying enterprises, and a myriad of service sector jobs—usually out of reach of legislation and labor inspection. Some children work in occupations that are especially hidden from the view of enforcement authorities and society, such as domestic servants and child prostitutes. These children, usually separated from their families, often suffer the worst exploitation.

The magnitude of the global child labor problem has grabbed the attention of the international community over the past few years, provoking worldwide discussion of the issue. This represents an important change from a decade ago, when few governments or organizations even acknowledged the problem. Today, numerous international organizations, governments in developing and industrialized countries, and nongovernmental actors are developing and implementing strategies and initiatives to address child labor

B. The Importance of Reliable Child Labor Data

Accurately identifying the extent of child labor within a country is an essential step towards the development of effective strategies for eliminating and preventing the problem. As discussed in Chapter II, there is a great need for reliable child labor data—not only to assist governments in developing solutions but also to enable them to monitor progress. Significant problems in the collection and reporting of child labor data remain, but with the assistance of the International Labor Organization (ILO), efforts are now underway to improve data quality.

Some of the efforts being undertaken by individual countries to improve the accuracy of child labor data include:

- conducting specialized national child labor surveys with the assistance of the ILO;
- using standard definitions and methodology for collecting and reporting child labor data, based on those developed by the ILO's SIMPOC program and tested in several countries; and
- institutionalizing the regular collection of child labor data by integrating a child labor component into periodic labor force surveys.

C. Enactment and Enforcement of Child Labor Laws

As described in Chapter III, all 16 countries studied for this report have laws prohibiting certain forms of work by children under a specified age and regulating the conditions of work for older children. Many of these countries have also ratified a number of international instruments addressing child labor, including ILO Convention No. 138 (Minimum Age for Employment) and the U.N. Convention on the Rights of the Child (CRC).

Chapter III outlined the basic and hazardous minimum work ages in each of the 16 countries, while Appendix D identified relevant child labor provisions in the laws of each of these countries. The minimum age for employment in these countries varies from 12 (**Bangladesh**, **Peru**, and **Tanzania**) to 16 years (**Kenya**). In some countries, there is one basic minimum work age, while in others, there are several age standards, depending on the industry or sector. Child labor legislation often applies only to certain sectors or exempts entire industries or occupations. The sectors most frequently excluded are those where the highest numbers of working children are found, such as small-scale agriculture, domestic service, and small-scale manufacturing. For example, in **Kenya**, the minimum work age of 16 years applies only to certain industrial undertakings. Likewise, in **India** and **Pakistan**, the minimum work age of 14 applies only to certain specified occupations and processes. In **Nepal**, the minimum work age of 14 does not apply to certain enterprises, such as plantations and brick kilns. Exceptions are also made in some countries for apprenticeships or educational work. In **Brazil**, for example, children under 14 are prohibited from working, except as apprentices. Employers sometimes use such exceptions to exploit children as a source of cheap and compliant labor.

All 16 countries studied have a minimum age for hazardous work, varying by country from 12 to 21 years. Some countries have a single minimum age for hazardous work, while others specify several such ages, depending on the type of work.

Some countries have a multitude of laws addressing child labor, often spanning decades, that may be inconsistent with one another or confusing to implement and enforce. In addition, inadequate fines and penalties for child labor law violations often undermine their overall effectiveness.

One of the most serious issues relating to child labor laws is their inadequate enforcement by many governments. In many countries, labor inspection is not a priority. Labor inspectorates often lack the vital resources and staff needed to reach remote areas and effectively monitor the child labor situation. Inspectors often receive little training, if any, and are often poorly paid, making them an easy target for corruption. In addition, they may not be motivated to enforce child labor laws if they do not perceive the employment of children as a problem, or believe that it is a necessary ill for many indigent families. Inspectors who do attempt to enforce labor laws may be faced with public indifference and hostility from employers.

A number of countries studied (including **Bangladesh, Brazil**, the **Philippines, South Africa**, and **Thailand**) have recently made or are considering changes to their child labor laws, including increasing the minimum age for employment, adopting uniform child labor regulations, and expanding coverage of child labor laws to additional sectors or occupations. Some countries (such as **Brazil, Kenya, Mexico**, the **Philippines, Tanzania**, and **Turkey**) are focusing on strengthening enforcement by increasing the number of labor inspectors, improving training, or implementing new strategies.

The fact that large numbers of children are still working, many under exploitative or hazardous conditions, indicates that significant action in the area of law and enforcement is urgently needed. Some countries faced with considerable numbers of child laborers are now taking steps to address shortcomings in their legislation and enforcement. Possible efforts in this area include:

- consolidating child labor laws and regulations in order to eliminate inconsistencies and confusion;
- increasing the legal age of employment to conform with international standards;
- increasing civil and criminal penalties for violators of child labor laws;
- improving training of labor inspectors, providing additional resources for investigations, and creating specialized inspection units that deal with child labor issues;
- developing partnerships with industry, labor groups, and NGOs to assist in identifying and preventing the exploitation of children; and

- increasing public awareness about child labor by informing the public about applicable child labor laws and penalties.

D. Access to Universal Primary Education

Universal primary education, as noted in Chapter IV, is widely recognized as an important means of preventing and eliminating child labor. No country can successfully end child labor without making education compulsory and accessible to all. Children who are required to attend school are less likely to be engaged in exploitative work and are more likely to be informed of their rights. Education, over time, can provide children with the skills and knowledge necessary to become productive adults and improve their employment and earnings prospects. Despite the obvious benefits of education, tens of millions of children do not attend school. Most of these children are working.

