THE WHITE HOUSE

WASHINGTON

March 21 , 1996

MEMORANDUM TO THE PRESIDENT

From: Laura Tyson
Gene Sperling

Subject: Social Security Responses

I. DEVELOPING COMMON TALKING POINTS ON SOCIAL SECURITY: As you are aware, members of your Administration have recently had to respond to questions about the long-term solvency of Social Security. This has been driven by two occurrences: First, several Republicans, including Steven Forbes, have called for diverting a portion of Social Security to Individual Retirement Accounts or IRAs; second, and most prominent, there have been public reports -- and even a two-evening CBS evening news segment -- on the expected recommendations of the Social Security Advisory Council. As you recall, the Quadrennial Advisory Council on Social Security is an independent, bipartisan council which you appointed in 1994 to consider long-term issues related to the Social Security system -- specifically, which approaches are best to ensure solvency over a 75 year forecast period. We expect that the current Council will release a report in the near future. At that point, the Administration will review their options or recommendations.

Because of these events, we anticipate that Administration members may be asked to comment on the Social Security Advisory Council recommendations, and we want to ensure that we are speaking in one voice. We wanted to show you the current talking points, explain the policy and political goals behind them, and see what next steps or additional information you needed.

II. BACKGROUND ON LIKELY OPTIONS: As was reported in the January 19, 1996 Weekly Economic Briefing, recent estimates suggest that the total income, including interest on accumulated assets, will continue to exceed payments until 2020, and that the shortfall will be covered by drawing down assets until the trust fund is exhausted in 2030. Even after that, the revenues would meet about 75% of the program's costs. Under the current economic assumptions, the 75 year projection shows a deficit of 2.17% of taxable payrolls. Currently, the employee and employer each pay 6.2% -- or 12.4% cumulatively. The "2.17 deficit" refers to how much the 12.4% payroll taxes would have to be raised to maintain 75 year solvency. *It is a measurement figure and is meant by those who use it as a recommendation that any or all of the gap be filled by raising payroll taxes.*

Our current understanding is that no consensus recommendation will be reported from the Advisory Council, but that they will instead report three separate plans. The plans do have a few elements in common. While we can send you a full explanation of each option, we very briefly list below the main items that are considered in each plan. As you can see, this entire area is highly charged and controversial, and dealing with this issue will only be plausible if there is a non-political, bipartisan process.

The recommendations in all three options are:

- 0.5% increase/adjustment to the CPI.
- Expanding Social Security coverage to all new state and local employees now covered by Social Security.
- Increasing the extent to which Social Security benefits are counted as taxable income.
- Investing a portion of the Trust Fund in equities.

In addition to these common elements, the following elements are recommended by some of the members:

Option 1: This plan relies on the elements listed above and includes no private accounts.

Option 2:

- Raise the retirement age to 68.
- Reduce benefits for upper-income recipients.
- Require 1.6% increase in payroll taxes above the current amount and require this 1.6% be put into a private account.

Option 3: This is the largest move toward privatization.

- 5% of the payroll is put into a private IRA and managed by private investment companies that would fund annuities.
- The remaining 7.4% would cover a smaller, flat retirement benefit plus survivor's and disability benefits.

III. OPTIONS FOR GOING FORWARD:

As mentioned above, to ensure that the Administration was speaking in one voice, a working group of the NEC, DPC, Treasury, OMB, CEA and Labor Department has come up with suggested talking points. The talking points are attached, and we wanted you to see them to ensure that you feel we are on the right track.

The general feeling of many of those who put the talking points together was that the best policy and the best politics would be to make clear that we oppose efforts to privatize Social Security, undermine it, make it voluntary or less dependable, but then avoid giving definitive opinions on specific elements in specific proposals or define exactly what we feel constitutes "privatize," "undermine," or make "less dependable."

This approach makes clear that we are opposed to efforts that would privatize or make Social Security riskier -- that we are not recommending any of these elements. By not giving specific opinions on specific elements, we avoid being drawn into discussions on what changes we would need, while from a policy perspective, we do not unnecessarily take options off the table that could be part of a bipartisan recommendation next year.

Another option would be to take firmer positions against some of these provisions. The benefits of this would be that we would be unlikely to support some of these proposals and our strong opposition could be both an affirmative part of our 1996 agenda as well as insurance against anyone suggesting that we would support such provisions. The downsides to a harder approach are that once we criticize too many elements, it could create pressure to answer "what do we propose," and from a policy perspective, we could serve to take too many options off the table. [Two specific issues that need thought: we have heard you may wish to take equity investment off the table. Furthermore, you opposed raising the Social Security age in October, 1994.] The other problem may be that when we take certain options completely off the table, does it leave the impression that the ones we don't specifically oppose are ones that we are considering?

A third option is to consider recommending a bipartisan commission for 1997. This could provide a process answer to the Social Security issue, yet it could also raise the profile of the issue and be seen as recommending a commission to follow-up on a commission.

In terms of how to proceed, please consider the following options, which are not mutually inclusive:

1) Use current talking points with your edits.

2) Take a clear stance against some of the proposals.

3) Receive serious pros and cons of the specific elements in the Social Security recommendations from your economic team, with a possible follow-up discussion.

4) Look at options for proposing a commission.

5) Set up meeting to discuss matters with policy advisors following pro-con memo.

TALKING POINTS ON SOCIAL SECURITY
March 21, 1996

Q: What is the Administration's position on these recommendations?

A: Social Security is one of our most successful programs. It is the bedrock of retirement for tens of millions of Americans. A Social Security check is all that keeps 13 million older Americans from poverty. Social Security has helped cut elderly poverty by more than half since the 1960s. In 1966, the poverty rate among our older Americans was 28.5 percent; today, it is 11.7 percent.

Oppose Privatization or Undermining Current Social Security System: The Administration strongly opposes efforts to move Social Security toward a private or voluntary system that would not provide the same true security in the future that it has provided for millions of older Americans over the last several decades.

Need Non-political, Bipartisan Review of Overall Steps Needed To Continue Long-term Viability of Social Security: Although Social Security will remain on firm financial footing for many years, we agree that steps will have to be taken to ensure its long-term solvency. Any specific steps must be judged within the context of an overall, bipartisan, non-political effort to secure Social Security. Commenting now on specific options that might be part of these overall steps would be counterproductive.

Q: Does the Administration support the proposals by Forbes and others to allow people to use a portion of their payroll tax to set up their own IRAs?

A: These are proposals that the Administration has not supported and is not currently considering. We will not support proposals that would lead to the privatization of Social Security or undermine its dependability. Our general position is not to comment on hypothetical elements of any future overall proposal, but to encourage a strong bipartisan process for devising a plan to continue the broad national support that exists for our current Social Security program.

Q: Would the Administration ever consider any proposal that allowed people to use part of Social Security in private savings accounts -- as even Senator Kerrey has supported?

A: We oppose proposals that seek to privatize Social Security or make it voluntary. Yet, as mentioned before, our general position is not to comment on hypothetical elements of hypothetical proposals or to discuss exactly which proposals constitute privatization and which don't. Our general position is that we oppose privatization of Social Security and that we want this discussion to take place in a non-political context where elements are being judged in the context of overall bipartisan plans.

Q: But there are serious problems with Social Security. Is the President going to have recommendations this year on how he would handle this? Isn't it irresponsible for him not to address these recommendations during the Presidential campaign?

A: As the President has long said, there are long-term financing concerns, and they need to be dealt with in a bipartisan context in the most non-political atmosphere possible.

We Have Time. This Shouldn't Be Part Of Election-Year Politics. The Social Security system is sound well into the next century; it will be able to pay benefits through the year 2030. Ensuring the long-term solvency of Social Security is a complicated and important issue. We should take advantage of the time we have to address it in a reasoned, rational, and bipartisan manner. It should not be caught up in election-year politics. This year's Congress would do well to focus on the urgent issues before it, such as balancing the budget, welfare reform, and health care insurance reform.

Q: Does the Administration support proposals to allow Social Security funds to be invested in the stock market in order to bring the Social Security system higher returns?

A: As we said, we will oppose proposals that undermine the current publicly managed and collective nature of Social Security or proposals that would make it less dependable for all Social Security recipients. There are some very serious questions that would have to be answered before any of these proposals could be recommended. Again, we believe the best way for this discussion to take place is in a bipartisan, non-political context where we are looking at the viability of the whole plan and not have debate over hypothetical elements in the middle of an election year.

THE WHITE HOUSE

WASHINGTON

July 1, 1996

MEMORANDUM FOR THE PRESIDENT

FROM: LAURA D'ANDREA TYSON Laura D. Tyson

SUBJECT: ASSESSMENT OF PETE PETERSON'S *ATLANTIC MONTHLY* ARTICLE

In a recapitulation of many earlier writings, Peter Peterson describes in dramatic terms how the sharp increase in the ratio of elderly Americans to the working-age population will put severe stress on the economic relationships between generations -- most notably as more resources are required to service Social Security and Medicare. While demographics predict that elderly in the United States will grow as a proportion of the total population, that prediction, by itself, does not lead to dire consequences. Moreover, the policy prescriptions suggested by Peterson are generally more radical than warranted by the scope of the policy problem.

Overview: Peterson argues strongly against what he calls the "entitlement ethic", where Americans claim many government-provided benefits as a right. He notes that if current policy choices are maintained indefinitely, non-discretionary spending (e.g., Social Security, Medicare, Medicaid, and interest on the Federal debt) becomes an ever-larger fraction of total government spending. Peterson attributes much of the increase in non-discretionary spending to changing demographics, particularly the projected aging of the population.

None of this is news -- the Administration's annual budget notes this trend, the recently-released reports on the status of the Medicare and Social Security Trust Funds make the point in the context of the respective programs, and the Administration's Health Care Task Force noted that Medicaid and Medicare spending were on unsustainable paths.

The questions to be addressed before formulating policy are how big are the respective problems and how much of each problem is attributable solely to an aging population as opposed to other factors. For instance, per capita health care costs are projected to grow far faster than the economy for almost any forecast horizon, while per capita costs for Social Security recipients are expected to grow in line with the economy as a whole.

Peterson notes that by 2030, Americans over age 65 are projected to comprise 20 percent of the total population. But looking at just the fraction of the population that is elderly can be misleading. For example, the 1996 *Economic Report of the President* notes that while the fraction of the population that is elderly will grow rapidly beginning around 2010, the fraction that is made up of children is declining. The total dependency ratio -- the fraction of total population under 20 and over 65 -- is projected to grow only slightly over the next 75 years, failing to reach the levels experienced without great fiscal stress in the 1960s. Even though the elderly have different needs than children, the ability to shift resources between age cohorts means the potential future problem is not insurmountable.

The dire predictions made by Peterson (and others who write on these topics) reflect the inexorable accumulation of Federal debt, as a result of continued projected deficits, with ever-higher Federal interest payments taking up increasing shares of the Federal budget (and GDP). But through a form of policy judo, steps taken today to partly reverse the financial outflows can make compound interest work to support significant improvements in projected future interest payments. This indicates the benefit of starting sooner rather than later to address these policy concerns.

Peterson blames the current system of maintaining separate trust funds for various entitlement programs (e.g., Social Security and Medicare Part A) for making it difficult to reform them, since the trust fund system masks their "pay-as-you-go" nature. However, the system of trust funds is partly responsible for the great political support these programs enjoy, because people feel their "tax contributions" are "earmarked" for their personal future benefit, even if this is not actually the case. In any event, Peterson's criticism of trust fund accounting is not really essential to his main argument.

Peterson's Policy Prescriptions: Peterson makes six broad policy recommendations in the article. They include:

(1) Balance the Federal budget by 2002 and run a budget surplus for many years thereafter.

(2) Reform entitlement spending programs by:

(a) Subjecting all entitlements to "means-testing" whereby people with incomes above $40,000 per year lose 10 percent of their benefits for every $10,000 of additional income (however, for those with incomes over $125,000, only 85 percent of benefits are eliminated). Affected entitlement benefit programs include Social Security, Medicare (presumably the insurance value of Medicare coverage), Federal pensions, farm payments, veterans' benefits, and Medicaid;

(b) Raising the normal retirement age for Social Security and Medicare to 70 by 2015 (this compares with the gradual increase to 67 by 2027 scheduled under current law);

(c) Establishing limits on Federal health spending by moving to vouchers, managed care, or higher deductibles and co-payments for Medicare and Medicaid; and capping or eliminating the tax favored treatment given to employer-provided health coverage.

(3) Encourage Americans to work longer through education efforts about the value of older workers and through the repeal of the Social Security earnings test.

(4) Establish a system of fully-funded, privately-managed mandatory retirement accounts to which 4-6 percent of pay is contributed each year. This would be a precursor to replacement of Social Security with private accounts.

(5) Shift to a consumption-based tax system.

(6) Mount a broad-based public education program on the importance of saving.

Virtually all of these proposals are intended to increase the amount of savings in the U.S. economy -- both public savings (lower deficits) and private savings. For many of these proposals, the expected effects on saving arise directly from the policy (e.g., a lower Federal deficit directly increases public saving and shifting to a privatized Social Security system would substitute pre-funded private retirement plans for a largely pay-as-you-go public system). Other proposals have an indirect effect on savings. For instance, Peterson argues that means testing for Federal payments would reduce people's expectations of future cash flows from the government, leading them to increase their current saving rate to support future consumption out of individual resources.

Assessment of Peterson Proposals: Most of the policy prescriptions posed by Peterson are more extreme than warranted by the seriousness of the underlying policy problems, but are consistent with his exaggerated portrayal of them.

Some of Peterson's prescriptions are already being undertaken to some extent, via Administration initiatives to implement its growth agenda. For instance, the Administration has proposed a plan that is projected to result in budget balance by 2002. The Administration signaled support for and you ultimately signed legislation to increase the amount that Social Security recipients can earn without having their benefits reduced. The Administration proposed pension simplification legislation that would encourage employers to establish simple, portable, fully-funded pension accounts for their workers. A number of savings and investment incentives were proposed by the Administration and enacted in 1993 and others have been proposed since then. Finally, a wide-ranging education campaign emphasizing the need to save and the value of saving throughout one's lifetime is already being undertaken by the Department of Labor.

Some of Peterson's proposals have been considered and rejected by the Administration. For instance, means-testing for all payments from the Federal government would undermine the universal support for programs like Social Security, have the same disincentive effect as a marginal tax rate increase on all people with incomes over $40,000, and strike at the heart of the credibility of promises made by the Federal government to pay pensions and veterans' benefits. Similarly, privatization of Social Security through a system of mandatory private retirement accounts would have several shortcomings including: shifting the risk of fluctuating returns to individuals; eliminating the redistribution that currently takes place within Social Security (by providing higher relative benefits to lower wage workers); substantially increasing transaction costs; threatening the ability to provide insurance against disability and premature death; and undermining the commitment to shared responsibility that characterizes Social Security.

While programs for the elderly will indeed rise in cost as the population ages, we believe that more modest steps than those proposed by Peterson could shore up Federal finances for the foreseeable future. In thinking about how to address these concerns, we note that, for example, Medicare spending per capita is rising rapidly relative to GDP, while Social Security spending per capita is increasing more modestly. Moreover, the potential shortfall in financing health programs such as Medicare is much larger than for other programs. Therefore, we believe that it is useful to separate health programs (such as Medicare) from other programs (such as Social Security) for purposes of both discussion and planning.

One possible strategy for major reform based on this separation would consist of three separate sequential initiatives:

(1) Short-term Medicare "fix" along the lines contained in the Administration's Budget proposals that would extend the life of the Part A Medicare Trust Fund through 2006.

(2) A bipartisan long-term Social Security reform process that should be initiated after the November election.

(3) A bipartisan health reform effort that would address the long-term costs of Medicare, noting that any incremental reforms be chosen so as not to prevent more far-reaching future reforms in other areas of health care.

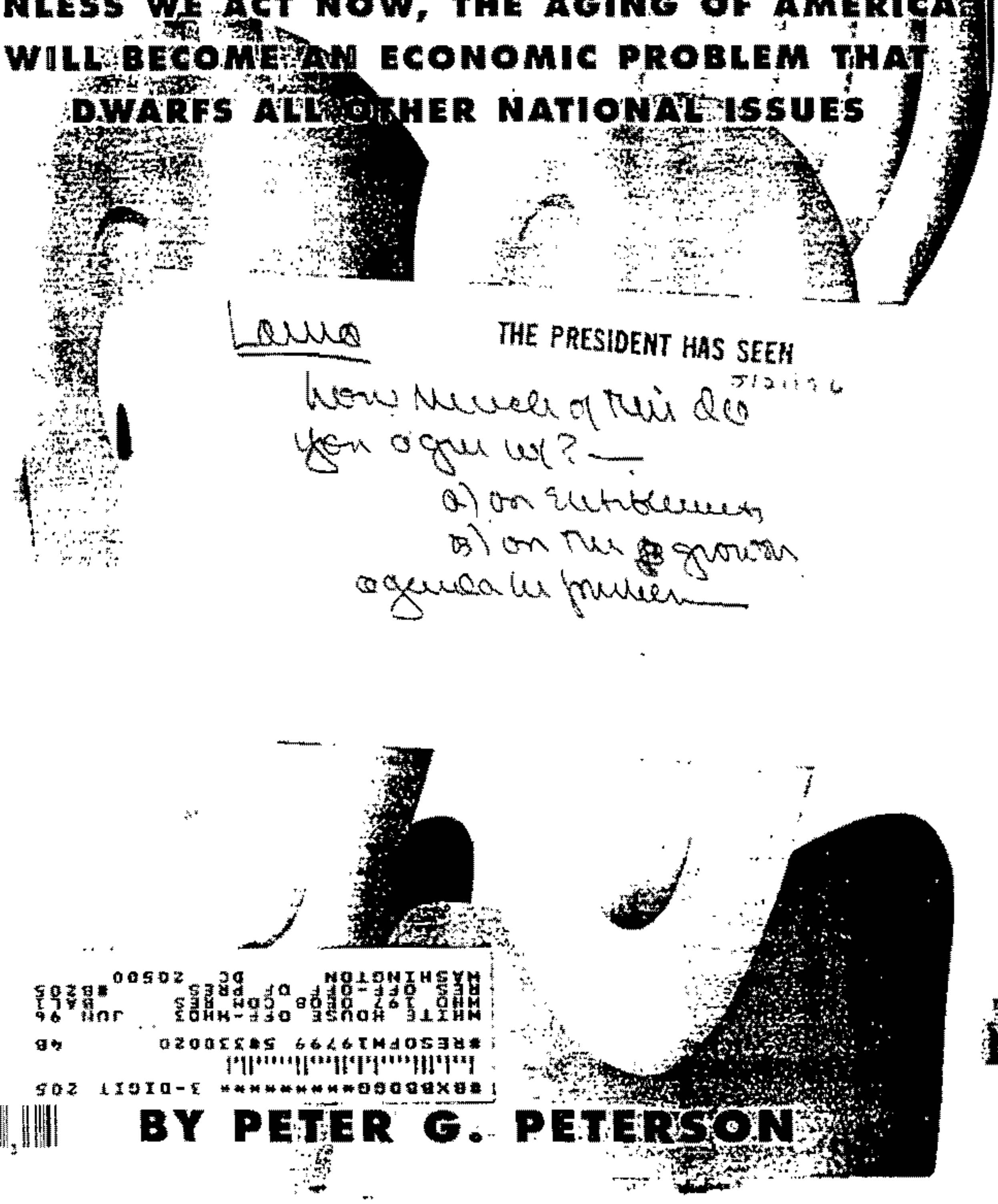
THE HOUSE THAT HOPPER IMMORTALIZED / FICTION BY CHARLES PORTIS

The Atlantic Monthly

MAY 1996

SOCIAL INSECURITY

UNLESS WE ACT NOW, THE AGING OF AMERICA WILL BECOME AN ECONOMIC PROBLEM THAT DWARFS ALL OTHER NATIONAL ISSUES



Laura

THE PRESIDENT HAS SEEN

How much of this do
you agree w/? —
a) on entitlements
b) on the growth
agenda he proposes

$2.95

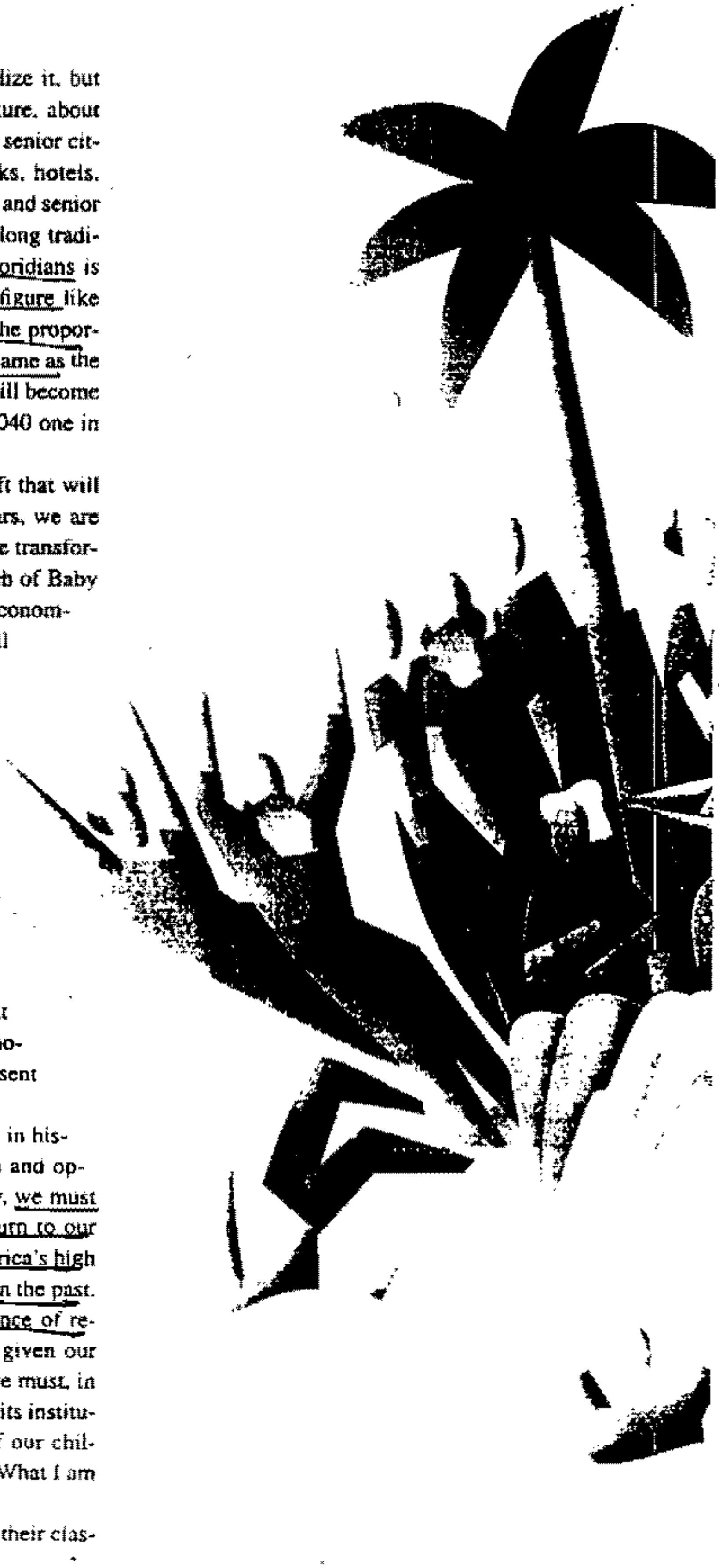
BY PETER G. PETERSON

BEEN to Florida lately? You may not realize it, but you have seen the future—America's future, about two decades from now. The gray wave of senior citizens that fills the state's streets, beaches, parks, hotels, shopping malls, hospitals, Social Security offices, and senior centers is, of course, an anomaly created by our long tradition of retiring to Florida. Nearly one in five Floridians is over sixty-five. But early in the next century a figure like that won't be exceptional. By 2025 at the latest the proportion of all Americans who are elderly will be the same as the proportion in Florida today. America, in effect, will become a nation of Floridas—and then keep aging. By 2040 one in four Americans may be over sixty-five.