Twelve of the 16 countries studied for this report have national laws making primary education compulsory (**Bangladesh, Brazil, Egypt, Guatemala, Mexico, Nicaragua, Peru**, the **Philippines, South Africa, Tanzania, Thailand,** and **Turkey**). The number of required years of schooling varies by country, from five (**Bangladesh**) to 11 years (**Peru**). Several countries, including **Egypt, South Africa,** and **Turkey**, have also recently passed laws extending their years of compulsory education.

In several of the countries studied for this report, the age for completion of compulsory education is not consistent with the minimum age of employment. When the minimum age for work is lower than the age for completing compulsory education, children might be compelled to abandon or neglect their studies and enter the workforce. In the opposite case, when the minimum work age is higher than that for completing compulsory education, children who are unable to continue their education must either remain idle or work illegally, thereby making illegal child labor more commonplace and acceptable.

In many countries, primary education is neither compulsory nor affordable. Schools are frequently not available or accessible to all children. Even when schools are available, the quality of education may be poor and the content may be perceived by many children and their families as irrelevant to their lives. For poor families who depend on their children's earnings to make ends meet, the opportunity cost of sending their children to school is often seen as too high. Parents' reluctance to send their children to school is often exacerbated by the various costs of education, including school fees, supplies, books, uniforms, meals, and transportation.

In the 16 countries studied for this report, significant numbers of children are not going to school. The most recent country data on educational attainment shows that less than 70 percent of children are enrolled in or attending primary school in five of the countries studied (**Guatemala, India, Nepal, Pakistan**, and **Tanzania**). In seven of the countries, less than 70 percent of children enrolled in primary school reach the fifth grade (**Bangladesh, India, Kenya, Nepal, Nicaragua, Pakistan**, and **South Africa**).

Government spending on education varies widely among the 16 countries studied. Data on education spending by country for the most recent available year (1990 to 1997) shows that public expenditures on education as a percentage of GNP range from 1.7 percent (**Guatemala**) to 7.9 percent (**South Africa**). Education spending as a percentage of total government expenditures ranges from under 10 percent (**Bangladesh** and **Pakistan**) to over 20 percent (**Mexico and South Africa**), and primary school spending as a percentage of total public education expenditures ranges from 18 percent (**Peru**) to over 65 percent (**Egypt** and **Nicaragua**).

Access to education is often not equitable. Children in rural areas and those belonging to marginalized groups are frequently more affected by a lack of adequate educational infrastructure. Rural children are also more likely to work. Indeed, work can constitute a major impediment to children's attendance and successful completion of primary school. Working children have low enrollment and high absentee and dropout rates. These rates may be attributable to fatigue from long hours of labor, work related injuries and illnesses, and/or work schedules that are incompatible with school hours

Some of the countries studied (**Brazil, Egypt**, the **Philippines**, and **Turkey**) have developed initiatives to make schools more accessible and improve the quality of primary education. Other countries (**Guatemala, India, Mexico, Nicaragua, Peru**, and the **Philippines**) are implementing programs that provide alternative educational opportunities for working children or ease their transition from work to school. Finally, some countries (**Bangladesh, Brazil, Egypt, Mexico**, and **South Africa**) are providing incentives to encourage families to send their children to school rather than to work.

While the impact of these policies and programs can only be assessed by future increases in the number of children attending and completing school, they provide an important indication of the level of government commitment to the provision of universal primary education in the 16 countries studied for this report. Steps that countries can take to accomplish this goal include:

- passing legislation making primary education compulsory for all children;
- increasing educational expenditures at the primary level to increase school accessibility and the quality of instruction (for example, enabling construction of new schools, improving existing infrastructure, and authorizing increases in teacher salaries and training);
- alleviating the costs associated with education that can prevent poor families from sending their children to school by providing transportation, subsidizing the costs of school meals, uniforms, supplies, and books, and eliminating school fees; and
- eliminating inconsistencies between child labor and compulsory education laws.

from working and assure that they attend school on a regular basis, in **India** to establish nonformal schools and release thousands of children from hazardous work, and in the **Philippines** to rescue children from exploitative work.

Key elements of targeted child labor projects include:

- targeting child labor in sectors or occupations that are hazardous and harmful to a child's development;
- removing children from exploitative work and providing them with alternatives, such as education or vocational training;
- providing income-generating opportunities for families of former child laborers;
- establishing partnerships among governmental and nongovernmental actors and international organizations such as the ILO and UNICEF and drawing on participants' respective expertise and resources; and
- raising awareness among vulnerable groups about children's rights and the dangers of premature entry into the workforce.

F. Final Comments

This report has attempted to illustrate the extent to which the 16 countries are currently addressing their child labor situations through the enactment and enforcement of child labor laws, the provision of universal primary education, and the development of and involvement in targeted child labor initiatives. A government's participation in such efforts can provide an indication of its commitment to combating child labor. Accurately determining the extent and nature of child labor within each country is also essential in adequately addressing the child labor problem.

There has been a significant increase in international concern regarding the plight of working children around the world. Many countries with child labor problems have not only acknowledged the problem but have begun to develop and implement comprehensive strategies to combat the exploitation of children. International organizations such as the ILO and UNICEF are heavily involved in such efforts. It is important, however, to monitor and measure the effectiveness of these efforts, since successful strategies can and should be replicated elsewhere.

The information provided in this report can serve as a framework for further study and evaluation of the progress being made toward eliminating child labor in the countries studied. Ultimately, the best way to determine such progress is by documenting a reduction in the overall number of working children and an increase in the percentage of children attending school and completing at least a primary education.