When we consider the great demographic shift that will shape our national future over the next fifty years, we are speaking not of a mere transition but of a genuine transformation. Just fifteen years from now the first batch of Baby Boomers will hit sixty-five, bringing changes—economic, political, social, cultural, and ethical—that will transform American society. This transformation will challenge the very core of our national psyche, which has always been predicated on fresh beginnings, childlike optimism, and aspiring new generations. How we cope with the cultural dimensions of this challenge I will leave to others—to sociologists, political scientists, historians, and philosophers. I am none of these. I am a businessman who has long participated in public debates over the political economy of rising living standards. What concerns me most about America's coming demographic transformation is simply this: on our present course we won't be able to afford it.

To provide for the largest generation of seniors in history while simultaneously investing in education and opportunity for the youth of the twenty-first century, we must reject the prevailing "entitlement ethic" and return to our former "endowment ethic," which generated America's high savings, high growth, and rising living standards in the past. Endowment implies "stewardship"—the acceptance of responsibility for the future of an institution. But given our current emphasis on individual self-fulfillment, we must, in addition to endowing the future of our nation and its institutions, endow our individual futures and those of our children, because no one else is going to do it for us. What I am talking about is *self-endowment*.

"Hope I die before I get old," The Who sang in their clas-



IN 1900 ONLY ONE IN TWENTY-FIVE AMERICANS WAS OVER SIXTY-FI

sic sixties anthem, "My Generation." That statement, like so many slogans of the Baby Boomers' youth culture, was wishful thinking. The generation that once warned "Don't trust anyone over thirty" is now passing fifty.

The real question is, Will America grow up before it grows old? Will we make the needed transformation early, intelligently, and humanely, or procrastinate until delay exacts a huge price from those least able to afford it—and confronts us with an economic and political crisis to which there is no longer a win-win solution?

DEMOGRAPHICS IS DESTINY

WITHIN the next fifteen years the huge generation of Baby Boomers, whose parents brought them into the world with such optimism, will begin to retire. As they do, they will expect the munificent array of "entitlements" that were guaranteed (again with such optimism) to every retiring American with no anticipation of the ever-growing length of retirement as life expectancy increases or the ever-rising expectations of independence, affluence, health, and comfort of life in retirement. But consider who is expected to pay for this late-in-life consumption: the relatively small "bust" generation in whose productive capacity we have failed to invest. Neither the founders of Social Security sixty years ago nor the founders of Medicare thirty years ago imagined the demographic shape of America that will unfold over the next several decades. Ponder the following:

• With 76 million members, the Baby Boom generation is more than half again as large as the previous generation. To get some idea of how much the number of seniors could grow by the time the youngest Baby Boomers turn seventy, think of the entire population of California and the New England states combined. Or think of it this way: the number of Social Security beneficiaries will at least double by the year 2040.

• In 1900 only one in twenty-five Americans was over sixty-five. The vast majority of these people were completely self-supporting or supported by their families. By 2040 one out of every four or five Americans will be over sixty-five, and the vast majority will be supported to some degree by government entitlements.

• In 1960 there were 5.1 taxpaying workers to support each Social Security beneficiary. Today there are 3.3. By 2040 there will be no more than 2.0—and perhaps as few as 1.6.

• The number of "young old" (sixty-five to sixty-nine) will

VI **BY 2040 THE FIGURE WILL BE ONE IN FOUR OR FIVE.**

roughly double over the next half century, but the number of "old old" (eighty-five and over) is expected to triple or quadruple—adding the equivalent of an entire New York City of over-eighty-five-year-olds to the population. Nearly three quarters of those over eighty-five will be single, divorced, or widowed—the groups most likely to need extensive government assistance.

• In 1970 children under five outnumbered Americans aged eighty-five and over by twelve to one. By 2040 the number of old old will equal the number of preschool children, according to some forecasts.

• The extraordinary growth of the old old population will add especially to federal health costs. This is because the average annual medical-care bill rises along a steep curve for older age groups. The ratio of Medicare and Medicaid spending on the old old to spending on the young old is about 2.5 to 1.

• In 2030 only about 15 percent of the over-sixty-five population will be nonwhite. But about 25 percent of younger Americans will be nonwhite. This will create a potentially explosive situation in which largely white senior Boomers will be increasingly reliant on overtaxed minority workers.

• In order to provide the same average number of years of retirement benefits in 2030 that were contemplated when Social Security was set up, in the 1930s, the retirement age would have to be raised from sixty-five to seventy-four by 2030. But this projection—daunting as it is—assumes that future gains in longevity will slow as average life expectancy approaches the supposed "natural limit" to the human life-span. Many experts now question whether such a limit really exists. Summing up research at the National Institute on Aging, the demographer James Vaupel goes so far as to suggest that we are now on the threshold of a "new paradigm of aging," in which the *average* life expectancy could reach 100 or more.

Of course, the United States is not the only country facing an "age wave." Indeed, the age waves in most industrial countries are approaching faster than ours, and—to judge by official projections—could have an even worse impact on their countries' economies and public budgets. But these other countries enjoy long-term defenses that we lack. Unlike the United States, most can actually budget their public spending on health care, and so have much greater control over this potentially explosive dimension of senior dependency. Unlike the United States, most generally tax public benefits as they do any other income. And unlike the United States, most have fairly healthy household savings rates (generally well over 10 percent of disposable income, as compared with about five percent here), and so can absorb public-sector deficits much better than we can.

Most important, unlike the United States, these other countries are unencumbered by the illusion that their people have some sort of inalienable right to live the last third of their adult lives in subsidized leisure. In other countries what government gives can be taken back if doing so is deemed to be in the public's long-term interest. In 1986, when Japan enacted a major reduction in future pension benefits, the Ministry of Health and Welfare issued a concise justification that cited "equity between the generations." Few if any objections were heard. In a statement issued the day he assumed office, Japan's new Prime Minister, Ryutaro Hashimoto, referred to the "imminent arrival of our Aging Society" as a priority imperative. Citing much longer life-spans and a much reduced fertility rate, he told the Diet in his opening speech that Japan would have to "overhaul those social arrangements premised upon a life-span of twoscore and ten to suit our new expected life-span of fourscore." Do we recall any American President ever making such a statement at *any* point in his term, let alone in the equivalent of an inaugural address?

Australia has made employee pensions mandatory, increasing coverage from under 40 percent to nearly 90 percent of the work force. Iceland has means-tested its social-insurance system. Germany has enacted, and France, Sweden, Italy, and the United Kingdom are debating, increases in the retirement age. Some of these changes have provoked fierce controversy—or even widespread protest, as happened in France last winter. But the disagreement is almost always over how best to allocate public resources. No one questions that government has the right to reduce benefits.

Even many developing countries with populations still much younger than our own are preparing for their demographic future with astonishing resolution. In South Korea the household savings rate runs at about 35 percent: "Working to make a better life for the next generation" is a typical company motto. Account balances in Singapore's Central Provident Fund—the country's mandatory pension-savings system—now total nearly three quarters of GDP. In Chile the average worker owns $21,000 worth of assets in the fifteen-year-old national funded retirement system—a sum about four times the average annual Chilean wage. Argentina, Peru, and Colombia are following Chile's lead and setting up funded systems of their own. Here, nothing has been saved in any national retirement system for any worker to own.

UNSUSTAINABLE PROMISES

THE economist—and sometime humorist—Herbert Stein once said, "If something is unsustainable, it tends to stop." Or, as the old adage advises, "If your horse dies, we suggest you dismount."

We cannot sustain the unsustainable. Nor can we finance the unfinanceable. By 2013, when Baby Boomers will be retiring en masse, the annual surplus of Social Security tax revenues over outlays will turn negative. By 2030, when all the Boomers will have reached sixty-five, Social Security alone will be running an *annual* cash deficit of $766 billion.

If Medicare Hospital Insurance is included, and if both programs continue according to current law, the combined cash deficit that year will be $1.7 trillion. The horse, in other words, will be quite dead. By 2040 the deficit will probably hit $3.2 trillion, and by 2050, $5.7 trillion. Even discounting inflation, the deficit that year for these two senior programs will come to approximately $700 *billion*—four times the size of the entire 1996 federal deficit. Long before that time we will have had no choice but to dismount.

Wall Street has yet to react to these obviously unfinanceable numbers. When will it? Since financial markets try to anticipate events, the reaction will surely come years before the first Boomers start retiring on Social Security, in 2008. How severe will the reaction be? Should the markets conclude that America has lost any chance to deal with this challenge in advance, we will almost certainly see a full-scale economic emergency as interest rates roar into outer space.

Apologists for the status quo dismiss these numbers as "mere projections." So let me emphasize that the numbers I have used for Social Security and Medicare are *official* projections, calculated by federal actuaries and economists working for the Social Security and Health Care Financing Administrations. The same experts also calculate an alternate and much worse "high-cost" projection, which has historically proved to be more accurate than the forecasts I have used here. Moreover, the retirement and medical-care needs of the Boomer generation are by no means hypothetical. The Social Security Administration's former chief actuary A. Haeworth Robertson points out that fully 96 percent of senior benefits payable over the next seventy-five years will go to people who are already alive (and therefore countable) today.

Well, say the skeptics, if we can't borrow trillions of dollars, maybe we can raise taxes a bit and muddle through. But this isn't a viable option either. Let's start with the political fact that both parties in Washington are currently hawking a tax *cut*, though they disagree about its size. A tax increase is unmentionable. Then consider the magnitude of the tax increases we would need. By 2040 the cost of Social Security as a share of worker payroll is expected to rise from today's 11.5 percent to 17 or 22 percent—depending on whether you accept the official or the high-cost projection. Add both parts of Medicare, which currently cost the equivalent of 5.3 percent of payroll but are growing so rapidly that they will eventually overtake and surpass Social Security in size, and we're talking about 35 to 55 percent of every worker's paycheck before we even start to pay for the rest of what government does.

Obviously, tax increases of this size would destroy the economy. More to the point, they would kill the taxpayers. There is also the interesting question of whether American taxpayers could be expected to comply with them. The experience of runaway pension systems in Latin America and Eastern Europe teaches us that when payroll taxes begin even to approach these levels, tax evasion becomes widespread and much of the economy moves into the tax-exempt "gray market." In other words, it may be impossible to fund the future cost of our current benefit promises no matter how willing we are to legislate higher tax rates.

The senior lobby asserts that whatever the economic consequences, future American workers are duty-bound to fulfill their side of an ill-defined "contract between generations." Yet one group's "earned right" to a benefit is another group's "unearned obligation" to pay a tax. It is to this second group that our children and grandchildren belong. Understandably, they are suspicious of a binding "contract" to which they never agreed. According to a 1994 poll, Americans under thirty-five are much more likely to believe in UFOs than to believe that they'll ever receive Social Security benefits.

There's an old adage about robbing Peter to pay Paul. In the entitlement shell game we're proposing to rob Peter Jr. to pay Peter Sr.—even when the Peter Sr. in question may not need the money. In fact, Peter Jr. is already paying plenty. Because so much of Social Security is tax-free (and because retirees no longer pay FICA taxes), a typical retired couple on Social Security in 1994 with $30,000 in total cash income paid, on average, only $790 in federal taxes. Meanwhile, their son and daughter-in-law, struggling to raise a child on the same income, had a total federal tax burden of $7,035, if you include both the FICA tax they paid and that paid by their employers. No other industrial nation tilts its tax system away from the elderly—or tilts its benefits system toward the elderly—as much as the United States does.

The present system's true believers dress up Social Security and Medicare in the reassuring rhetoric of "insurance" and "pensions" and claim that beneficiaries are only getting back what they paid in. They're wrong. The majority of today's beneficiaries are getting back *far more* than they ever paid in FICA contributions: given an average life expectancy, the average one-earner couple retiring today will get about $123,000 more out of Social Security than the average earner and his or her employers ever paid into it, plus interest. Omit the employer's contribution and calculate only the payback on the personal taxes paid by the employee, and the windfall rises to $173,000. With Medicare thrown in it rises to nearly $310,000, much of that tax-free. These are not "earned benefits" but unearned windfalls that our children will have to pay for and certainly will never enjoy themselves.

Moreover, since FICA contributions have never been saved by the federal government, the point is moot: regardless of what a worker paid in, the federal trust funds now possess on

TO HOUSEHOLDS WITH INCOMES THAT ARE ABOVE THE U.S. MEDIAN.

that worker's behalf nothing but claims on future taxpayers. The term "trust fund" may suggest a vault in which one's Social Security taxes are stacked up, to be paid out later. But the Social Security "trust fund" is the ultimate fiscal oxymoron. Its "assets," which we are told will keep the system "solvent" until 2030, consist of nothing more than Treasury IOUs—claims against future generations. When it comes time to redeem these claims and the interest they have accumulated, where will the Treasury find the cash? Either by borrowing from the public or by raising taxes. Either way, absent any policy change future taxpayers will have to pay again for today's Social Security "surplus."

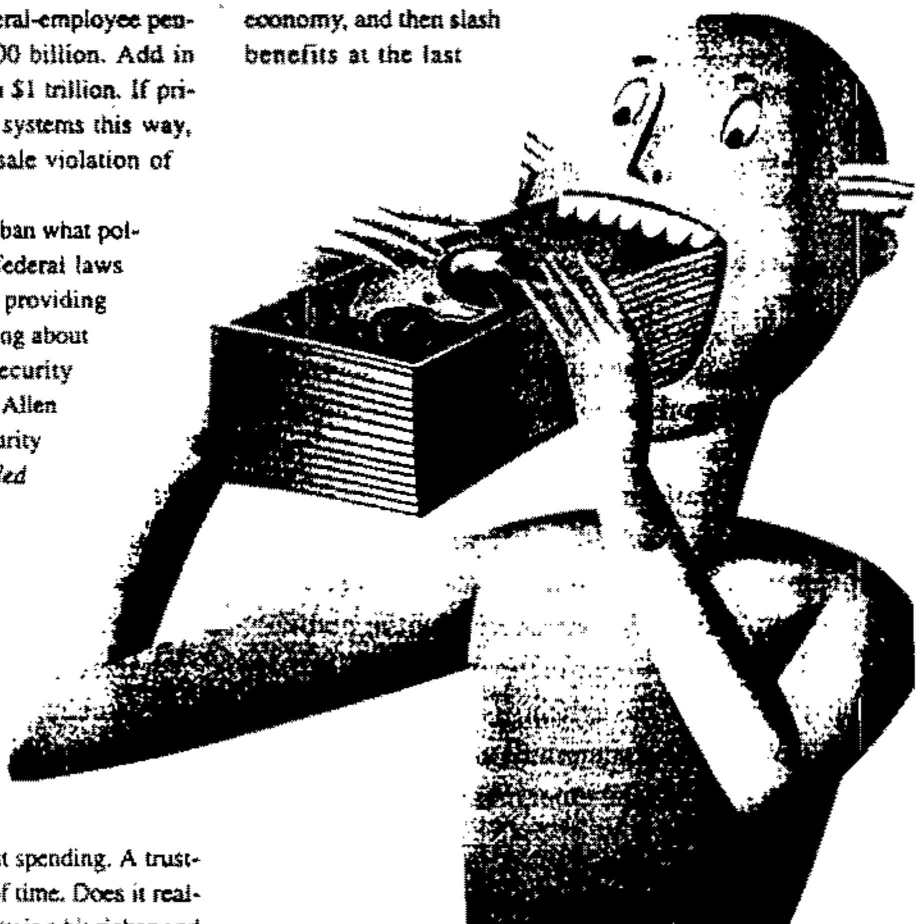
If the Social Security and Medicare balance sheets were evaluated according to private-sector accounting standards, both would be declared disastrously insolvent. How disastrously? Consider that the federal government has already promised to today's adults $8.3 trillion in future Social Security benefits beyond the value of the taxes they have paid to date—a figure more than 250 times as great as the much-decried "unfunded liabilities" of *all* private-sector pension plans in America! If federal law required Congress to fund Social Security the way private pensions must be funded, the annual federal deficit would instantly rise by some $675 billion. Add in our lavish and unfunded federal-employee pensions and the deficit would rise by $800 billion. Add in Medicare and it would rise by more than $1 trillion. If private-sector executives ran their pension systems this way, they would be thrown in jail for wholesale violation of federal pension-plan regulations.

Meanwhile, Congress has attempted to ban what policy wonks call "unfunded mandates"—federal laws that impose costs on the states without providing funding for them. That's fine—but worrying about such mandates while ignoring Social Security and Medicare is like mistaking Woody Allen for Arnold Schwarzenegger. Social Security and Medicare are *the mother of all unfunded mandates*.

It's time to face up to the fact that trust-fund accounting is a hoax, that Social Security is in fact a pay-as-you-go system. Payroll taxes go directly to today's beneficiaries; benefits come directly from today's workers. Since FICA is a tax, and tax revenues are fungible, any annual surplus of FICA taxes over benefits is used to cover other government spending. A trust-fund ledger for such transfers is a waste of time. Does it really help anyone to know that Social Security is a bit richer and the Treasury is a bit poorer? Given the apparent congressional appetite for constitutional amendments, why not consider one banning government trust funds?

As Federal Reserve Chairman Alan Greenspan has summed it up, the only bottom line that really counts is government's total borrowing balance with the public—otherwise known as the annual consolidated budget deficit or budget surplus. Transferring IOUs from the right pocket to the left pocket does nothing to bridge Social Security's and Medicare's enormous funding shortfall.

Along with this melancholy list of fiscal unsustainables we should consider some troubling moral unsustainables. Social Security was established to protect the elderly from indigence late in life—to prevent a "poverty-ridden old age," in the words of Franklin D. Roosevelt. If we allow it to go bankrupt by paying benefits to middle-class and affluent Americans, many of whom can live well enough without these benefits, what will happen to those who really need them? Among Social Security recipients whose incomes are under $20,000, Social Security accounts for *more than half* of the total. In spite of this sobering dependence, many political leaders imply by their inaction that it's fine to wait until trillion-dollar deficits have devastated our economy, and then slash benefits at the last



minute. By doing so we would then deprive Americans at all income levels of the chance to plan for their futures. Millions of lower-income beneficiaries would be stranded in what might be called a demographic Depression, as the safety net that Social Security was enacted to provide suddenly vanished. Future historians may record that Social Security's "defenders" were the ones who most wanted to exempt the program from a balanced-budget amendment and thus from gradual and timely reform.

Paul Tsongas likes to say, "It's not enough for our children to love us. We should want them to respect us." When our children look into the Social Security trust fund and find nothing there but IOUs with their own names listed as payers, they will surely wonder how we could have treated them so shabbily.

THE INESCAPABLE BOTTOM LINE

NOTWITHSTANDING its strengths, real and imagined, the U.S. economy since the early 1970s has failed at what matters most: *raising productivity*. Why should the average American care about such a seemingly abstract concept? Because working longer hours—or putting everyone's spouse (or child) to work—is not the way to raise living standards. A higher standard of living means producing more while working the same or a lesser number of hours—in other words, being more productive. Only thus can real (after inflation) hourly compensation and take-home pay rise. The astute economist Paul Krugman once summed it up this way: "Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."

Since the early 1970s real national income per full-time worker (as calculated by the Commerce Department) has grown by approximately 0.4 percent a year. Total worker compensation has grown at about the same meager pace. This rate of growth is so low that a debate rages among economists over whether—after accounting for inflation and the rising costs of employer-paid health care—the typical U.S. worker has seen any perceptible wage growth since 1973.

We can no longer ignore what economists from Adam Smith to Karl Marx to Alfred Marshall to John Maynard Keynes to Paul Samuelson have insisted is the bottom line: sustained productivity growth requires investment, and no country can sustain high rates of investment without saving. These economists all understood that productivity growth depends on many underlying conditions, such as technological innovation and efficient markets, but they all agreed that capital accumulation is essential to productivity growth—and is, moreover, the one condition over which society can exercise direct control. Few experts disagree, especially when "capital" is defined, as many economists define it, to include such intangible collective investments as infrastructure, research, education, and training. Yet we now face public budgets strained to the breaking point by the costs of demographic aging, which will crowd out all forms of capital accumulation—private and public, material and human. Without fundamental policy reform a graying America cannot be a saving America.

But thrift is precisely what we've forgotten. From an average of 8.1 percent of GDP in the 1960s, the net national savings rate dipped to 7.2 percent in the 1970s and then plunged to 3.9 percent in the 1980s and to 2.3 percent thus far in the 1990s. Net domestic investment has fallen in tandem, from 7.3 percent of GDP in the 1960s to 3.5 percent in the 1990s—a decline that would have been much steeper if we had not switched from investing abroad to borrowing abroad.

Our structural deficits drain our already shallow pool of private savings—and hence crowd out private investment. To the extent that we try to control these deficits by reducing "discretionary" federal spending (a category that includes most future-oriented programs), they also crowd out public investment. Out of every nondefense dollar the federal government now spends, only about five cents builds tangible things that remain after the fiscal year is over. Recently a General Accounting Office study suggested that we must invest $112 billion to bring the infrastructure of schools back to acceptable levels. But where can we find such a sum when entitlements and interest on old debts crowd out everything else?

Long before the Boomers reach retirement age, we're preparing to cut everything from Head Start and school lunches to rapid transit and space shuttles in order to pay the rising cost of senior entitlements. Despite the radical rhetoric in Washington, the recent budget plans I have seen don't reverse but accelerate our current fiscal trajectory. Each of them proposes to slash appropriated domestic spending in real dollars while only gently restraining the growth in senior entitlements. Even in Congress's plan senior benefits in 2002 would consume still another record share of the budget—nearly 50 percent of noninterest outlays, up from 40 percent today and just 17 percent in 1965. This is in a benign demographic period, when the relatively small Depression generation (born before VJ Day) is still retiring and the relatively large Boomer generation (born after 1945) is still working and paying taxes. And remember: this is the *Republican* plan, widely attacked as a "declaration of war" on America's seniors.

To break out of this slow-growth, low-investment cycle we must set a higher productivity goal and then dedicate the resources required to meet it. A sensible objective would be to increase the rate of growth in real per-worker national income by a percentage point, from the post-1973 average of 0.4 to about 1.5 percent a year. Even this substantial increase would not equal American growth rates of the 1950s and 1960s, or match Japan's record during the 1970s and 1980s. But it would come close to returning U.S. productivity growth to its average rate over the past century—and it would bring growth close to the rates of most of our European competitors. If we raise productivity to 1.5 percent, twenty years from now national income per worker would be nearly $10,000 higher in today's dollars, and federal revenues (at the same tax rates) would be nearly $400 billion higher, than will be the case if we continue on our current course.

Conventional economic theory suggests that this ambitious goal requires a shift of six to eight percent of GDP from consumption to savings, giving us a long-term savings and investment rate of about 10 percent of GDP. But where will these extra savings—an average of at least $4,500 per U.S. household annually—come from? About a third can be financed by balancing the federal budget and keeping it balanced. The rest will have to come from greater private saving.

AMERICA'S SAVINGS GAP

THUS we come to what we Americans as individuals can and must do for ourselves and the nation—ichthyology from the standpoint of the fish. There are four main sources of income for those over the age of sixty-five: continued employment, government benefits, private pension income, and accumulated personal savings.

AMERICANS SEEM TO THINK THEY HAVE AN INALIENABLE RIGHT TO LIV

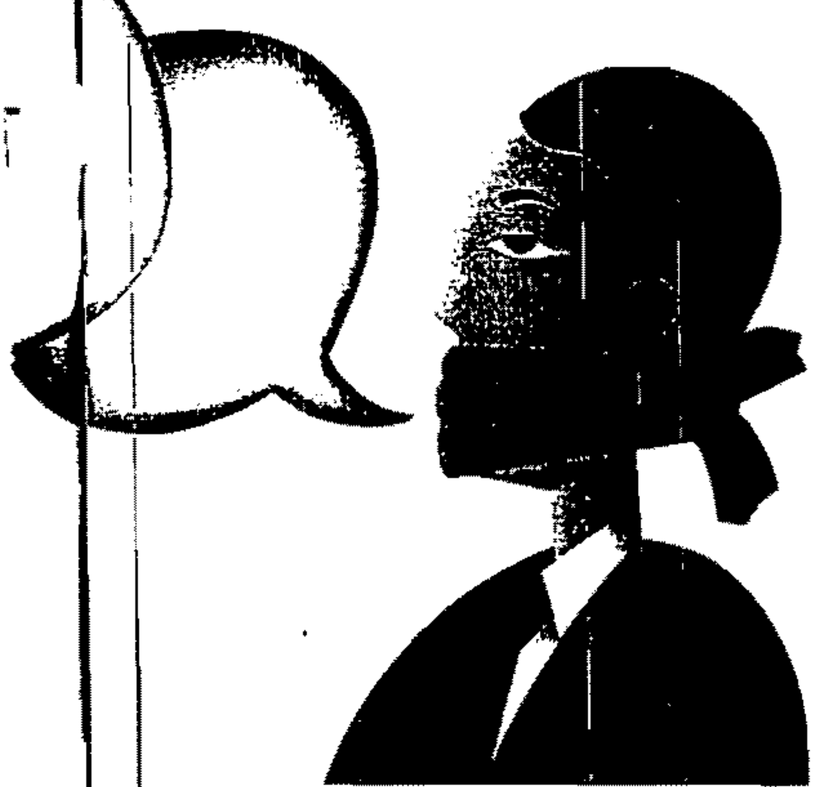
As we shall see, the adequacy of each of these sources is uncertain.

When it comes to our retirement plans, we are a nation in denial. About nine out of ten Boomers say they want to retire at or before age sixty-five (about six out of ten before age sixty). More than two thirds say they will be able to live "where they want" and live "comfortably" throughout their retirement years. A stunning 71 percent expect to maintain in retirement a standard of living the same as or better than what they enjoyed during their working years.

Yet probe them more deeply about their retirement dreams, and most Boomers admit that they are terrified that neither they nor their government is saving enough. Some two thirds confess that they've never even calculated how much they need to save for their retirement, and an amazing 86 percent acknowledge that "future retirees will face a personal financial crisis 20 years from now." Yet at the same time, they do not expect or even want much from government. Nearly nine out of ten Boomers agree that "the government has made financial promises to [their] generation that it will not be able to keep." For every Boomer who says that government should shoulder the "main responsibility for providing retirement income," five say that individuals should. They will very likely get their wish. From all the numbers we have seen, it is obvious that government retirement benefits (mainly Social Security, Medicare, and Medicaid) are likely to be severely reduced by the time most Boomers retire.

What could take their place? Thirty years ago experts hoped that private pensions would become a universal supplement to Social Security. Such hopes never panned out. Today less than half of all U.S. private-sector workers are covered by pensions. Overall coverage has been flat since the early 1970s, and in recent years coverage has actually dropped sharply for younger men. This stems from long-term changes in the work force and in the nature of work—part-time work, working at home, multiple careers. Rates of pension coverage have always been highest for full-time career jobs, unionized jobs, and jobs in government and large corporations—in short, for jobs that are becoming increasingly scarce. As for Americans lucky enough to have pensions, they will be surprised, if not seriously disappointed, by how little their plans have set aside for them: the typical defined-benefit pension plan for average-earning workers with thirty years of service replaces just one third of pre-retirement earnings—an amount that is not indexed for inflation.

Clearly, retiring Boomers will have to rely heavily on the remaining source of retirement income: private savings apart from pensions. But this source may be the most un-



median savings are still shy of $10,000. Even optimists admit that a bleak future awaits the approximately one third of all Boomers who are expected neither to accumulate financial assets nor to receive a private pension.

Ironically, the Baby Boom is the best-educated, most sophisticated, most well-traveled generation in our history. This irony provides still another illustration of the depth of our denial.

B. Douglas Bernheim, of Stanford University, concludes that Boomers on average must *triple* their current saving if they want to enjoy an undiminished living standard in retirement. And if one assumes a 35 percent reduction in Social Security benefits (which seems more than likely if not inevitable), then Boomers will have to *quintuple* their saving. A recent study by the Committee for Economic Development, *Who Will Pay for Your Retirement? The Looming Crisis*, comes to a similarly stark conclusion.

If it's true that the promise of late-in-life government benefits helped to suppress private savings in the past, maybe the growing expectation of cuts in government benefits will help to boost private savings in the future. Though economic theorists debate the point, people do take government subsidies into account when deciding how much to save. By thirteen to one, households say that they would save more if they knew that future Social Security benefits were going to be cut.

IVE | THE LAST THIRD OF THEIR ADULT LIVES IN SUBSIDIZED LEISURE.

certain of all, for it is questionable whether the average American is saving *anything* on his own: what one household saves in a bank account or a nonpension mutual fund scarcely offsets what another household borrows. Whenever the stock market or housing prices rise, many households may feel that they're saving enough. But our aggregate personal-savings rate, except for pensions, is now barely positive.

Many have argued that the current bust is attributable to the passage of so many Baby Boomers through the years of household formation, and that saving will turn up again as Boomers reach the traditionally high-saving middle years. But for this explanation to be valid, the personal-savings rate should have bottomed out by the mid-1980s—and climbed back again. Many Boomers have already entered the traditionally peak saving years. But the savings decline persists, contrary to predictions of a demographic reversal.

In 1992, according to the Federal Reserve Board, 43 percent of U.S. families spent more than their income; only 30 percent accumulated assets for long-term saving. In 1993, according to a Merrill Lynch analysis of Census Bureau data, half of all families had less than $1,000 in net financial assets—a figure that had not risen over the previous decade, even in nominal dollars. Among adults in their late fifties, the age at which workers are staring directly at retirement,

Finally there is the prospect of inheritance, that magic cure-all for any generation's retirement worries. In recent years Boomers have been cheered by a spate of upbeat stories about the "$10 trillion inheritance boom" that today's affluent seniors are expected to pass on. These Boomers may not have noticed the bumper stickers one sees in resort areas frequented by seniors: I'M SPENDING MY CHILDREN'S INHERITANCE. But even if the hoped-for hand-off takes place, there's a problem. Because this wealth is highly concentrated among relatively few families (what Donald Trump calls the "Lucky Sperm Club"), bequests may *average* as much as $90,000 per Boomer but will amount to only about $30,000 for the median Boomer. Muffy and Duffy will do fine, but for most of this generation the typical inheritance will just about cover the costs of settling Dad's estate and pay off a few lingering medical bills.

Dan Yankelovich, the dean of American opinion surveyors, has wisely said that our collective denial is not due to emotional or moral pathology. Rather, it is a case of "cognitive denial," by which he means a failure to make connections between how we prefer to see reality and what reality actually is. Clearly, this denial is manifest at the national level and at the personal level.

PRAYING FOR PRODUCTIVITY AND OTHER GOOD THINGS

ARE there any favorable trends under way that might moderate these bleak forecasts? Perhaps. But there is less to them than meets the eye. First, consider productivity growth, which determines real wage growth and hence tomorrow's tax base. Those who preach that high tech will bail us out and that we can avoid saving and investing our way back to economic growth tell us not to worry: we're in the midst of a productivity revolution. But we have good reason to worry. For one thing, after the Commerce Department recently updated its methodology, it became clear that the much-touted productivity gains of the 1990s are just about typical of earlier business-cycle recoveries over the past twenty-five years. For another, the Social Security Administration's best estimate of future deficits presupposes a permanent one-third improvement in productivity over our actual historical record since 1973. In other words, productivity growth will have to accelerate simply to ensure that the future isn't *worse* than the SSA's already unsustainable official projection. It would have to accelerate still more to ensure that things turn out better.

Well, if the productivity revolution—at least as it is now unfolding—won't save us, maybe the new baby "boomlet" will. It's true that current fertility rates, of about 2.0 to 2.1 lifetime births per woman, are a bright spot when compared with the low rates of 1.7 to 1.9 recorded during the "birth dearth" of the 1970s and 1980s. But even if these higher fertility rates turn out to be lasting, they won't have much effect on federal tax revenues until the mid-2020s—long after fiscal meltdown is scheduled to occur. Even then the positive impact will be small. To stabilize the ratio of retirees to workers, U.S. fertility would have to surge to 3.0 or higher—in other words, back to the Baby Boom levels of the 1950s and early 1960s, which no one expects. For one thing, the share of American women who say that a family of four or more children is "ideal" has plummeted from nearly 50 percent to about 10 percent since the 1950s. For another, the United States already has one of the highest fertility rates in the developed world. Average fertility in other major industrial countries is now 1.6; in Germany and Italy it is 1.3.

Well, then, if not babies, what about immigrants? Isn't importing more young workers a viable solution to America's aging? Again, not really. Immigrants, too, eventually grow old—and thus begin adding to Social Security and Medicare costs. To make a substantial dent in the costs of America's aging, huge and destabilizing waves of immigration would be required. In fact, to cancel out the projected growth in the Social Security payroll-tax rate over the next half century, today's level of net immigration would have to roughly quintuple, to about five million a year, beginning now. The reality, of course, is that America is in no mood to reopen Ellis Island.

Finally, consider health-care spending. Some point to the recent slowdown in medical-*price* inflation (as measured by the Consumer Price Index) and conclude that our problem is behind us. Not so. First, what matters is total *expenditures* on health care, and thus far in the 1990s real federal health-benefit outlays have not slowed at all. Second (and once again), the bleak official projections *already* assume a dramatic turnaround in recent trends. Over the past quarter century real Medicare spending per beneficiary has increased at the rate of five percent a year—several times as fast as real per capita income growth. Over no five-year period since 1970 has the growth in spending been less than three percent a year. Yet the Health Care Financing Administration's official projection assumes that the growth in real per-beneficiary Medicare spending will slow to about one percent a year by 2020. This projected cost-containment "triumph" is timed to occur just as aging Baby Boomers begin to increase the demand for every imaginable health-care service.

So let's hope—or pray—for productivity gains, higher fertility rates, and market-imposed discipline on health-care costs. But let's not forget the rosy scenarios of the 1980s that never came true and the problems we never grew our way out of. Public policy must be based on prudent expectations about the future—and prudence suggests that on our current trajectory the future may be worse than the bleak official forecasts.

No matter how clearly Social Security actuaries tell us that financial trouble looms ahead, politicians on both sides of the aisle are convinced that "middle-class" entitlement programs constitute the "third rail" of American politics: "Touch it and you're toast." So denial persists. It would be pleasant to blame this denial on Washington and say that the rest of us know better—that all we have to do is elect more-principled public servants who will dare to confront these issues. But the problem is interactive—the politicians and the people have all become gifted deniers.

Consider this irony: the public enthusiasm for budget balancing and cuts in "wasteful" programs is inversely proportional to the cost of those programs. Ninety-four percent o those polled in one recent survey favored slashing foreign aid, 77 percent wanted to cut public-housing funds, and 75 percent wanted to cut the space program. Yet these program together make up only about three percent of the federa budget. Meanwhile, only 14 percent of respondents wante to cut Social Security, and only 22 percent favored cuttin Medicare. Yet these two programs together account for staggering one third of the budget.

Or consider how we deny the truth about entitlement pro grams. In justifying every new benefit increase and ever refusal to accept slower growth in expenditures for the el derly, the senior lobby talks as if "old" meant "poor." But el derly Americans now have the highest level of per capi household wealth of any age group—and, counting in-kin income such as health benefits, a lower poverty rate tha

younger adults. Although old-age benefits were originally intended to be a safety net for the truly needy, today's entitlement system more closely resembles a well-padded hammock for middle- and upper-class retirees. One third of Medicare benefits, nearly two fifths of Social Security benefits, and more than two thirds of federal pension benefits now go to households with incomes above the U.S. median. Back in the early 1960s the typical seventy-year-old consumed about 30 percent less (in dollars) than the typical thirty-year-old; today the typical seventy-year-old consumes nearly 20 percent more.

It is obvious that this senior affluence is not evenly distributed. Millions of seniors would be destitute without federal benefits. There is also no guarantee that this affluence will continue for future generations of elders, which is why Boomers must prepare for their own retirement now. Households that are not saving enough must confront and act on their retirement-income needs. In a recent study Public Agenda found that only 20 percent of U.S. households are "planners" who deliberately save toward a quantitative goal. The rest—"strugglers," "impulsives," and "deniers"—leave their future more or less to fate.

Younger Americans need to understand how great a change in saving behavior is required, but that this change will hardly be unbearable *if they start now*. Thanks to compound interest, even small sacrifices count. A recent study published in *Fortune* magazine found that if a couple at age forty decide to go out to dinner and a movie only twice a month instead of four times, and put the savings into a 401K plan, they will net $169,500 for their retirement at sixty-five. Paying off credit-card bills when they come in instead of incurring finance charges will yield another $121,400.

But if Boomers don't start providing personally for their retirement, then their golden years will hold nothing like the life of leisure that most of them seem to expect. In *The Retirement Myth*, Craig Karpel warns that the generation we met in the 1980s as "yuppies" may reappear around 2020 as "dumpies"—destitute, unprepared mature people wandering the streets with signs reading WILL WORK FOR MEDICINE.

TAXES A BIT AND MUDDLE THROUGH? THIS IS NOT A VIABLE OPTION.

COMING TRANSFORMATIONS

MODERN Americans are inverse Victorians. The Victorians, of course, were famous for their prudishness about sex. But they were loquacious in planning for their old age and eventual death. A dignified death and a proud cemetery site represented important social values. Their detailed wills were a boon to Britain's legal profession. We are just the opposite: We will talk to almost anyone and say almost anything about our sexual experiences. Yet we deal with aging and mortality as reluctantly as the Victorians dealt with sex.

Because we have difficulty talking about our collective aging, the social, cultural, and economic transformations that will be caused by it will come as a shock and a surprise to many of us. "Shake the windows and rattle the walls" is what Bob Dylan wrote about Baby Boomers when they first came of age. My purpose in this essay is to suggest how aging Boomers might shake the windows and rattle the walls of our society one more time.

The Retirement Transformation

As recently as 1950 most men who were physically capable of doing so continued to work past the age of sixty-five: fully a third of those aged seventy and up were still in the labor force. Today just 16 percent of elderly men work. This trend toward early retirement is no longer affordable. Moreover, given the growing number of Americans who reach the late sixties and seventies in good health and with valuable skills, it is no longer enlightened social policy.

As Robert Butler, a former director of the National Institute on Aging, puts it, America must develop a new vision of "productive aging" in which "work expectancy" increases along with "life expectancy." We seek satisfying love and sex after sixty—why not satisfying work as well? The old idea of a rocking-chair retirement is dead, and it is time for the new idea of an active yet aimless and dependent retirement to die as well.

The open question is when and how this transformation will occur. Should we change the Social Security retirement age to sixty-eight? seventy? seventy-two? When will we tell those who will be affected, so that they can begin to adjust their life plans? And how will employers keep so many seniors on the payroll? What private-sector management and training programs will make senior employees more attractive? How are we going to change the perverse Social Security incentives that discourage seniors from remaining in (or re-entering) the work force? What jobs will best suit seniors who continue working, and how can we maximize their availability? How do we revamp traditional career patterns to allow for semi-retirement, phased retirement, and "un-retirement"?

The Health Transformation

On the eve of the New Deal all levels of government spent roughly $1.00 annually on health care for the typical older American. By 1965 the figure had risen to roughly $100, by 1975 to roughly $1,000, and by 1995 to roughly $7,000. Thirty years ago America spent more on national defense than it did on health care. Health care is expected to consume 18 percent of GDP by 2005—at least five times what we are likely to spend on defense. And that's before the special multipliers of the age wave—especially the huge growth in the old old, who are most likely to require extensive acute and chronic care—even begin to kick in.

Americans prefer to believe that high and rising health-care costs are primarily the result of waste, fraud, and abuse. If only we got rid of all the unnecessary tests and treatments, or slashed the excessive paperwork, or got tough on Medicaid cheats and profiteering drug companies, then presto, the problem would be solved. But experts know that the real causes are far more intractable: fabulous (and fabulously expensive) new medical technologies, cost-blind benefit and insurance systems that exempt most Americans from having to make choices about treatment, and the American tendency to disdain limits, including the ultimate limit—death itself.

Heirs of Ponce de León, in search of the Fountain of Youth? Perhaps that's too harsh. But no other country switches on multimillion-dollar MRI scanners for routine complaints (we have eight times as many MRI units per capita as Canada), commits terminally ill patients to intensive-care units, or performs heart bypasses on septuagenarians at anywhere near the rates we do. Americans, a European once observed, like to think everything is an option—even death.

The problem is that it is almost impossible to pinpoint aspects of our lavish style of medicine that are "wasteful" in the sense that they are of absolutely no medical benefit. Little of what physicians do is based on certain knowledge of the outcome: most involves judgment calls about unknown probabilities. Henry Aaron, the director of the economic-studies program for the Brookings Institution, speaks for most thoughtful observers when he writes that "sustained reductions in the growth of health-care spending can be achieved only if some beneficial care is denied to some people."

In the end the long gray wave will leave us no choice but to rethink what we mean by health. Is it a consumer good that can be purchased on demand at the doctor's office, or is it a lifelong investment? Should that investment be a personal choice, or should it be regarded as a public duty? How much should government be responsible for health care and how much should individuals? Most important, what share of public resources do we wish to spend on health care for ourselves, and how much do we wish to dedicate to such economic and social goals as productivity-enhancing R&D and a better education for our children?

No other transformation presents such profound ethical questions. Who will decide what costly heart transplants and similar death-defying high-tech operations are appropriate for the growing elderly population, especially the burgeoning old old group? When, and how, will society determine that even if an eighty-five-year-old can enjoy another year of life through an expensive high-tech intervention, this may be the wrong value to pursue—especially when so many children lack even basic health-care coverage?

The Youth Transformation

In an aging America everything will depend on the skills, education, productivity, and civic good will of younger generations—for their labor must support the elderly. Yet nothing seems less obvious than their capacity to rise to the challenge we are passing on to them. They will be relatively few in number. They will inherit a huge national debt and a high and rising payroll-tax burden. To make matters worse, many more of these future adults than today's adults are growing up in families, neighborhoods, and schools plagued by economic hardship and social dysfunction.

Since 1973 the real median income of households headed by adults aged sixty-five and over has risen by more than 25 percent, while the real median income of households under age thirty-five has fallen more than 10 percent. Counting all sources of income, poverty in America is three times as likely to afflict the very young as the very old. The United States is the global leader in the life expectancy of eighty-five-year-olds but has fallen near the bottom of the industrial world's rankings in rates of infant mortality, marital breakup, child poverty, child suicide, hours of school-assigned homework, and functional illiteracy. Meanwhile, per capita federal spending on the elderly towers eleven to one over federal spending on children. The appropriate response to the outrageous is to be outraged, yet we seem oblivious of this devastating disproportion.

How can we remain an economic superpower when nearly a third of our children are born out of wedlock and few of their fathers are willing to assume legal, financial, and moral responsibility for them? How will America prosper in a competitive technological and information-based global economy when its children grow up to exhibit school-dropout rates and rates of functional illiteracy that are among the highest in the industrial world? How do we answer Senator Daniel Patrick Moynihan's haunting question: "Will we be the first species that forgets how to raise our young?" Or, to paraphrase Churchill, "Have we ever asked so much from so few, having done so little to prepare them for their burdens?"

We're talking not about physical capital but about human and social capital: the intact families, work habits, education, and high-tech skills upon which any hope of increasing productivity ultimately rests. If we are going to rely on just 1.6 to 2.0 workers to support every retiree, as the SSA forecasts suggest, we should want today's children to become the best educated, most skilled, and most productive citizens imaginable. How does that square with our current rush to cut discretionary spending and defund social programs, from Head Start to vocational schools, that have long provided education and training? How can we generate the funding and the political support to educate our young in today's overburdened economy? How can we make the twenty-first century the century for our children?

The Political Transformation

Today's seniors, represented by powerful lobbies and voting in disproportionate numbers compared with the young, are already a potent political force. Will the rapid growth in the number of elderly enthrone the senior lobby as an invincible political titan? Or will the young, who must pay for tomorrow's senior benefits, find their political voice while there's still time to do something about it? Averting a destructive conflict between the generations will require a political transformation. But how can the young be encouraged to participate more aggressively in the political process? How do we merge the public interests of young and old and show how dangerous it is for them to become adversaries?

The Global Transformation

I recently asked the head of Japan's Central Bank why Japan has resisted America's requests to cut its budget surplus and stimulate consumer demand. His immediate response was "Because Japan must save so that it can afford its coming retirement wave"—a warning that the abundant and relatively inexpensive supply of foreign capital we have depended on for many years may soon disappear. The banker's reply underscores the high priority that some other industrial nations assign to the economics of aging populations.

Americans have paid little attention, but since 1980 roughly a third of net U.S. domestic investment has been funded by foreign creditors. Although some have expressed concern over how these capital inflows must give rise to a permanent annual debt-service charge on our national income, virtually no one has pointed out a more alarming prospect: not that the inflows will continue but that they could slow substantially as aging populations in other industrial countries consume more of their national income and savings at home. If America cannot boost its domestic savings rate within the next decade, we may enter an era of rising real interest rates, capital rationing, and a forcible curtailment of domestic investment.

There is also the issue of our relation to the less-developed world. When half the population in the United States is over forty, half the population in some emerging markets of Latin America and Asia may still be under twenty-five. Will the current distinction between rich and poor nations gradually come to be seen as a difference between old and young nations? Will the former be characterized by creative consumption, short time horizons, and the defense of the global status quo, while the latter, mainly in Asia and Latin America, become known for energetic investment, long time horizons, and revolutionary changes in the global balance of power? Will the newly democratizing economies of the former Soviet bloc be deprived of the foreign investment they need? Or, alternatively, will a high-saving Third World be exporting capital to a low-saving First World—an ironic turnabout of the policy recommendations of the 1970s? How will these demographic and economic shifts affect global institutions such as the United Nations, the OECD, and the World Trade Organization? Will they effectively address the myriad issues associated with the global age wave and enormous unfunded retirement liabilities?

TURNING AMERICA FROM CONSUMPTION AND DEFICITS TO SAVING AND INVESTMENT: WHAT NEEDS TO BE DONE

To argue in favor of thrift is sometimes enough to earn one the label "declinist"—a person who believes that America's best days may be over. This is not my view. Still, I want to explain why, if we do not face up to the economic and social challenges ahead, America will age prematurely and perhaps enter a precipitous decline. I do not believe it is un-American to suggest that we live in a finite world, that some desires can't be satisfied, and that bad choices can lead to tragic outcomes. On the other hand, some good choices—eminently feasible, gradual, and humane choices—can provide a sound future for all of us.

In an era crowded with social "crises"—from race to class—it may seem presumptuous to say that here we have a "real" problem that deserves our full attention. But let there be no doubt: the economic implications of America's aging population over the next several decades will dwarf, in sheer dollars, any other big issue one might name. Indeed, how we deal with the entitlement and savings crisis may determine how the other issues we face will ultimately play out.

If my analysis so far is correct, we are heading for a major crisis for which our society is unprepared. But our political leaders cannot be expected to take this challenge seriously unless we as individuals do so as well. A program of thrift thus has to work on all fronts, from the halls of Congress to our homes. Here are some workable steps.

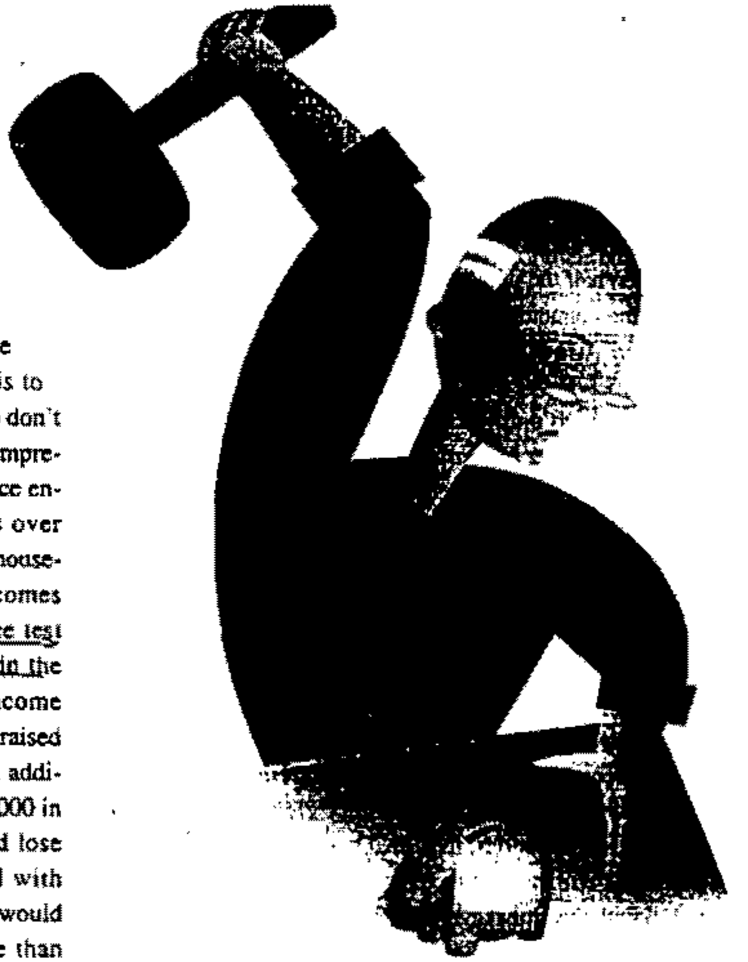
1. ***Achieve and guarantee long-term budget balance by the year 2002.*** A campaign to boost saving must start with the federal budget, which can no longer be a borrower but must be a saver. Of all the policy choices directly available to American voters, none would do a more reliable—and faster—job of raising the national savings rate than eliminating our chronic deficits. I believe that we should achieve budget balance no later than 2002—a date, happily, around which a bipartisan consensus has finally emerged, after considerable Republican pressure. The reforms we make, moreover, should, at least provisionally, guarantee long-term budget balance *after* 2002—not just temporary balance *in* 2002.

The federal deficit is now 2.4 percent of GDP. Over the past thirty years the United States—along with every other major industrial nation—has repeatedly achieved this degree of public-sector deficit reduction in fewer than seven years. Moreover, since the federal deficit is projected to grow rapidly *after* the year 2002, a longer timetable would only make the long-term effort more difficult. Balancing the budget, starting now, is like running to catch a train that's leaving the station. To catch it in two minutes we would have to run harder than we would to catch it in one minute.

Some experts worry that this is not the right time in the business cycle to initiate a balanced-budget plan. But according to these critics, it may never be the right time. So long as reforms are phased in gradually over seven years, there is little danger that a shift from consumption to saving will seriously depress the economy. Indeed, a credible budget plan might boost the economy if—as many economists, including Alan Greenspan, think likely—the markets react by lowering interest rates, particularly long-term rates, by two percent.

But mere budget balance is too timid a goal. Given the shortage of our national savings, I believe that Congress should aim for a federal budget *surplus* of perhaps one or two percent of GDP through the first two decades of the next century, to make up for our recent profligacy and, more important, to lay up stores during the Boomers' peak earning years for the sudden burden that will accompany their retirement. Or, better, Congress could aim for a smaller surplus but substantially increase spending on targeted public investments in education, worker training, and research and development—the kind of human-infrastructure investment that is essential to an information-age economy, but in which we are now sorely deficient. Either way, we would radically change federal budgeting. We would no longer presume on the good will of our children but would demonstrate our good will toward them by moderating excess consumption, which makes us net takers, in favor of investment, which unites us as net givers.

2. *Reform entitlement programs.* Trying to achieve long-term budget balance without reforming entitlements is like trying to clean out the garage without removing the Winnebago. The following reforms, taken together, would put these programs in long-term sustainable balance well into the twenty-first century.



• *Subject all federal benefits to an "affluence test."* The first sensible step toward long-term budget balance is to scale back entitlement subsidies flowing to people who don't need them. To this end I recommend that we enact a comprehensive "affluence test" that would progressively reduce entitlement benefits to all households with incomes over $40,000—or more than $5,000 *above* the U.S. median household income for 1996. Households with lower incomes would retain all government benefits. The affluence test would be applied *annually*—protecting the elderly in the event of an unexpected loss of income. Higher-income households would lose 10 percent of all benefits that raised their income above $40,000, and 10 percent for each additional $10,000 in income. Thus a household with $50,000 in total income and $10,000 in federal benefits would lose $1,000, or 10 percent of its benefits; a household with $100,000 in income and the same $10,000 in benefits would lose $6,000, or 60 percent; a household with more than $120,000 in income would lose $8,500, or 85 percent—the maximum benefit-withholding rate. (This 15 percent exemption would ensure that even today's most affluent beneficiaries continue to enjoy a respectable tax-free return on their personal FICA contributions.) All income brackets would be indexed for inflation.

WE MUST PUT ASIDE THE "ENTITLEMENT ETHIC" AND RETURN TO THE

Because the test would leave in place all benefits to lower-income households, the original "floor-of-protection" intention of nearly all federal benefits programs would continue to apply. Because such a large share of entitlements now goes to middle- and upper-income Americans (nearly 40 percent of Social Security payments go to recipients with incomes above the U.S. median), savings would be large and would compound as the population aged and the number of beneficiaries grew. Indeed, it is estimated that by 2040 *annual* savings would amount to more than $550 billion. Finally, because the test would also be comprehensive, covering not just Social Security and Medicare but everything from farm aid to federal pensions to veterans' benefits, this plan would not pit one special-interest constituency against another.

Since this affluence test was first proposed, in my book *Facing Up*, it has attracted considerable interest from both Democrats and Republicans. It has also elicited criticism from those who for various reasons don't want entitlements reformed. Some have said that an affluence test would constitute a tax on savings, and thus would discourage thrift. There is no evidence to support this hypothesis. More important, it ignores the larger issue—which is how to increase national savings. Any decline in private saving caused by an affluence test would be dwarfed by the decline in benefit outlays—which in turn would translate dollar for dollar into smaller deficits and greater net national savings.

It has also been said that an affluence test would undermine public support for Social Security and other universal social-insurance programs. The theory seems to be that we must bribe the affluent in order to ensure political support for benefits for the needy. This is dead wrong. Of all major proposals to reform entitlements, affluence testing receives the greatest public support. According to a recent opinion poll by the Concord Coalition—a group that I helped to form in 1992, along with the former senators Warren Rudman and Paul Tsongas—67 percent of those asked would support reductions in Social Security benefits to higher-income households, and 77 percent would support reductions in Medicare benefits. Even majorities of older and of affluent households support such a reform.

• *Raise the eligibility age for full benefits.* Congress has already raised the Social Security full-benefit retirement age from sixty-five to sixty-seven, to be phased in from 2000 to 2027. This is a step in the right direction (although most Americans are not aware of it), but the step is too small and too gradual. My recommendation is that the Social Security retirement age be raised by three months a year until a new eligibility age of seventy is reached in 2015—a phase-in that would leave Boomers plenty of time to plan ahead. In my view, early retirement should still be allowed at age sixty-two, but the benefits extended to early retirees should be reduced commensurately. When this reform had been entirely phased in, workers would still enjoy more years of full benefits than were envisioned when Social Security was founded. As Social Security's full-benefit eligibility age went up to seventy, so should Medicare's. Americans aged sixty-five to sixty-nine could still participate in the program, but only by paying extra premiums.

• *Set limits on federal health-benefit spending.* We must restructure health-care benefits to control federal health-care costs. Currently we offer fee-for-service reimbursement to all eligible comers, with few cost disincentives, and then surround the process with a thicket of regulatory controls. I propose that Medicare, Medicaid, and other health-benefit programs offer three choices: take a fixed-dollar voucher and use it toward the purchase of the health insurance of your choice; enroll in an accredited managed-care program that

IE ""NDOWMENT ETHIC," ACCEPTING RESPONSIBILITY FOR THE FUTURE.

will then bill the government a fixed annual amount; or remain in the current fee-for-service system and face much greater co-payments and deductibles.

Any reform that seeks to introduce market discipline into our system of federal health benefits must give beneficiaries real incentives to be cost-conscious. Hence the greater co-payments and deductibles for those who choose the expensive fee-for-service option. The Medicare plan that Congress passed last year was all carrot and no stick. It gave beneficiaries the choice of enrolling in new kinds of managed-care plans, but would have imposed no penalty on those who opted to stay in traditional fee-for-service plans.

These measures would shift the task of cost control away from regulators and back to patients and providers, where it belongs. They would also allow Congress to live within a health-benefits budget, like the government of every other industrial country. As for the senior lobby's attachment to a "free choice of doctor" guarantee, voters must be reminded that a declining proportion of today's young workers—whose FICA taxes pay for much of Medicare—enjoy the full freedom of choice that was once common in American medicine. Most young workers consider themselves lucky if their employer pays for any health insurance at all.

Another prime candidate for reform is the unlimited tax deduction for company-paid health-care insurance (which now amounts to a $92 billion annual subsidy from the federal government). This wasteful and regressive deduction should be capped. Federal efforts to establish national health-practice guidelines for doctors, hospitals, and insurers should be encouraged. Although these standards would not be mandatory (patients or providers would still be free to spend their own money for services above the guidelines), they would give everyone a clearer idea of the cost-effectiveness of various treatment options—something all experts agree we lack.

Finally, we need to reduce the huge costs of "defensive medicine," through malpractice reform, and of "heroic" intervention when recovery is highly unlikely. Medicare spends approximately 30 percent of its budget on patients in their last year of life—often when the attempt to prolong life merely prolongs a hospitalized death. Few Americans want to end their lives this way. A recent survey shows that 89 percent of Americans support the concept of living wills. Yet only nine percent actually have them. Until we launch a widespread educational effort, make enforceable living wills widely available at very low cost, and perhaps even provide financial incentives to maintain them, doctors will continue to perform costly and painful procedures on patients who do not (or would not) want them and who will die in a few days or weeks anyway.

We should have no illusions about the future. Whatever reforms we implement, federal health-care costs are going to grow faster than our economy. This is one more reason why we must do everything possible to reduce growth in Social Security and other non-health-related programs.

3. ***Extend working lives.*** One of the best ways to reduce the crushing burden ahead is to encourage seniors to work longer—and make it easier for them to do so. This would require more than raising the age of eligibility for full benefits under Social Security and Medicare. To encourage longer working lives we should abolish the Social Security "earnings test" for beneficiaries who continue to work. (Let me stress that this reform must be implemented along with the affluence test I have described: a stand-alone aberration such as what Congress has recently proposed would be

an unearned windfall for senior-citizen CEOs like me.) Yes, there would be a small direct budget cost. But the benefits to the economy and to society, and to seniors themselves, of encouraging later retirement would be far more significant than the small increase in outlays.

The maturity, wisdom, and experience of older adults should not be lost to the workplace. This is a matter not just of combating age discrimination but of unlocking a powerful human resource. The market for jobs for which the elderly might be especially well suited should be explored: for example, full- and part-time service jobs in health care, child care, and various education and training efforts. It is time to do elders the honor of making their phase of life one of ongoing contribution—of genuine "generativity," to use Erik Erikson's classic description—as long as they are willing and able.

Not everyone, of course, is able to go on working. Richard Trumka, the president of the United Mine Workers, who recently served with me on the Kerrey-Danforth Commission on Entitlement and Tax Reform, warns that later retirement is simply not a realistic option for worn-out industrial laborers in physically demanding occupations. But such workers make up a small and shrinking share of the total labor force. Under my plan they would still have the option of early retirement (though with reduced benefits) and would be protected by federal Disability Insurance and Workers Compensation, not to mention the system of mandatory personal retirement accounts that I propose below. I would also use a small part of the savings achieved by raising the Social Security retirement age to lower eligibility ages and raise benefit levels under Supplemental Security Income, the means-tested floor of protection for the low-income elderly. In sum, we should encourage the elderly to work but not force work on those who are truly incapacitated. In any case, our national retirement policy should not be determined by the miner retiring at age sixty-two any more than by the police officer retiring at fifty-two or the athlete at forty-two.

4. ***Establish a system of mandatory pensions or personal retirement accounts***. I have concluded—reluctantly—that a fully funded, privately managed, and portable system of personal retirement accounts should be mandatory. The system I envision would initially supplement Social Security—and over time might increasingly substitute for it. But Social Security would continue to provide a floor of protection to all Americans, albeit one subject to the limits of the affluence test described above. Governments around the world have tried to achieve both these objectives—retirement savings and poverty protection—in a single system. They have achieved neither efficiently.

Why mandatory? In 1993 C. Fred Bergsten, the chairman of the Competitiveness Policy Council (a publicly financed, bipartisan group), asked me to chair a committee on capital formation. An impressive group of the nation's leading economists joined me in this effort. I had expected to hear that certain tax favors for saving (IRAs, for example) would significantly increase net savings—that is, savings beyond the cost of the tax incentive that encourages them. I quickly learned otherwise. The net effect of many of these conventional incentives has been marginal, because much of the money deposited in IRAs is simply shifted out of other investments. When I asked how we might increase net savings significantly, one important area of agreement emerged: mandatory pensions or savings accounts covering the entire work force. In addition to boosting private saving, such plans—by making tomorrow's retirees more self-sufficient—would allow us to reduce traditional Social Security gradually, thus reducing public dissaving as well. I am perfectly well aware of the libertarian argument that decisions about saving should be left entirely to individuals. The melancholy truth, however, is that many Americans are currently too myopic to save for the future unless compelled, and so end up becoming free-riders in the government safety net.

Why fully funded? First, to boost national savings. A funded retirement system would add to America's capital stock; a pay-as-you-go system does not. Second, because the dynamics of pay-as-you-go financing have encouraged politicians around the world to promise benefits that can be paid for only by excessively high taxes on future generations. The only way to avoid that temptation is to make it clear to everyone that above some minimum safety net a worker's future benefits will be determined solely by the resources that have been set aside for that worker, by some combination of employer contributions and the worker's own savings. These pensions must be invested in diversified investment-grade assets and must be the worker's personal property.

Why privately managed? A sound system of mandatory pension accounts must be publicly regulated to maintain fiduciary standards but should be privately managed to maximize returns. The evidence is overwhelming that publicly managed systems, which are often required to invest in low-return government securities, earn far less than privately managed accounts invested in the real economy.

Why portable? The new and fluid global economy, characterized by intense competition, rapid innovation, and relentless technological change, has made "lifetime employment" with one company rare. Instead making several major job changes in one's lifetime—perhaps seven or eight for the average worker now in his or her twenties—is normal, and therefore many workers lack enough years of service in any one job to qualify for a pension. The plan I propose would vest all contributions immediately, and so workers could take their pension savings with them as they moved from job to job.

To provide adequate retirement income, these accounts would require substantial contributions. In my view, all workers (in some combination with employers) should be required to contribute four to six percent of their pay—which, added to FICA, would come to a total contribution of 16–18 percent of pay. As a point of comparison, Australia's new system of mandatory pensions will ultimately result in total contributions of 15 percent of pay. In the scheme I propose, workers would have the option of making additional voluntary tax-free contributions. Employers who currently provide pensions could divert their contributions to workers' savings accounts as well. The primary function of this system would be to finance retirement and survivors' benefits; in time it might also pay for long-term medical care.

Although mandatory pension contributions would be made in addition to current FICA payroll taxes, and thus would decrease the consumable portion of each paycheck, the system would be linked to the Social Security reforms described above—and this would prevent FICA taxes from rising to the alarming levels forecast for the next century. Eventually workers would be paying no more (and maybe substantially less) in combined FICA and savings contributions under my plan than they would be paying in FICA taxes alone in a status quo future. By putting more of our income into genuine savings today, we could relieve the crushing payroll-tax rates that unfunded public transfers will otherwise exact on workers tomorrow.

The reform I propose would also require that any current-year Social Security or Medicare cash surplus be transferred, on a pro rata basis, to workers' personal retirement accounts. This provision would be consistent with pay-as-you-go accounting. Meanwhile, workers would have a direct stake in reforms that constrain future growth in federal benefits. To the extent that Social Security declines as a share of payroll, a growing share of FICA taxes would automatically be transferred to workers' savings accounts. Let me repeat: My proposal is for a two-tiered system under which everyone would continue to receive Social Security benefits. But over time my proposal would also allow us to go a step further. As the savings in private retirement accounts built, the current universal Social Security system could be converted into a purer and much less costly floor of protection that paid out benefits only to the truly needy.

A mandatory savings plan would generate substantial net gains in household (and national) savings—and thus ultimately gains in productivity and living standards. For middle- and upper-income workers subject to the affluence test this system would at least make up for reduced government retirement benefits—and probably go much further. For lower-income workers, who are the least likely to save (either on their own or through pensions), it would vastly reduce the chances of a destitute retirement. Seniors who were beneath the affluence-test threshold would receive their private pension on top of full federal benefits. True, the deduction from wages would be a burden, but it's worth noting that because of the Earned Income Tax Credit, the existing FICA tax on many of the working poor is now entirely borne by the federal government.

Dismissed until recently as too "radical," "privatization" of Social Security has burst upon the scene over the past year. Major proposals are under development at half a dozen think tanks—left, right, and center. Privatization has been featured on the cover of *Time* and embraced by the presidential candidate Steve Forbes, and, in one form or another, is endorsed by seven out of thirteen members of the Administration's official Social Security Advisory Council.

My plan has elements in common with many of these proposals. Where it differs from most is that it would fully pay for the transition to a funded Social Security system—and would do so *without adding to the national debt and without new general-purpose taxes.*

The challenge is that a single generation must somehow pay for two retirements—its own and that of its parents. Some proposals simply ignore the challenge. Take Steve Forbes's plan to keep all benefits for current retirees intact and yet permit younger workers to shift a substantial share of their FICA contributions into personal retirement accounts. What his plan would add to private savings it would cancel out dollar for dollar by increasing the federal deficit. Other proposals would issue Treasury debt directly to Social Security beneficiaries in the amount of the system's accumulated liabilities. This, too, is a zero-sum game that will leave tomorrow's workers no better off than if we had never reformed the system. A few proposals, like that of the Social Security Advisory Council, are more honest. But to pay for the transition they would resort to large general-purpose tax increases.

My plan would pay for transition costs the old-fashioned way: not with smoke and mirrors but by taking the essential step of asking current beneficiaries and current workers to give something up—the former by forgoing some benefits, the latter by saving more. This would not be painless. The magic of compounded returns from the stock market and other long-term investments cannot solve all our problems. To save more, we must consume less, at least temporarily. This "transition cost" is the price of escaping the generational chain letter we have so far depended on.

5. Shift our tax base from income to consumption. In an aging society taxpayers should be penalized for what they take out of the economy (consume) as opposed to what they put in (save). I therefore propose that only "consumed income"—spending, that is—be taxed. It is true that by exempting savings from taxation this reform would narrow the tax base. On the other hand, it would also widen the base, by rendering taxable various forms of government-financed and -subsidized consumption—from Social Security benefits and the insurance value of Medicare to employer-paid health care—which today are partly or fully tax exempt. Tax rates thus need not be any higher than they are today.

Many will object that consumption taxes are regressive; but the consumed-income tax plan introduced by Senators Sam Nunn and Pete Domenici—in which the more one spends, the higher one's tax rate—demonstrates that consumption taxes need not sacrifice the principle of progressivity, which I support. Moreover, without increased saving we cannot expect the real income of the typical American household to grow again—and without such growth the distribution of incomes will continue to widen. The zero-sum politics of economic stagnation will overwhelm whatever weak contribution to economic equality we might continue to derive from our current system of progressive income-tax rates.

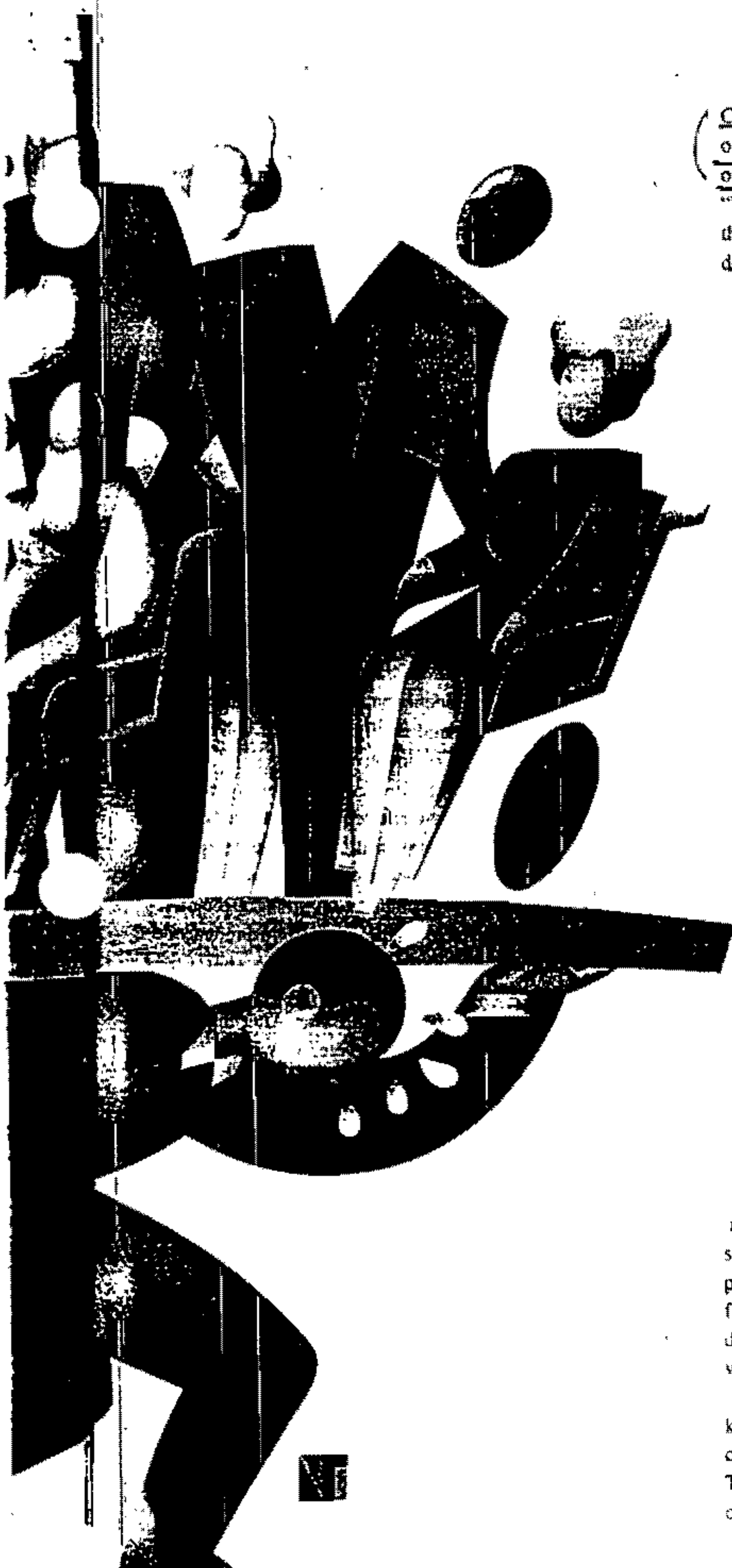
We are currently bombarded with tax-reform proposals of every variety—from sales taxes to flat taxes. Some want to get rid of the Internal Revenue Service. Some want tax returns that can be filled out on a postcard. Who doesn't want simplicity? And who likes the IRS? But I would suggest a more important criterion for evaluating tax reforms: Which is most likely to increase net national savings?

6. ***Mount a broad-scale public-education effort to promote saving.*** National leaders must help to mobilize citizens by articulating a sense of moral imperative. A thrift plan needs a bully pulpit.

Can the right kind of education and exhortation make a difference? Consider Japan. Until the 1950s, when the country rallied behind a campaign to promote thrift, the Japanese were poor savers. Since then they've become famous for their saving. Or consider Singapore, whose Central Provident Fund has furnished much of the investment capital that has fueled Singapore's legendary economic growth—not to mention the savings that have enabled nine out of ten households to become homeowners. Or consider Chile and Australia, which have also established national pension systems based on the principles of full funding and portability. In each instance public education was crucial to securing public support. In Chile, for instance, José Piñera, then the Minister of Labor, went on national television, often weekly, to explain why the mandatory pension plan was such good news for Chileans.

In a society like our own, where grassroots consensus is so important to governance, public discussion and debate are all the more important. The problem is that for at least three decades leaders have been telling us that consumption, not savings, is the key to prosperity. The campaign in favor of consumption has worked—all too well. Now it's time for a different kind of campaign—one in which not only our political leaders but also our businesses, our universities, and our public-policy institutions must persuade Americans to adapt to the realities of our aging society.

THE FIRST STEP TOWARD LONG-TERM BUDGET BALANCE IS TO



What we need most of all is a moral vision, a Middle-Class Bill of Responsibilities—not a gaggle of leaders falling over one another in their rush to propose a Middle-Class Bill of Rights, or the middle class silently rehearsing the mantra "We are not part of the problem and we need not be part of the solution." Instead we must be encouraged to ask, What do we expect individuals and families to do for themselves, and what do we expect federal, state, or local governments to do for them? What are our responsibilities to our own children and grandchildren? How can we strengthen families so as to provide support for older people? What are our obligations as a nation to our collective progeny?

The manual for Germany's social-security system looks, at first glance, a lot like our own—page after page describing the benefits due if one retires, is widowed, or loses one's job. The most obvious difference is the generous benefits to German children. But there is a more striking contrast. For each benefit, alongside a box describing "Your Rights" is a box describing "Your Duties." Citizens are thus reminded that society must always balance the payer against the payee, the future against the present. We need to find that balance again in our culture.

Why can't the President call for a White House Conference on Aging different from the one held last year—not one that panders to the senior lobby but one that encourages serious dialogue between old and young? Why can't the President call for a global summit at which the leading economies focus on reducing their tremendous and unsustainable unfunded liabilities, and at which developing economies with younger populations concentrate on avoiding the mistakes the industrial countries have made in providing old-age security?

Companies also have a major educational responsibility. With their human-resources and accounting departments, they are able to educate workers on the basics of saving—why they should save more, the power of compound interest, how to invest. They can also make it easier for their employees to save—through automatic salary deductions, 401K plans, stock-purchase and dividend-reinvestment plans.

Bringing our youth into the savings crusade is another key. John F. Kennedy once challenged us to ask not what our country can do for us but what we can do for our country. Today's youth see the most conspicuous interest groups in our political system busily asking what the country can do

REDUCE ENTITLEMENTS FOR PEOPLE WHO DON'T NEED THEM.

for them. But who represents the future and the general interest? The young, alas, are the new silent majority. The demographer Samuel Preston once remarked apropos of the relentless growth in senior entitlements that the political system would behave a lot differently if people were forced to live their lives backward—that is, if they had to look forward to the burdens imposed upon youth as their own future.

I suggest that young people embark on dual careers—a private career and one as a citizen. As citizen lobbyists in behalf of the future, they are responsible for becoming informed about the debts they are going to assume, the unfunded liabilities they are going to pay for, and the unsustainable taxes they are going to bear. Once they are informed, perhaps America's youth will initiate an honest dialogue with their parents and grandparents, without assuming that their elders are greedy old fogies who don't care. My generation may be uninformed and even misinformed, but we do care about our children, our grandchildren, and our collective future. But if anyone is to create a general-interest lobby in behalf of the future, youth must lead the way.

If we expect our leaders to lead, the voters must make it safe for them to do so. The Concord Coalition is a bipartisan grassroots "lobby for the future," dedicated to breathing new life into the American Dream. The warm reception we have received from countless concerned citizens has rekindled my faith that we can still build a special interest in behalf of the general interest.

CONCLUSION

AND what of the special role for geezers like me? Pessimists say, "Forget it"—Americans will not reform senior benefits until a severe crisis is actually upon us, but will persist in viewing them as contractual obligations that by definition are always affordable. After all, an America that acknowledges limits is an America that has lost the one illusion that makes it unique and creative. According to this view, America must always be an unteachable force of nature that can never back away from any promise or expectation, no matter how extravagant. This, pessimists say, is why American voters repeatedly elect leaders who promise lower taxes, higher benefits, rejuvenated economic growth, and a magic bullet for every social problem—without caring how the pieces fit together.

But I have a more optimistic view. Two years ago I was interviewed by *60 Minutes* about the need to enact gradual but far-reaching structural reforms in federal entitlements for the elderly. The show's producers, after patiently taping my arguments, invited me to join them at a middle-class retirement community. Here, they said (with a few wry smiles), I could explain my suggestions to those who would be immediately affected.

Standing before this group of retired grandparents, I began by showing photographs of my own grandchildren. I explained my concerns about their future and the world they would inherit. I then reminded the retirees how much of our national affluence today rests on the willingness we had to make collective sacrifices during the Great Depression and the Second World War. Back then we felt that we were "all in this together" for the sake of tomorrow. I told them that the German theologian Dietrich Bonhoeffer said it best for us when he observed, at the height of the Second World War, "The ultimate test of a moral society is the kind of world that it leaves to its children."

Sooner or later, I told the retirees, we will have to prepare for the future. We will have to balance our public budgets, trim back benefits to those who need them least, save more as households, retire somewhat later from the work force, explore innovative means of economizing on health care, take a more effective public interest in the welfare of children, and offer the rising generation some tangible evidence that we are willing to make sacrifices in their behalf. If we do so sooner, we still have time to plan for a gradual and humane transformation. If we do so later, the changes are likely to be forced upon us, suddenly and painfully, in the midst of an economic, political, and family crisis that will leave the eventual outcome much in doubt.

Given all that, I asked them, if everything else were also put on the table and it really would lead to a balanced budget, how many of you would be willing to give up some share of your federal benefits, above what you need to live on, in order to ease the deficit burden on younger generations? To the visible surprise of the *60 Minutes* producers nearly everyone raised a hand.

The generation I was speaking to survived the Depression and fought and won the Second World War. After the war this generation provided its returned veterans with college educations, built the interstate highway system, eradicated polio, took us to the moon, and won the Cold War against communism. Against these monumental accomplishments what it would take to solve our current crisis seems small. I believe that this generation is capable of doing the right thing, and that politicians might well discover that it is better to appeal to their nobler instincts than to pander to their baser ones.

A people who have made a tradition of quick gratification must now be asked to focus on the requirements of a society graced with the patina of age—on saving rather than consumption, on prudence rather than desire, on collective restraint rather than individual satisfaction. As Americans grow older, they will have to recognize that the live-for-today attitude that may be endearing or at least understandable in youth is not just unseemly but ruinously dysfunctional at the far end of life. They would do well to heed the eighteenth-century French moralist Joseph Joubert, who warned, "The passions of the young are vices in the old."

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

January 6, 1997

MEMORANDUM FOR PRESIDENT CLINTON

FROM: Robert E. Rubin RER

SUBJECT: Treasury Accomplishments and Goals

Treasury is and will continue to be involved in a broad array of activities, from assisting in budget negotiations with Congress to drug interdiction, from strengthening the stability of the international financial system to improving the economic prospects of the poorest, from enforcement of the Brady Law and the Assault Weapons Ban to auctions of government securities, from negotiating international tax treaties abroad to tax legislation and improving the IRS.

This memorandum broadly outlines Treasury's current priorities. Under each priority, there are accomplishments from your first term and specific second term goals in areas where Treasury has the lead responsibility or is significantly involved. We look forward to working with other agencies and the White House in all of these areas.

- **Balance the budget**
- **Enact the President's tax proposals, simplify the Code and improve the IRS**
- **Improve retirement security and increase savings**
- **Maintain U.S. leadership on the issues of the global economy**
- **Help low-income households and economically depressed areas**
- **Modernize the U.S. financial system**
- **Fight financial and other crimes**
- **Continue to build a strong institution**

BALANCE THE BUDGET

As a result of the 1993 deficit reduction program and other economic policies, we have experienced sustained economic growth and significant deficit reduction. We now have a rare, historic moment to adopt revenue and spending measures leading to a balanced budget, which would be particularly important in sustaining favorable economic conditions over the long term in the context of global financial markets that are very heavily focused on fiscal and other financial conditions. We must do everything possible to defeat Congressional efforts to pass a balanced budget amendment which would create the possibility of seriously exacerbating downturns in the economy.

<u>Accomplishments:</u>

- Helped develop and win passage of the deficit reduction package in 1993 which contributed substantially to diminishing deficits and continued economic expansion.

- Changed the maturity mix of Treasury debt to save interest costs.
- Helped defeat the Balanced Budget Amendment in the 104th Congress.
- Provided oversight of a number of privatization projects including the National Petroleum Reserves, Connie Lee and Sallie Mae.
- Helped stand firm against Congress in the Fiscal Year 1996 budget negotiations through government shut-downs and threatened default under the debt limit.

Goals:

- Help negotiate a balanced budget that preserves the Administration's priorities.
- Help defeat a balanced budget amendment.
- Help develop a long-term strategy and process for entitlement reform.
- Work with OMB to develop an agenda and timetable for possible privatizations, complete pending privatizations and privatize significant additional government assets and operations.
- Improve the liability side of the Federal balance sheet to further reduce interest costs.

ENACT THE PRESIDENT'S TAX PROPOSALS, SIMPLIFY THE CODE AND IMPROVE THE IRS

Over the last four years, we have worked to provide targeted tax cuts, simplify the tax system, reduce paperwork burdens, protect the taxpayer and improve the IRS. We must continue on this path. Tax policy is likely to remain a hot-button issue, in the context of both budget negotiations and efforts to restructure the IRS. Also, there are those who have proposed structural tax reform, an immensely complicated issue. While there will be quite a bit of rhetoric around structural tax reform, I do not believe that it will become a serious Congressional possibility, nor should this be an Administration priority. Instead, I believe that we should focus on enacting the President's middle class tax cuts, on tax simplification, and on improving the IRS.

Accomplishments:

- Oversaw passage of the Tax Payer Bill of Rights 2 (TBOR 2) which strengthened the rights of all taxpayers in dealing with the IRS in a reasonable fashion.

- Joined the tax debate in Congress which included the development of coordinated responses to issues such as the Kemp Commission's report on the flat tax.

- Took steps to achieve tax simplification and improve IRS processes.

- Completed bilateral income tax agreements with many countries -- including Canada, France, Sweden, Thailand, and Mexico -- which created more opportunities and improved the competitive position for U.S. companies abroad.

<u>Goals:</u>

- Negotiate the tax provisions of the Administration's budget, including middle class tax cuts.

- Accomplish further tax simplification (e.g., TBOR 3 and tax simplification measures we will propose).

- Achieve major progress in reinventing the IRS to provide better service and improve tax compliance. This includes improved management systems, application of information technology and changes in the organizational structure, including the possibility of making the IRS into a performance-based organization (PBO).

- Complete additional tax treaties.

IMPROVE RETIREMENT SECURITY AND INCREASE SAVINGS

Increasing our national savings rate is key to raising future living standards. Your Administration deserves credit for a quiet transformation of policy on national savings. Deficit reduction, changing the maturity mix of the federal debt structure, pension portability and the introduction of inflation-indexed securities have helped improve the prospects for savings. We must pursue other means of increasing the savings rate and improving the security of retirement savings.

<u>Accomplishments:</u>

- Introduced inflation-indexed securities and conducted a vast marketing effort to educate potential investors for first auction of inflation-indexed notes in January 1997.

- Enacted pension reform to increase pension availability and portability.

- Presented new incentives for savings with the proposed expansion of IRAs.

- Contributed to increased public savings by helping to develop and enact the President's economic plan which brought down the deficit by over 60 percent.

Goals:

- Develop and implement a package of initiatives to increase savings and enhance retirement security, including through IRAs and further pension reform.

- Evaluate the savings bond program and make changes to improve its contribution to increasing private savings, including through the introduction of an indexed savings bond.

- Work with the rest of the Administration to develop a long-term agenda for the reform of the Social Security system.

- Improve the liability side of the federal balance sheet to further reduce interest costs.

- Launch a major public education effort to encourage private savings.

MAINTAIN U.S. LEADERSHIP ON THE ISSUES OF THE GLOBAL ECONOMY

An overriding challenge for the Administration is to prevent the U.S. and other major powers from turning inward and to build support, including support among the American public, for globalism and the prosperity and security it fosters. The stability of the global economy is critically important to U.S. economic, political and security interests, and we need to engage and provide leadership on the issues of the global economy. That includes the issues of opening markets abroad and supporting development in developing and transitional economies around the world, our largest growing export markets. We do this most efficiently and most effectively through the World Bank, the IMF and other international financial institutions. Global leadership also includes dealing with crises that affect the international economic system, such as the one that occurred in Mexico in 1994.

Accomplishments:

- Helped secure passage of GATT and NAFTA.

- Helped encourage and preserve international financial stability, including through the handling of the Mexico crisis.

- Guided international program of support for Russia which led to the stabilization of its economy.

- Through the G-7, brought about during the past two years an appreciation of the dollar and a restoration of U.S. leadership in the international economy.

- Concluded a market-opening agreement with Japan for its financial markets, and established a framework for WTO financial services negotiations.

- Implemented the Halifax agenda to create a truly global capital market with real transparency and safeguards.

- Used U.S. leverage in the multilateral development banks to make them a key tool for addressing global problems such as environmental degradation, illiteracy, poverty and AIDS.

- Worked closely with our G-7 partners in helping to build the foundation for prosperity and political stability in Central Europe, the NIS and the other transition economies. In particular, helped Bosnia lay the fundamental economic groundwork for a stable and lasting peace under the Dayton Accords.

- Created a process for regular consultations with Finance Ministries in Latin America and APEC to strengthen our ties and their commitment to financial soundness and market-based economic policies, including privatization and effective capital markets.
- Strengthened our bilateral economic and financial ties with key countries such as China, Russia and Argentina.

<u>Goals:</u>

- Help to secure fast track authority.

- Seek an IMF quota increase and authorization from Congress on New Arrangements to Borrow, neither of which has any budget outlay impact.

- Seek Congressional support for the multilateral development banks.

- Help organize a successful 1997 G-7 Summit in Denver which significantly furthers an agenda of international cooperation on economic, environmental and law enforcement issues.

- Work with the rest of the Administration to define a new approach to China and Africa.

- Work with the rest of the Administration to maintain constructive relations with key countries and regions, specifically Japan, Russia, Europe, and Latin America to support financial soundness and market-based economic policies, including effective capital markets.

- Maintain a strong dollar consistent with economic fundamentals.

HELP LOW-INCOME HOUSEHOLDS AND ECONOMICALLY DEPRESSED AREAS

Work to use the tax tools and the tools of finance to address the persistence of high levels of poverty and dependency, the social problems associated with that poverty, and the acute economic isolation of large numbers of poor people.

Accomplishments:

- Helped expand the Earned Income Tax Credit which provided tax relief to 15 million working Americans.
- Helped secure a permanent Low Income Housing Tax Credit (LIHC). Through the LIHC, the flow of private investment dollars to rebuild housing expanded helping to create over 60,000 units of affordable housing every year.
- Stood firm against attempts to weaken the Community Reinvestment Act (CRA) and reformed regulations of the CRA which has unleashed significant capital to our inner cities by helping capital flow from mainstream financial institutions.
- Initiated a nationwide network of community development banks with the passage of the Community Development Financial Institutions Fund (CDFI) bill which provides capital to distressed communities across the U.S.
- Worked with others in the Administration on enactment and implementation of Empowerment Zones and Enterprise Communities.
- Assisted the D.C. Government in returning to financial stability by providing financial assistance when market financing was unavailable.

Goals:

- Work with the rest of the Administration to shape the welfare-to-work program to maximize results.
- Maximize Federal efforts to collect delinquent child support through Treasury's funds payments and explore techniques to assure child support.
- Secure Congressional passage of the Brownfields tax credit to encourage the clean up of abandoned industrial properties in economically distressed areas and put them back into productive use.
- Create an initiative to facilitate the development of secondary markets for urban debt.

- Contribute to the effort to make D.C. financially self-sufficient and better able to provide for the needs of its citizens.

- Expand the CDFI program.

MODERNIZE THE U.S. FINANCIAL SYSTEM

Updating the regulatory framework to take into account the evolution of the financial services sector is instrumental to increasing competition and containing threats to financial stability. In addition, the advent of new technology poses fresh challenges to financial regulation and opportunities to expand the delivery of services to those currently outside the system.

Accomplishments:

- Secured passage of interstate banking legislation which made banks more competitive and allowed them to provide better service to their customers.

- Secured the passage of legislation which merged the Bank Insurance Fund with the Savings Association Insurance Fund (SAIF), thus, saving SAIF from its severe undercapitalization and staving off its projected collapse.

- Worked with the rest of the Administration on reviewing and negotiating many of the provisions in the securities law reform legislation passed by the 104th Congress.

- Delivered 425-million federal payments electronically (valued at nearly $700 billion) in 1996 which represented over 50% of all federal payments and thus saved millions of dollars for the government and the banking industry.

- Significantly revised banking regulation, improved access to credit by ending the credit crunch through strengthened economic policies, and promoted credit access for all Americans, substantially increasing the share of mortgage lending going to minorities.

Goals:

- Seek passage of a financial modernization bill to increase competition and efficiency in the U.S. financial services market.

- Develop a sound and coherent e-money policy.

- Prepare to implement the requirement that all Federal payments be made electronically by 1999, including the development and implementation of a policy to facilitate the provision of financial services to those who are currently unbanked.

FIGHT FINANCIAL AND OTHER CRIMES

Treasury will continue to be involved in a broad range of law enforcement issues from firearms to drug interdiction, from protective service to money laundering, and the other roles in its law enforcement mission. Treasury, with roughly 40 percent of the Federal government's law enforcement officers, will be a key player in the Administration's overall crime-fighting efforts and has a particularly important role to play in the area of financial crime.

Accomplishments:

- Helped pass, implement, and vigorously enforce the Brady law, Lautenberg Amendment to the Brady Law, the Crime Bill which included the Assault Weapons Ban, and the Anti-Terrorism Bill.
- Successfully introduced new $100 note after conducting an extensive public education campaign across the world to inform users of American currency that our currency was being redesigned to include advanced counterfeiting deterrence features.
- Increased narcotics seizures and arrests at the Southwest Border and in the Caribbean through expanded border interdiction efforts.
- Conducted investigations into church fires which resulted in a permanent arson database, arson prevention efforts, arrest rates that are double that for arson overall, and new efforts in cooperation with local officials and communities.
- Reached out to our global partners in crime fighting on money laundering, anti-narcotics. Identified international narcotics traffickers and froze their U.S. assets.
- Reviewed and implemented findings of the White House Security Review, the Waco Review, and the Good O' Boys Roundup Review.
- Provided critical law enforcement support in numerous investigations and operations including Olympic Security, and the World Trade Center and Oklahoma City bombings.

Goals:

- Strengthen efforts to fight financial crimes to support broader anti-crime activities and to strengthen international cooperation against money-laundering, organized crime and the trafficking of drugs.
- Accomplish anti-terrorism mission, including through the expanded use of taggants and the creation of a national data repository for explosives and arson incidents.

- Achieve more strategic Customs enforcement at the border to maximize interdiction and the facilitation of trade.

- Upgrade the professionalism and standards of enforcement personnel and procedures, including those associated with key enforcement missions such as anti-terrorism, drug interdiction and protective services.

CONTINUE TO BUILD A STRONG INSTITUTION

Treasury is a strong institution, and one of our principal responsibilities is to maintain and improve Treasury's ability to serve the American people in many ways.

__Accomplishments:__

- Introduced technology to make Treasury more efficient and improve its service to its customers -- e.g., instead of making trips to the IRS or the local public library, taxpayers were able to download forms instantly through the IRS homepage on the World Wide Web and now taxpayers with simple tax forms can file at home on the phone. (The IRS Web page has received over 100 million "hits" thus far.)

- Cut paperwork requirements, canceled many useless regulations, and overhauled many other regulations by rewriting them in plain English.

- Led the multi-agency project named Simplified Tax and Wage Reporting System which will significantly reduce the wage data reporting burden of employers and improve Federal and state employer tax operations.

- Established customer service plans and reliable feedback mechanisms to determine customer satisfaction in 90 percent of Treasury's operations (pursuant to the Customer Service Executive Order which targeted 25 percent rate by 1996).

- Reorganized Customs to eliminate two layers of bureaucracy and move more staff to front-line jobs that provide service directly to the public.

__Goals:__

- Reform the IRS, as discussed above.

- Reinvent Treasury's personnel system to implement a process for strategic and effective human resource management to identify, recruit, develop, reward and retain high performing individuals.

- Use new approaches and new technology to work more efficiently and serve the public better.

- Complete a clean and comprehensive audit of an agency-wide financial statement, including the IRS.

- Explore opportunities for further reinvention and deregulation.

cc Vice President Gore
Leon Panetta
Erskine Bowles
Donald Baer
Rahm Emanuel
Sandy Berger
Kitty Higgins
John Hilley
Frank Raines
Bruce Reed
Gene Sperling
James Steinberg
Dan Tarullo

THE WHITE HOUSE

WASHINGTON

CLOSE HOLD
July 3, 1997

MEMORANDUM TO THE PRESIDENT

FROM: **GENE SPERLING**

SUBJECT: **Long-term entitlement reform**

As you know, our original game plan on long-term entitlement reform was first to pass the balanced budget agreement and then to turn our attention to the longer-run challenges. But we no longer have the luxury of waiting until after the budget agreement is implemented: both the House and Senate reconciliation bills set up Medicare commissions. We must therefore decide immediately whether to accept a commission on long-term Medicare reform. We must also decide whether we want to set up a commission on Social Security -- probably separately from the Medicare commission -- within the budget legislation.

The purpose of this memorandum is to explore three related questions and to give you an opportunity to provide us with your guidance on these questions. First, should our long-term entitlement strategy put more priority on initial action on Social Security reform or Medicare reform? Second, even if we believe that our best strategy is to focus initially on Social Security, should we still support a Medicare commission, and, if so, should we try to change the congressional proposals to ensure that the commission neither interferes with our efforts on Social Security nor produces problems for Medicare? Third, should we support the creation of a Social Security commission now, or should we allow ourselves more time to analyze the best way to proceed?

I. Where should we initially focus our efforts on long-term entitlement reform?

A first step in addressing our immediate concerns is that you must decide where to place our initial emphasis in long-term entitlement reform. Senator Lott and other Hill leaders have indicated that they want to tackle long-term Medicare reform first. *But your economic and* *health advisers believe that we should concentrate our initial political capital primarily on Social Security.* The basic argument is that the various options for tackling Social Security are -- at least by comparison with Medicare -- well-researched and relatively well-understood. Our understanding of how to address the long-term solvency of Medicare is limited. Indeed, your four top health advisers -- Donna Shalala, Chris Jennings, Bruce Vladeck, and Nancy-Ann Min -- believe that the budget agreement embodies most of the obvious steps in reforming Medicare, and that we need much more analysis before considering which additional long-term policies are sensible. Even new proposals such as raising the eligibility age from 65 to 67 and introducing a home health care co-payment will have only a small impact over the long run. Medicare combines Social Security's demographic challenges with those posed by a health care delivery system characterized by generally rising health costs per beneficiary but much uncertainty over the dynamic evolution of those costs, making effective reform particularly complicated.

Chris Jennings will be submitting a separate memorandum to you explaining why long-term Medicare reform is difficult. Nonetheless, in deciding whether to pursue Social Security reform first, you should remember that such a strategy would be complicated because Senator Lott and other Republican Hill leaders favor addressing Medicare first.

Decision

_________ Put initial emphasis on Social Security reform

_________ Put initial emphasis on Medicare reform

_________ Discuss

II. How should we respond to the Medicare commission proposals?

While you obviously have the option of opposing a Medicare commission in reconciliation, we believe that it is basically a done deal, and our focus should be on how to fix it to fit our needs. If you agree that we should focus our efforts on Social Security first, it is important that a Medicare commission not hinder or undermine that objective. For example, an over-hyped commission on Medicare with key officials from both sides and an early reporting date could divert attention away from Social Security reform. It could also lead to ill-conceived and possibly harmful recommendations for Medicare.

Under both the House and Senate plans, the commission would comprise 15 members (eight Republicans and seven Democrats): six (four Republicans and two Democrats) chosen by the Senate Majority Leader in consultation with the Senate minority leader, six (four Republicans and two Democrats) chosen by the Speaker in consultation with the House minority leader, and three Administration representatives. Under the House bill, you are not granted any discretion in choosing your representatives, who would be the Secretary of Treasury, the Secretary of Labor, and the Secretary of HHS. Thus, under the House bill, the Hill leadership could choose their own representatives, which provides distance from controversial decisions, while you would be forced to put three Cabinet secretaries on the commission. Unlike almost all previous commissions, neither the House nor the Senate proposal would give you the right to choose the chair. The reporting date for the commission would be May 1, 1999 under the House bill and one year after passage of the act -- implying a likely deadline of August 1998 -- under the Senate bill.

You could of course oppose the creation of any Medicare commission. However, your advisers would be concerned that opposition to a Medicare commission may be incorrectly viewed as indicating a lack of interest on our part in tackling entitlement reform. John Hilley believes that the Medicare commission will survive in conference regardless of whether we oppose it.

Instead of opposing a Medicare commission, we could try to ensure that any such commission is not over-hyped, forced to follow a face-track decision-making process leading to an up-or-down vote on a package, or in other ways crowds out your ability to put your initial focus on Social Security. There is enough uncertainty over the substance of Medicare reform, even among your top health advisers, that an intelligent analysis of the issues by a commission could prove extremely beneficial. A commission comprising serious, top-flight people could thus advance the cause of Medicare reform by illuminating possible options, much like the Gramlich commission did for Social Security. To ensure that a Medicare commission is beneficial and does not detract from Social Security reform, we would recommend several changes to the congressional proposals:

- **Membership.** We should not be required to name top Administration officials to the commission, which would preferably also not include Senators and Representatives. If its membership includes top policy-makers, the commission may be constrained by possibly premature policy statements and would seem unlikely to engage in the type of wide-ranging analysis most beneficial on the Medicare front. A commission comprising outside specialists and academics seems more auspicious. As mentioned above, the House version currently appoints to the commission the Secretaries of Treasury, Health and Human Services, and Labor, but grants flexibility to the congressional leadership over appointments. We could fight to remove the Cabinet members from the commission and provide you with full discretion over your appointments.

- **Party balance.** We should also insist on a truly bipartisan commission, with equal numbers of Republicans and Democrats. The current proposals would have eight Republicans and seven Democrats.

- **Chair.** The chair of the commission could set the tone for the entire exercise. Unlike almost all previous commissions, the congressional proposals do not allow you to appoint the chair of the commission. We could insist that you appoint the chair. As a fall-back, we could ask that the chair be chosen mutually.

- **Consensus voting rules.** We could insist on super-majority (3/5 or 2/3) voting for any of the commission's recommendations -- making it more likely that a diversity of views would be represented in the commission's work. Unfortunately, even super-majority voting may not be able to prevent bad outcomes, given the most likely makeup of the commission. (A super-majority could likely be achieved even if only two of the four congressionally-appointed minority members vote with the majority.)

- **Reporting deadline.** The House proposal includes a May 1, 1999 deadline. The Senate proposal sets a deadline of one year after passage of the act -- implying a likely deadline of August 1998. An August 1998 deadline is likely to be too soon to permit the commission to conduct a careful analysis. And the May 1999 deadline would allow us time to make proposals on Social Security before the Medicare commission reports.

- **Analysis.** The House proposal requires the commission to use CBO rather than HCFA estimates. HCFA has produced the numbers for previous commissions, and HCFA should produce them here as well.

<u>Decision</u>

_______ Support changes to Medicare commission proposals outlined above

_______ Do not support changes to proposals outlined above

_______ Discuss

III. Should we support a Social Security commission within the budget legislation?

As noted above, your advisers believe that we should initially focus our long-term entitlement efforts on Social Security. Although it will not be easy to obtain, true Social Security reform would ease the burden from expected increases in the elderly dependency ratio over the next several decades, and would represent a substantial and lasting achievement of your second term. Regardless of the process, *the Administration would need to spend much of next year -- perhaps starting as early as this fall -- educating the American public and reaching out across the political spectrum to build support for reform.* Historically, a short-term crisis has been necessary for change. (Scholars argue, for example, that the success of the 1983 Greenspan commission was due in large part to the imminent exhaustion of the Trust Fund.) We do not face such a short-term crisis now, making it more difficult to motivate reform. <u>Your challenge would be to motivate the nation to sensibly address and protect one of our most successful programs -- so we could avoid dealing with it in a more disruptive crisis environment later.</u> Public understanding of these issues -- though still inadequate -- is far greater than it has been before. And early action would permit time to implement changes gradually -- and slowly phased-in changes may be more feasible than sudden ones.

The immediate question before us is whether creating a bipartisan Social Security commission in reconciliation will help our chances for achieving long-term reform. Some think the best way to proceed on Social Security is to include a commission in the budget legislation. Others think that we should take more time before pushing for a commission, so that we can more carefully consider our options. Then if we decide that we want a commission later, we could always create one by executive order (as with the Greenspan commission in the early 1980's) or by a separate statute.

Option 1: Try to negotiate a bipartisan Social Security commission in the budget legislation

Under the first option, we would engage the Republicans immediately to create a bipartisan Social Security commission within the omnibus budget legislation. The goal would be to make the commission <u>credible and specific</u>: It would be charged with issuing its recommendations within a relatively short time period, perhaps by next summer.

- Under one approach, the commission's membership could include all key policy players from the beginning. This approach would facilitate rapid implementation of proposals.
- An alternative approach would have the commission represent a broader array of relevant groups: older Americans, younger Americans, the unions, corporate leaders, etc. The commission's proceedings would then be used as part of our public education effort.

Following the commission's report, we could hold a smaller high-level negotiating process or look to another process -- perhaps including announcing our own proposals -- to implement reform.

While a commission was undertaking its work, an inter-agency team within the Administration would put together our own proposals. The Administration would then work with the commission and the Hill to reach consensus on an acceptable package that would carry bipartisan support, and to translate the commission's proposals into legislation.

Option 2: Do not create a Social Security commission within the budget legislation — instead act later, either with or without a commission

The alternative is not to create a commission within the budget legislation, but rather to engage with the Republicans later -- either with or without a commission. The basic logic is that we should not create a bipartisan process before we have fully developed our own strategy for Social Security reform and considered what bipartisan processes would best advance that strategy.

For example, our strategy could involve holding our own series of public education events, while reaching out to prominent Republicans like Bob Dole or Warren Rudman. It could include a series of regional public hearings. And it could include a commission created by executive order, or one created by statute. There are many possibilities, and with more time we could think through which ones are most promising. After we reached internal consensus on the right approach, we would be able to present a coherent, unified front and would be more likely to achieve success. And after we evaluate our options, it may turn out that we do not even need a commission: Frank Raines points out that President Carter was able to reform the Social Security system without one.

Pros and cons of including a Social Security commission in the budget legislation

<u>Pros</u>

- It dissipates some of the focus away from a Medicare commission, maintaining momentum behind Social Security reform.
- You would clearly signal your commitment to Social Security reform.
- Secretary Rubin and John Hilley feel that we have a short window of opportunity to engage in a bipartisan process, and that opportunity could be lost if we wait to analyze

our options further.

Cons

- It may not make sense to create a commission before we have carefully explored the best strategy for achieving reform.

  -- Moving now would not allow us time to consider our options and to consult with the Republican and Democratic leadership, Senator Moynihan, the AARP, and others on how best to proceed.

- Given that Senator Lott and other Hill leaders want to focus initially on Medicare, we may not even succeed in getting a Social Security commission into the budget legislation.

- Some are not sure that a commission is beneficial or necessary for effecting reform.

Decision

_________ Create Social Security commission within budget legislation

_________ Do not create Social Security commission within budget legislation to allow more time to consider strategy

_________ Discuss

Action

We will be convening an NEC inter-agency process with your budget team, HHS, DPC, and others appropriate to consider both the strategy and substance of Medicare and Social Security reforms. I will talk with Erskine about how best to design a process for ensuring that we maintain the appropriate degree of confidentiality while still benefitting from the insights of relevant agencies and officials.

If you want to create a Social Security commission within the budget legislation, we will hold an expedited process to present you with options on how that commission should be structured.

THE WHITE HOUSE

WASHINGTON

July 12, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: NEC Weekly Report

Social Security Reform. Following up on my memorandum to you last week, I led two meetings on our strategy for Social Security reform this week, including one in Erskine's office with your economic team. One conclusion from our internal meetings was that we did *not* want a Social Security commission included in the budget legislation -- the collective judgement of Erskine and your top advisers was that such a move would unduly complicate the budget negotiations, would not allow sufficient time for carefully designing a commission, and would represent too stark a contrast with the Medicare commission already included in the legislation (which we are trying to shape into more of an advisory commission).

The discussion therefore moved on to other related and complicated issues. A key question is whether we should come out with our own specific proposal early next year. Some felt that we can not afford to wait until past the fall 1998 elections, and that acting soon was therefore essential. Coming out with a proposal early, according to this argument, would demonstrate your leadership, help to focus the debate, and move the process along. Others questioned whether it would be possible to develop a coherent proposal by early 1998, would prefer taking the time to invest in a public education effort and a bipartisan process, and were concerned that a proposal without bipartisan support would politicize potential solutions and harm prospects for legislation. Related questions include how we should approach the Republican leadership to sound them out on how they want to proceed; whether you should seek other bipartisan support (Rudman, Peterson, Dole) if the Republican leadership initially balks; whether you should give a speech in the near future laying down a marker on the issue; and whether it would be helpful to appoint a group of eminent Americans to serve on an education panel or an advisory commission. These are huge questions, and we plan to meet again soon to refine the various options before presenting a memo and, if appropriate, arranging a meeting with you on the topic.

Erskine and Secretary Rubin did consult, as you requested, with Senator Moynihan. He said he would get back to us, although his initial response to Erskine was a one-page substantive plan -- of which 75 percent was the 1.1 percent CPI adjustment recommended by the Boskin Commission.

Medicare. This week, Chris Jennings and Jeanne Lambrew discussed major Medicare issues both internally and with Congressional staff and Members. The focus has been on issues surrounding the income-related premium. NEC has been coordinating an interagency working group comprised of staff from Treasury Economic Policy, Tax Policy, and IRS; HCFA; Social Security Administration; and OMB. This group has thoroughly examined issues associated with administering the premium through Treasury versus HHS/SSA. We have produced internal documents detailing concerns and costs, as well as summary documents for public distribution.

Climate Change. Dan Tarullo, Katie McGinty and I hosted a principals meeting on climate change to restart the decision process in light of your U.N. speech calling for a dialogue with the American public. We will hold principals meetings every week for the next five weeks so that, by early September, we will have developed the best ways of reaching different emissions target levels. To support the principals' decision-making process, we are also creating a set of working groups -- which will draw upon the best people in the Administration -- to study a set of specific questions (such as how to design the best possible emissions trading system). Janet Yellen was selected to represent the Administration at Congressional testimony next week focusing on the economic aspects of policies to reduce greenhouse gas emissions. Our policy process will be working hand-in-hand with Todd Stern. Todd and others, as you know, will help us in ensuring that we are aware of, and are addressing as much as possible, concerns being raised in the business, environmental, and other outside communities.

EU Review of Boeing-McDonnell Douglas Merger. Dan Tarullo chaired an NEC principals' meeting on Tuesday to decide what (if any) actions the Administration should take toward the European Union, which has voted preliminarily to prohibit the proposed merger of Boeing and McDonnell Douglas. Even though neither company has operations in the Europe, the EU has authority to prohibit the merger and (if the merger were to proceed anyway) to impose fines of up to $5 billion on Boeing.

As a result of decisions made at the principals' meeting, we are pursuing a three-track plan: First, the Justice Department requested formal consultations under the 1991 U.S.-EU agreement on antitrust cooperation. The EU agreed to consultations, and Joel Klein and others will meet with EC counterparts over the weekend in Brussels. Second, senior Administration officials communicated to EU officials their serious concerns about the EU merger review process and what a prohibition of the merger would do to U.S.-EU relations. And, third, the NEC is developing a list of retaliatory actions that the U.S. might take, if necessary. Boeing and EU negotiators will meet on Sunday and Monday to try to reach a compromise on remedies. We have scheduled another NEC principals' meeting for Tuesday to consider next steps. If appropriate, we will give you a decision memo laying out possible retaliatory actions that we might want to threaten prior to the EU's final decision on July 23.

NAFTA Report. We released the NAFTA Report Friday at a press briefing with Secretary Rubin, Secretary Daley, Ambassador Barshefsky, Special Envoy Mack McLarty and me. The event drew an overflow crowd of reporters. Press reports previewing the NAFTA report on Friday morning were balanced and generally favorable. We arranged to have surrogates, such as Mickey Kantor, provide validation on television and in the papers, while Charlene and I made calls to editorial boards and handled requests from the financial cable stations. The usual NAFTA opponents were very well organized and very quick to react.

Family Friendly Internet. Tom Kalil on the NEC staff is working with OVP and others to prepare for your meeting with industry executives, leaders of groups representing parents and teachers, and members of Congress next Wednesday to discuss making the Internet "family-friendly." Internet companies will be making commitments that will make it easier for parents to prevent their children from getting access to inappropriate material. Groups such as the American Library Association will be launching an initiative to make it easier for parents and children to find educational resources on the Internet.

Fed Nominees. We announced on Thursday your nomination of Edward M. Gramlich and Roger W. Ferguson, Jr., to the Federal Reserve Board. I held a conference call with reporters; the reception to the formal nomination of the candidates was generally positive. The Federal Reserve's legislative affairs office will now guide the candidates through their confirmation hearings with the Senate Banking Committee. As you know, we will have to fill another slot on the Board early next year, when Susan Phillips's term ends.

Budget Agreement and Education Appropriations. The House Labor-HHS-Education Appropriations Subcommittee next week will not likely provide the full amount for America Reads, nor do they plan to make the Pell Grant change to expand benefits for 218,000 independent students -- both required by the budget agreement. We are hearing a similar message from the Senate. Secretary Riley is sending a letter today to the Hill on the issue. We have been working with Education and WH Legislative Affairs to send a strong message to the Committees on this issue, and the education groups have become more engaged.

America Reads Work-Study Commitments. We now have *more than 500* colleges signed on. You recently asked about the number of *slots* that are filled in the coming year. We had found that many colleges were reluctant to sign up if they were required to commit to a specific number of slots. Working with Carol Rasco, we therefore determined that our priority should be getting the colleges to commit to the concept, *then* working with them to develop a high-quality, high-participation program. The strategy has worked: we had only 183 colleges at the end of May, and we now have over 500. And many of those colleges will be sending representatives to four training sessions around the country scheduled for the next two weeks. Colleges were reluctant to promise a particular number of slots for several reasons, including: (1) they want to run pilot efforts in the fall before they expand; (2) there are not yet significant resources for training large numbers of tutors; (3) they want to base the size of their program on the interest level from students, which they could not predict without having experience first; (4) they were afraid that they would be audited based on the commitment level, and (5) they (especially some of the sectarian schools) want to focus on volunteers, not paid tutors.

Tax Package Rollout -- Urban Tax Event with Mayors. We held a press event with the Vice President and Secretary Rubin at the White House on Monday. They were joined by Mayor Marc Morial of New Orleans, Mayor Ron Kirk of Dallas, Mayor Anthony Masiello of Buffalo, Mayor Tom Murphy of Pittsburgh, Mayor Floyd Adams, Jr. of Savannah, and Supervisor Mary Rose Wilcox of Maricopa County (Phoenix). The Vice President focused on the urban tax initiatives in your tax package -- specifically discussing the EZ/EC expansion, WTW tax credit, Brownfields tax incentive, and CDFI tax credit. There was good coverage by National Public Radio, *USA Today, The Washington Times*, *The Los Angeles Times, Dallas Morning News*, and other regional papers.

Tax Package Rollout -- Roundtable on Higher Education Tax Cuts. We worked with the Vice President's office to coordinate a roundtable on your higher education tax package on Tuesday in Pittsburgh. The Vice President was joined by several students and families, as well as Mayor Tom Murphy and Rep. William Coyne. We drafted a detailed package on the higher ed tax cut plan, which included a state-by-state analysis of how many students would benefit from the plan compared with the congressional alternatives. The packet was distributed to the Senate and House Democratic members, Democratic governors and mayors, higher education groups, as well as the Cabinet. We also worked with the Vice President's press office, the Education Department, and Media Affairs to distribute the state-by-state to regional media and the wires.

Tax Package Rollout -- Press Event on Tax Cuts for Working Families. We worked with the Vice President's office on a press event at the White House on Thursday to discuss the Administration's $500 child tax credit. Joining the Vice President were Sen. Daschle, Rep. Gephardt, Sen. Landrieu, and Rep. Rangel, as well as several lower-income families who would benefit from our child tax credit, but would be shortchanged by the congressional alternatives. We released a packet on our child credit, as well as a state-by-state analysis of the four million families that are left out of the congressional alternatives. There was solid coverage on CNN and in the *Washington Post*, *New York Times, and LA Times*.

Electricity Restructuring. The interagency process is preparing to advance options and recommendations to the NEC principals later this month, and we expect to have a number of meetings to consider the issues relating to possible Administration legislation on this subject. We are also working closely with CEQ on possible linkages between electricity restructuring and global climate change to see whether it would be prudent to pursue carbon reductions in the electricity restructuring legislation, and to assess whether it would be possible to do so without making the Administration's bill non-viable. Secretary Pena and I met Friday about possibly accelerating a memo to you on the general parameters of the legislative options.

Tobacco Settlement. As a part of the DPC-led effort, NEC staff continued to participate in meetings relating to the tobacco settlement. In the economics/industry meetings, we are assessing how much of the payments will be passed through to consumers in the form of higher prices, how effective the youth "lookback" provisions will be, and what the impact of the settlement on government revenue will be.

Product Liability. NEC staff went over some last questions with Staff Secretary concerning the options memo to you. The memo is scheduled to be forwarded to you this weekend.

DC Pensions. Together with OMB, PBGC and Treasury, we met with House (committee and legislative counsel) and CRS staff to discuss concerns legislative counsel and CRS had raised about the pension provisions. The meeting was productive, and legislative counsel better understands what we were trying to do. Rep. Davis' staff was very supportive. We will meet on Monday with Senate staff.

Black Colleges. Bob Shireman on the NEC staff spoke to HBCU college presidents at the annual meeting of the National Association for Equal Opportunity in Higher Education. He emphasized the investments in higher education in the budget agreement, the improvements in the tax package (and the contrast with the Republican plans), concern about the direction of Congress on affirmative action, and made a pitch for America Reads involvement by the colleges. He responded to questions about the need for more effort to increase the number of minority graduate students, and a concern about the lack of refundability in the HOPE Scholarship and tuition credit. Privately, some of the NAFEO leadership expressed concerns about the Education Department's plan to elevate the status of Hispanic-Serving Institutions in the reauthorization of the Higher Education Act.

August 3, 1997

MEMORANDUM TO: **ERSKINE BOWLES**

FROM: **GENE SPERLING**

SUBJECT: **Social Security**

Now that the budget legislation has been passed, we must turn our attention to long-term entitlement reform. The President has already indicated that in tackling entitlements, we should put our initial focus on Social Security reform. The purpose of this memorandum is to:

- Provide an overview of the Social Security problem;
- Outline the three schemes proposed by the Gramlich commission on Social Security;
- Examine a series of scenarios that may help us to think strategically about how to maximize the probability of effecting reform;
- Use those scenarios to examine whether we should have the President lay down a marker on Social Security this week; and
- Set forth a proposed workplan.

I. Overview of the Social Security challenge

There are currently just over 3 workers for every Social Security beneficiary. By 2040, it is expected that there will be only 2 workers for every beneficiary. These demographic pressures are at the heart of the Social Security challenge: According to the 1997 intermediate projections of the Social Security actuaries, the combined Old-Age and Survivors and Disability Insurance (OASDI) Trust Funds would be exhausted in 2029. The same projections suggest a 75-year actuarial deficit in the OASDI program equivalent to 2.23 percent of taxable payroll. In other words, immediately raising the combined employer-employee OASDI payroll tax by 2.23 percent (from 12.4 percent to 14.63 percent) would produce long-run balance in the program -- income from payroll taxes and interest on the Trust Fund assets would be sufficient to meet projected expenditures over the next 75 years. If the payroll tax rate is not increased immediately by 2.23 percent, other changes to the tax system or benefit provisions would be necessary to eliminate the long-run actuarial deficit.

One underlying question that we must address is what our goal is in reforming Social

Security. One goal is to eliminate the 75-year actuarial imbalance and extend the life of the Trust Fund. But that may be too narrow: we may want to ensure that reaching balance doesn't involve unsustainable flows either into or out of the Trust Fund during sub-periods of that 75-year horizon. Or we may want to focus on the more fundamental goal of ensuring that any reform boosts national saving, thereby raising future income and reducing the burden implied by our falling worker-beneficiary ratio. The decline in that ratio noted above means that every worker in 2040 would have to work 50 percent more efficiently than today in order to support today's standard of living for both beneficiaries and workers.

At the same time, other priorities may include maintaining the system's progressive benefit structure and its protection against elderly poverty. Social Security benefits currently represent more than three-quarters of money income for elderly households in the bottom two quintiles of the income distribution. Social Security benefits keep some 15 million people above the poverty line, and are commonly associated with the dramatic reduction in elderly poverty over the past several decades. The elderly poverty rate has fallen from more than 35 percent in 1959 to just 10.5 percent in 1995. Balancing the desire to maintain the social insurance aspects of the program against the desire to restore long-run solvency and raise national saving is perhaps the fundamental trade-off in the effort to reform Social Security.

II. Gramlich Commission options

The Advisory Council on Social Security, led by Ned Gramlich, produced three different plans for addressing the long-run actuarial imbalance in the program: the maintain benefits (MB) plan, the individual accounts (IA) plan, and the personal security accounts (PSA) plan. The plans include several extremely controversial proposals, including establishing individual accounts -- either managed by the government (as in the IA plan), or by individuals themselves (as in the PSA plan) -- and investing the Social Security funds in equities.

The Maintain Benefits (MB) plan would (numbers in parenthesis show the reduction in the long-run actuarial imbalance resulting from the change):

- Increase the payroll tax rate in 2045 by 1.6 percentage points (0.22);
- Consider investing 40 percent of the Trust Fund in equities (0.82);
- Change the benefit computation period from 35 years to 38 years (0.28);
- Phase out the low-income thresholds for taxation of Social Security benefits (0.16);
- Redirect revenue for taxation of high-income benefits from HI to OASDI Trust Fund (0.31);
- Tax benefits in the same manner as private defined benefit pension plans (0.15); and
- Cover all state and local employees (0.22)

The Individual Accounts (IA) plan would:

- Require all workers to contribute 1.6 percent of their taxable wages to government-administered individual savings accounts;
- Accelerate the increase in normal retirement age and index it to life expectancy (0.50);
- Reduce benefits to middle- and upper-income recipients by roughly 20 percent (1.32);
- Change the benefit computation period from 35 years to 38 years (0.28);
- Phase out the low-income thresholds for taxation of Social Security benefits (0.16);
- Reduce the spousal benefit from 50 percent to 33 percent (0.17);
- Replace the surviving spousal benefit with highest of spouse's benefit, own benefit, or 75 percent of combined benefit (-0.32);
- Tax benefits in the same manner as private defined benefit pension plans (0.15); and
- Cover all state and local employees (0.22)

The Personal Security Accounts (PSA) plan would:

- Redirect 5 percentage points of combined employer-employee OASDI taxes to Personal Security Accounts (-4.60);

- Replace current benefits with basic flat benefit equivalent to $410 per month (3.82);
- Accelerate the increase in the normal retirement age, index to life expectancy, raise early retirement age, and limit disability benefits (1.25);
- Increase payroll tax by 1.52 percent of taxable payroll from 1998 to 2069 (1.42)
- Phase out the low-income thresholds for taxation of Social Security benefits (0.16);
- Replace the surviving spousal benefit with highest of spouse's benefit, own benefit, or 75 percent of combined benefit (-0.39); and
- Cover all state and local employees (0.22)

While the three plans clearly adopt different approaches to fundamental aspects of Social Security -- differences with which we will have to grapple in formulating an Administration position -- they do share several common elements. It is often argued that these elements could form the basis for an Administration approach to Social Security reform. It is important to recognize, however, that these steps would not suffice to address the long-run actuarial imbalance by themselves., And many of them could prove quite controversial. The common elements include:

- All three plans would expand coverage to state and local government workers, narrowing the 75-year deficit by 0.22 percent of taxable payroll. Since the Social Security Act of 1935, coverage has expanded from workers in business and industry to include the self-employed, nonprofit groups, agricultural and household workers, the Armed Services, Congress, and all other Federal employees hired after 1983. Despite efforts to include them in the 1983 Greenspan reforms, state and local government employees are the final sizable group of workers not universally covered (only about 70 percent of state and local workers are covered for various reasons).

- All three plans would tax Social Security benefits for lower-income recipients. Currently, the partial tax on Social Security benefits does not apply to seniors with income below $25,000 if single or $32,000 if married. In calendar year 1997, according to CBO estimates, only 25 percent of beneficiaries will be subject to taxes on their Social Security benefits. All three plans would tax *all* recipients by phasing out the low-income thresholds by 2007. Nonetheless, other provisions in the tax code (e.g., standard deduction and exemptions) would ensure that 30 percent of beneficiaries would still not have to pay taxes on their benefits. The change would reduce the long-run actuarial deficit by 0.16 percent of taxable payroll.

- The MB and IA plans would tax Social Security benefits like other pensions. Both plans would replace the current rule under which seniors count up to 85 percent of their benefits as taxable income if their income is more than $34,000 (single) or $44,000 (married). Instead, the plans would tax benefits -- on an individual-by-individual basis -- to the extent that benefits exceed what workers had paid in. This treatment, which would reduce the long-run actuarial imbalance by 0.15 percent of payroll, would mirror the tax treatment of other defined benefit pension plans.

- The MB and IA plans would also change the way in which benefits are computed. Currently, Social Security retirement benefits are linked to a recipients' average wage over the 35 highest-earning years of employment. The two plans would extend the period to 38 years, thereby adding in more relatively low-earning years. The change would reduce benefits by an average of 3 percent and cut the long-run deficit by 0.28 percent of taxable payroll.

- The IA and PSA plans would accelerate the increase in the normal retirement age and then index it to life expectancy. Under current law, the normal retirement age (the age at which the beneficiary is entitled to full retirement benefits) will gradually increase from age 65 to age 66 by 2009. It will then remain there for over a decade, before gradually rising again to reach age 67 by 2027. Both the IA and PSA plans speed up this schedule so that the normal retirement age reaches 67 by 2011. Both plans subsequently index the normal retirement age to life expectancy. The combined effect of these two provisions is to reduce the long-run actuarial imbalance by 0.50 percent of taxable payroll. (The PSA plan also increases the early retirement age, at which workers can retire and accept actuarially reduced benefits).

As the table below indicates, these steps by themselves would not be sufficient to close the projected 75-year deficit. And several of them -- such as removing the low-income tax thresholds and changing how benefits are computed -- may be quite controversial.

In addition to the steps noted above, all three plans recognize adjustments to the CPI made by the BLS. But the Commission emphasized that it strongly opposes "changes in the COLA motivated by political considerations...Changes should be made only as a result of careful expert consideration by the government agency charged with that task."[1] How to handle the CPI issue will clearly be a crucial challenge in any reform effort.

Combined impact of "common elements" from Gramlich Commission plans

Measure	Percent of 75-year taxable payroll
Expand coverage to state and local workers	0.22
Remove low-income thresholds for taxation of benefits	0.16
Tax benefits like other pensions	0.15
Change how benefits are computed, reducing average benefit by 3 percent	0.28
Accelerate increase in normal retirement age, and index it to life expectancy thereafter	0.50
TOTAL OF ABOVE	1.31
PROJECTED 75-YEAR DEFICIT	2.23

The Gramlich Commission plans illustrate two points:

- There is substantial controversy over whether to allow individual accounts or investments of the Trust Fund in equities.
- Even the steps that are common to the plans -- including changes in the coverage of the system and the tax treatment of benefits -- could be very controversial and would not by themselves eliminate the 75-year deficit in the program.

[1] All three plans include adjustments to the CPI only because the report was written before the actuaries could factor in the effects of changes to the CPI made by the BLS in 1996. Those changes are expected to reduce the CPI inflation rate by 0.21 percentage point per year, reducing the long-run actuarial imbalance by 0.31 percent of taxable payroll.

III. Possible scenarios

One of our fundamental decisions is when we think it will be best to come out with specific reform proposals:

- State of the Union 1998;
- March/April 1998; or
- Post-election/State of the Union 1999.

Within each of these broad timing alternatives, there are a multitude of related and difficult questions: whether a commission would be helpful; whether we should seek other bipartisan sources of support (Rudman, Peterson, Dole) if the Republican leadership initially balks; how we should react if our proposals do not generate support; and how we should ensure that proposals for reform actually become law.

Scenario 1: Release proposals in the State of the Union 1998

Under this scenario, we would need to develop a specific proposal quickly. The timing constraint would probably not allow the creation of an outside commission, so we would need to convene a rapid internal process for deciding the Administration's positions on important substantive issues: privatization, investing the trust funds in equities, and the CPI. At the same time, we would be engaged in an outreach process to interested parties, including the AARP, AFL-CIO, etc. The decision-making process would probably need to reach closure by late November or so.

After the Administration had decided on its position, the President would announce the package in his State of the Union address. Then we could either follow the normal legislative procedure or convene some sort of ad hoc high-level negotiating process with the Hill leadership.

<u>Pros:</u>

- A January proposal would demonstrate the President's leadership on Social Security as the focus shifts from deficit reduction to entitlement reform.

- Our window of opportunity may be short-lived, especially given the budget and electoral cycle. So acting in January would push the process along.

- An early proposal could help to focus the debate and make the public education process more concrete.

<u>Cons:</u>

- Announcing proposals in January -- especially without bipartisan support -- may expose them as a political target, even if we were able to enlist the support of prominent Republican outsiders. If our proposals do not generate support, the President could call for a bipartisan process to report back after the 1998 elections. But in the meanwhile, we could have ruined any chance we have for success and exposed our supporters to substantial criticism.

- It may not be possible to develop a coherent proposal by early 1998.

- Acting soon may not permit us enough time to invest in a public education and outreach effort before releasing proposals.

Scenario 2: Release proposals in March or April 1998

Aiming to release specific proposals in March or April 1998 allows a longer consultation and public education period, and opens up the possibility of appointing a short-tenured commission of either outside specialists or the real players. Possible approaches could include:

- Turning the issue over to an official commission comprising top-level representatives of Congress and the Administration, perhaps with some sort of "fast-track" mechanism for ensuring passage of the commission's proposals.

- Convening a commission of eminent Americans-- such as Bob Dole, Warren Rudman, Bill Bradley, and George Mitchell -- to report back by early next year. We could flesh out our own ideas internally over the same period, and then engage in high-level negotiations with the Republican leadership -- possibly also involving the eminent Americans. Such an approach would mirror the informal method ultimately used by the Greenspan Commission.

- Engaging in a more extensive public education and outreach effort, while allowing more time for an internal policy process to develop our own proposals. We could then release our proposals and either follow the normal legislative process or engage in a special high-level negotiating process with the Hill leadership.

<u>Pros:</u>

- Allows more time to educate the public and generate bipartisan support before releasing specific proposals

- Allows enough time for a commission to report back, if we want a commission

Cons:

- May become too politicized with the run-up to the fall 1998 elections

-

Scenario 3: Release proposals after the fall 1998 elections, perhaps in State of the Union 1999

If we instead decide to move after the fall 1998 elections, we would have more time to develop an extensive public education effort and to allow the public to digest the various options. Moving after the fall 1998 elections would also facilitate, if we wanted, having a longer-term outside commission that would issue its own policy recommendations. The basic options are similar to those in Scenario 2 above, but with more time to invest in education, bipartisan support, and internal policy development.

Pros:

- Allows more time to develop policies and support.

- Allows a full-fledged commission, if we want one.

Cons:

- May look weak.

- Runs into Medicare, since the Medicare commission must report by March 1, 1999.

Other related issues

There are at least two other issues that we should consider:

- Technical advisory panel: We may want to appoint a technical advisory panel comprising academics and outside specialists to support our internal substance process. This panel would be similar to the panel that advises CBO on its economic forecasts: it would bring together the most knowledgeable outside people, and allow us to draw upon their knowledge. The Social Security Trustees could appoint the panel.

- CPI: It may be necessary to form some sort of CPI panel to feed into the policy-making process, given the large outstanding questions surrounding the CPI. One issue is whether such a panel should include BLS economists or members of the Boskin commission. If not, there aren't too many experts left.

IV. Laying down a marker this week

Depending at least in part on when we decide that we want to come out with proposals, the President may want to lay down a marker soon to ensure that the Administration is identified as leading on the Social Security reform effort. His message could be:

- I welcome the creation of the Medicare Commission, which will report back on March 1, 1999.
- In the meanwhile, though, we should address Social Security reform.
- I am instructing my economic team to conduct an intensive outreach program on how best to take action and to begin developing proposals.
- I hope that the Republican leadership will join together with me to address this critical problem, just as we worked together to produce the first balanced budget since 1969.
- We will have specific proposals by [TBD].

Pros

- We will be taking the initiative and signalling our interest in Social Security reform. Representative Kasich has already stated (on *Meet the Press* this weekend) that he intends to hold hearings on entitlement reform this fall. Others will not be far behind.

Cons

- The announcement may give too much of a role to the Republicans and thus potentially reduce our chances of being bold.

- If we decide on a post-election deadline, the announcement may look too weak and it may be better not to say anything at this point.

V. Proposed workplan

Our workplan will depend on our general approach. But first steps should include:

1. Deciding now when we want to move

2. Deciding now whether to lay down POTUS marker on issue

3. Deciding on which process scenario is most promising: commission, no commission, etc.

4. Giving all relevant principals a background binder to review over the August break

5. In early September, holding special NEC principals meeting or cabinet meeting on nature

of the problem and on Administration approach re process. Have CEA brief on demographic challenge. HHS brief on long-run imbalance in program, Treasury brief on Gramlich proposals, and NEC brief on process.

6. In September, beginning substance process:

A. Convene regular small working group of senior officials reporting directly to Erskine
-- Substance group: Sperling, Rubin, Yellen, Summers, Raines, Lew, Klain, Hilley, Shalala, and Apfel

B. Set up technical support group to work with senior working group

-- Gotbaum, Cohen, Orszag, Minarik, Wilcox, Gruber, Scholz, Seidman, Carroll, Montgomery, HHS, SSA actuaries (?), more OMB staffers (?)

7. Begin outreach to AARP, AFL-CIO, and other interested parties:
-- POTUS and VPOTUS phone calls and meetings
-- Cabinet
-- White House conference?

August 5, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: Laying down a marker on Social Security

As today's longer memorandum on Social Security notes, the decisions on Social Security reform involve at least three different levels:

- Overall process strategy: timing for a real deal, whether to call for a commission, whether to make a unilateral announcement, etc.
- Substantive decisions: Forging policy proposals to address the Social Security challenge
- Whether to lay down an early marker on the issue

Your advisers will clearly have extensive processes to evaluate different scenarios and options on the first two levels. The immediate question is whether you want to lay down an early marker on the issue. Your advisers have discussed this specific question both yesterday and today, and have narrowed the options to the following three.

1. <u>Declare tomorrow that you want to act on Social Security before Medicare</u>

Possible language: *"While the Medicare commission is conducting its analysis, we must work in a bipartisan way to create solutions -- before the Medicare commission issues its report -- that will strengthen Social Security, so that Social Security will be just as strong and secure for the next generation as it has been for past generations. We must act not because we are in a state of crisis, but because we have the opportunity to act wisely to prevent a crisis from ever occurring. I will be asking my economic team to engage in broad consultation with the Congressional leadership, with Democrats and Republicans, with those who represent seniors and younger people, and with experts and hard-working citizens, so that we can find the best way to garner the full support of our people for such a significant reform."*

<u>PROS</u>

- Signals that you want to do Social Security first and puts you out front on issue
- Provides flexibility, since it commits us only to have proposals before March 1,

1999 -- when the Medicare Commission reports.

- May lead to questions about timing and process, but at least the questions would be about our actions and our strategy.

CONS

- Could raise expectations for a specific proposal
- Endless questions could make us look evasive
- Could still be seen as not quite stepping up to the plate

2. Maintain current stance and do not signal anything new on timing

Possible language: *"I want to explore a bipartisan process for strengthening Social Security, so that it will be just as strong and secure for the next generation as it has been for past generations. We must act not because we are in a state of crisis, but because we have the opportunity to act wisely to prevent a crisis from ever occurring."*

PROS

- Until we know how to proceed, we should not make any pronouncements
- Doesn't lock us in to anything specific

CONS

- Some will say you didn't seize the initiative when you were strong
- Leaves door open to other political leaders to be first to call for addressing Social Security
- Doesn't break new ground or make news because it doesn't make clear that we want to do this before Medicare.

3. Conduct a prominent interview (e.g., New York Times) next week in which message is the same as in Option 1 (Social Security proposals before Medicare) to lay a marker

PROS

- Still allows us to lay a marker without drowning out budget stories this week
- Gives us more time to analyze options and speak to you about them

CONS

- Leaves door open over the next week for other political leaders to be first to call for addressing Social Security
- Less high-profile than the press conference

Recommendations

The principal benefits of Option 2 are that it does not limit our flexibility on Social Security reform at all -- including whether to act on Social Security before Medicare. Along with Option 3, it doesn't drown out the budget stories this week. The principal danger with Option 2 is that the longer we wait to lay down a marker, the higher the likelihood that we will be criticized by opinion leaders and some on the Hill for not stepping up to the plate on entitlement reform.

In terms of tomorrow, most of your advisers support Option 2 rather than Option 1, although Gene and John Podesta support Option 1. A compromise position that Rahm, Sylvia, and Gene support is not to make news tomorrow, but rather to do a prominent newspaper interview next week (Option 3). Secretary Rubin wanted to stress that he is not against the idea of laying down a marker, but thinks that such a step should be taken only after you have had a chance to consider and internalize all the different options and constraints.

August 5, 1997

MEMORANDUM TO THE PRESIDENT

FROM: **GENE SPERLING**

SUBJECT: **Social Security**

While you have made clear your desire to enact meaningful long-term entitlement reform, it is crucial that we decide our strategy for how best to accomplish this goal. You have indicated to us in response to a previous memorandum that we should proceed on parallel tracks on Medicare and Social Security, but that you agreed with a strategy of putting an initial focus on Social Security reform. Achieving Social Security reform requires not just addressing difficult substantive issues. It also requires thinking carefully about our strategy for coming out with proposals, and for getting those proposals passed.

Given the importance and complexity of the issues involved, we thought it would be useful to think through a variety of strategic scenarios on how to achieve reform. This memorandum examines some scenarios that may help you think about how to maximize the probability of effecting reform, and discusses whether you should lay down a marker *this week* on Social Security. *Your immediate decision is whether to make an announcement on Social Security this week -- and if so, what the announcement should say -- while we are mapping out our plan.* An appendix provides a brief overview of the Social Security problem, and outlines the three schemes proposed by the Gramlich commission on Social Security.

I. Possible scenarios

We face an extremely complicated and difficult -- but compelling -- challenge. While there are well-defined options, it is important to realize that all of them involve highly controversial reforms that will be portrayed by critics as raising Social Security taxes or cutting Social Security benefits. (Investing the Trust Funds in equities raises other difficult questions -- such as perceived and real risks of market volatility -- and is seen by some as more of an accounting gimmick than a true solution.) Indeed, the only measures included in all three Gramlich Commission plans were expanding the taxation of benefits (which we learned was difficult in 1993), and extending coverage to state and local workers (which may prove very unpopular in California and Ohio).

In considering our best strategy for going forward, we must consider the various elements and steps that will play out under any scenario. In doing so, it is helpful to keep in mind the following goals and the means to achieve them:

- *Fundamental goals:*

-- Long-term viability: 75-year or perpetual balance; is the year-to-year path important?
-- Keep some social insurance/progressivity in system
-- Establish Presidential leadership

- *Key issues/other goals:*

-- Increase national savings
-- Impact on budget reform
-- CPI
-- Acceptability of partial solutions

- *Optional means:*

-- Expert commission
-- CPI commission
-- Public education advisory board
-- Public education campaign

- *Eventual real process for proposals:*

-- You simply announce a proposal (alone or following commission or public education effort)
-- Leadership-designated negotiating process
-- Non-leadership bipartisan process
-- Commission with fast-track/base-closing vote
-- Key players commission (similar to second possibility above), including chairs of relevant committees, etc.

Three scenarios

Keeping the above factors in mind, it may be helpful to think through the timing of when specific proposals will need to be discussed seriously and released publicly. This "real deal" period could be the State of the Union 1998; March/April 1998; or post-election/State of the Union 1999. Within these three different scenarios, there are still many decisions to make about which elements would be useful (the scenarios do have some different implications for the feasibility of some potential elements of the process -- such as outside commissions or public education boards). Considering the timing for releasing specific proposals seems one useful way of organizing our thoughts.

Scenario 1: State of the Union 1998

Elements:

- Timing constraint would probably not allow the creation of an outside commission.
- Since we would be acting soon, it may be difficult (if not impossible) to do a CPI commission. If we want a CPI fix, we may therefore have to do it our own.
- Key to success may be large-scale consultations. Could look to working with outside Republicans and key Democrats to get buy-in and bipartisanship for announcement.
- If our proposals do not generate support, you could call for a bipartisan process to report back after the 1998 elections. But in the meanwhile, we could have undermined our chances for achieving reform.
- For better or worse, the timing means that the fall would likely be filled with stories of our substantive discussions on controversial issues and specific proposals.

Options:

- Option 1: You announce proposals in State of the Union 1998. We could then either follow the normal legislative procedure or convene some sort of ad hoc high-level negotiating process with the Hill leadership.
- Option 2: You announce Leadership/POTUS negotiating process.

Pros:

- With defined, specific proposals, a January move would be seen as demonstrating great Presidential leadership on Social Security. You would be addressing a critical long-term reform as the focus shifts from deficit reduction to entitlement reform.
- If we use consultation period well, we could garner some bipartisan support and outside validation, although it is unlikely that we would succeed in obtaining the support of the Republican leadership along.
- Our window of opportunity may be short-lived, especially given the budget and electoral cycle. So acting in January would push the process along.
- An early move could help focus the debate and the public education process.
- Given that it is unlikely that legislation will be passed quickly, it may be helpful to release proposals to demonstrate your leadership on this issue.

Cons:

- Even the most basic proposals are likely to create a firestorm in the absence of strong bipartisan support. For example, taxing benefits proved to be extremely controversial in 1993, and including state and local workers from California and Ohio is also likely to generate significant opposition.
- Democrats may be upset at again having process that few could get involved in.
- Acting soon may not permit us enough time to invest in public education/outreach.
- Putting out specific proposals without bipartisan cover may push Democrats and Republicans to make "no Social Security tax hike or benefit cut" pledges in the fall elections, thereby setting back our reform effort.

Scenario 2: Release proposals in March or April 1998

Elements:

- Aiming to release specific proposals in March or April 1998 allows a longer consultation and public education period, and opens up the possibility of appointing a short-tenured commission of either outside specialists or the real players.
- May allow enough time for a CPI technical advisory panel. But we may still have to release a CPI adjustment on our own, with little bipartisan cover.

Options:

- Option 1: Turning the issue over to an official commission comprising top-level representatives of Congress and the Administration, perhaps with some sort of "fast-track" mechanism for ensuring passage of the commission's proposals.

- Option 2: Convening a commission of eminent Americans -- such as Bob Dole, Warren Rudman, Bill Bradley, and George Mitchell -- to report back by early next year. We would flesh out our own ideas internally over the same period, and then engage in high-level negotiations with the Republican leadership -- possibly also involving the eminent Americans. Such an approach would mirror the informal method ultimately used by the Greenspan Commission.

- Option 3: Engaging in a more extensive public education and outreach effort to obtain Republican validation for reform effort, while allowing more time for an internal policy process to develop our own proposals. We could then release our proposals and either follow the normal legislative process or engage in a special high-level negotiating process with the Hill leadership.

Pros:

- Allows more time to educate the public and generate bipartisan support before releasing specific proposals
- Allows enough time for a commission to report back, if we want a commission

Cons:

- May provide too little time before the fall 1998 elections
- May still not permit us enough time to invest in a comprehensive public education and outreach effort before releasing proposals.
- Putting out specific proposals without bipartisan cover may push Democrats and Republicans to make "no Social Security tax hike or benefit cut" pledges in the fall elections, thereby setting back our reform effort.

Scenario 3: Release proposals after the fall 1998 elections, perhaps in State of the Union 1999

<u>Elements:</u>

- We would have more time to develop an extensive public education effort and to allow the public to digest the various options.
- May allow enough time for a CPI technical advisory panel. But we may still have to release a CPI adjustment on our own, with little bipartisan cover.
- Moving after the fall 1998 elections would also facilitate, if we wanted, having a longer-term outside commission that would issue its own policy recommendations.
- The AARP, Pew Foundation, and others will be undertaking year-long public education efforts. Our efforts could dovetail with theirs.

<u>Options:</u>

- Option 1: Public education effort including <u>public education advisory board</u>, while developing specific proposals. The public education effort could involve a panel of prominent Americans -- such as Bob Dole, Warren Rudman, Bill Bradley, and George Mitchell -- in addition to the Administration's own efforts and those of the AARP and the Pew Foundation. This approach would be a type of "commission-lite."

- Option 2: Engage in public education effort without blue-ribbon public education board while developing our own specific proposals. Then use a variety of implementation strategies: announcing our own package, conducting ad hoc high-level negotiations, or forming a commission of top officials with tight deadline and mandate to come up with a specific package.

- Option 3: Form a longer-term outside commission that would issue its own policy recommendations (the panel of prominent Americans mentioned above would not issue policy recommendations). The benefit may be bipartisan buy-in. The substantial cost is "commission-itis" -- especially after the Gramlich commission. We would also still need an implementation strategy for turning the commission's proposals into law.

<u>Pros:</u>

- Allows more time to develop policies and bipartisan support for policies.

- Allows a full-fledged commission, if we want one.

<u>Cons:</u>

- May look weak.
- Runs into Medicare, since the Medicare commission must report by March 1, 1999.

II. Laying down a marker this week

Depending at least in part on when you decide that you may want to come out with proposals, you may want to lay down a marker soon to ensure that the Administration is identified as leading on the Social Security reform effort. Your message could be:

> "This balanced budget agreement is the most significant package of savings and reforms to strengthen and modernize Medicare in the history of the program.
>
> "Yet because we must also prepare for the retirement challenges of the next century created by the aging of the so-called baby boom generation, I am pleased that this budget legislation includes a bipartisan Medicare commission that will report back by March 1, 1999 on how to keep Medicare strong for decades and decades to come.
>
> Then you could follow with one of the following options.

Option 1: Deadline before Medicare commission reports

> *"But while the Medicare commission is conducting its analysis, we must work in a bipartisan way to create solutions -- before the Medicare commission issues its report -- that will strengthen Social Security, so that Social Security will be just as strong and secure for the next generation as it has been for past generations. We must act not because we are in a state of crisis, but because we have the opportunity to act wisely to prevent a crisis from ever occurring. I will be asking my economic team to engage in broad consultation with the Congressional leadership, with Democrats and Republicans, with those who represent seniors and younger people, and with experts and hard-working citizens, so that we can find the best way to garner the full support of our people for such a significant reform."*

PROS

- Signals that you want to do Social Security first and puts you out front on issue
- Provides maximum flexibility, since it commits us only to have proposals before March 1, 1999 -- when the Medicare Commission reports.
- May lead to questions about timing and process, but at least the questions would be about our actions and our strategy.

CONS

- Could be seen as not quite stepping up to the plate
- On the other hand, it may raise expectations for a specific proposal
- Endless questions could make us look evasive

Option 2: No deadline

"But I want to explore a bipartisan process for strengthening Social Security, so that it will be just as strong and secure for the next generation as it has been for past generations. We must act not because we are in a state of crisis, but because we have the opportunity to act wisely to prevent a crisis from ever occurring."

PROS

- Until we're sure of how we want to proceed, we should not make any pronouncements
- Doesn't lock us in to anything specific

CONS

- Doesn't break new ground or make news because it doesn't make clear that we want to do this before Medicare.
- Leaves door open to other political leaders to be first to call for addressing Social Security

Option 3: Deadline before Medicare commission reports and CPI commission

"But while the Medicare commission is conducting its analysis, we must work in a bipartisan way to create proposals -- before the Medicare commission issues its report -- that will strengthen Social Security, so that Social Security will be just as strong and secure for the next generation as it has been for past generations. We must act not because we are in a state of crisis, but because we have the opportunity to act wisely to prevent a crisis from ever occurring. ***We must start by addressing the bias in the consumer price index. I am therefore calling for a commission on the CPI."***

PROS

- Adds more specificity to commitment to address Social Security by calling immediately for CPI commission
- Lives up to our commitment to address CPI outside budget

CONS

- Putting initial Social Security emphasis on CPI focuses the debate on benefit cuts
- Best way to deal with CPI may be as part of overall broader Social Security reform that "saves Social Security," and when negative impact from CPI fix could be mixed together with other reforms that have progressive effects

Option 4: Announce that you will make proposals in State of the Union

> *"But while the Medicare commission is doing its work, I want to explore a bipartisan process that will lead to proposals to strengthen Social Security. After broad consultation with the Congressional leadership, with Democrats and Republicans, with those who represent seniors and younger people, and with experts and hard-working citizens,* ***I will be announcing a plan to save Social Security in my next State of the Union address."***

PROS

- Will be a bold, news-generating step.
- Will generate support and credit from important policy-makers, both Democratic and Republican, and influential opinion leaders.
- Will make our internal and external steps on substantive Social Security issues the main focus of domestic policy debate for the fall and winter.

CONS

- Takes away our flexibility if we decide we need more time or more of a bipartisan process.
- Could set up partisan reaction: Republican leadership may pull back and wait to see approach; Democrats may feel excluded and want to distance themselves from perceived Social Security tax increases or benefit reductions. Without bipartisan cover for our proposals, Democrats and Republicans may make "no Social Security tax hike or benefit cut" pledges -- thereby setting back our reform effort.
- Will make our internal and external steps on substantive Social Security issues the main focus of domestic policy debate for the fall and winter.

Appendix: Overview of the Social Security challenge

According to the 1997 intermediate projections of the Social Security actuaries, the combined Old-Age and Survivors and Disability Insurance (OASDI) Trust Funds would be exhausted in 2029. The same projections suggest a 75-year actuarial deficit in the OASDI program equivalent to 2.23 percent of taxable payroll. In other words, immediately raising the combined employer-employee OASDI payroll tax by 2.23 percent (from 12.4 percent to 14.63 percent) would produce long-run balance in the program -- income from payroll taxes and interest on the Trust Fund assets would be sufficient to meet projected expenditures over the next 75 years. If the payroll tax rate is not increased immediately by 2.23 percent, other changes to the tax system or benefit provisions would be necessary to eliminate the long-run actuarial deficit.

One underlying question that we must address is what our goal is in reforming Social Security. One goal may be to eliminate the 75-year actuarial imbalance and extend the life of the Trust Fund. But that may be too narrow: we may want to ensure that reaching balance doesn't involve unsustainable flows either into or out of the Trust Fund during sub-periods of that 75-year horizon. Or we may want to focus on the more fundamental goal of ensuring that any reform boosts national saving, thereby raising future income and reducing the burden implied by our falling worker-beneficiary ratio.

At the same time, other priorities may include maintaining the system's progressive benefit structure and its protection against elderly poverty. Social Security benefits currently represent more than three-quarters of money income for elderly households in the bottom two quintiles of the income distribution. Social Security benefits keep some 15 million people above the poverty line, and are commonly associated with the dramatic reduction in elderly poverty over the past several decades. The elderly poverty rate has fallen from more than 35 percent in 1959 to just 10.5 percent in 1995. Balancing the desire to maintain the social insurance aspects of the program against the desire to restore long-run solvency and raise national saving is perhaps the fundamental trade-off in the effort to reform Social Security.

Gramlich Commission options

The Advisory Council on Social Security, led by Ned Gramlich, produced three different plans for addressing the long-run actuarial imbalance in the program: the maintain benefits (MB) plan, the individual accounts (IA) plan, and the personal security accounts (PSA) plan. The plans include several extremely controversial proposals, including establishing individual accounts -- either managed by the government (as in the IA plan), or by individuals themselves (as in the PSA plan) -- and investing the Social Security funds in equities.

The Maintain Benefits (MB) plan would (numbers in parenthesis show the reduction in the long-run actuarial imbalance resulting from the change):

- Increase the payroll tax rate in 2045 by 1.6 percentage points (0.22);
- Consider investing 40 percent of the Trust Fund in equities (0.82);
- Change the benefit computation period from 35 years to 38 years (0.28);
- Phase out the low-income thresholds for taxation of Social Security benefits (0.16);
- Redirect revenue for taxation of high-income benefits from HI to OASDI Trust Fund (0.31);
- Tax benefits in the same manner as private defined benefit pension plans (0.15); and
- Cover all state and local employees (0.22)

The Individual Accounts (IA) plan would:

- Require all workers to contribute 1.6 percent of their taxable wages to government-administered individual savings accounts;
- Accelerate the increase in normal retirement age (0.10) and index it to life expectancy (0.40);
- Reduce benefits to middle- and upper-income recipients by roughly 20 percent (1.32);
- Change the benefit computation period from 35 years to 38 years (0.28);
- Phase out the low-income thresholds for taxation of Social Security benefits (0.16);
- Reduce the spousal benefit from 50 percent to 33 percent (0.17);
- Replace the surviving spousal benefit with highest of spouse's benefit, own benefit, or 75 percent of combined benefit (-0.32);
- Tax benefits in the same manner as private defined benefit pension plans (0.15); and
- Cover all state and local employees (0.22)

The Personal Security Accounts (PSA) plan would:

- Redirect 5 percentage points of combined employer-employee OASDI taxes to Personal Security Accounts (-4.60);
- Replace current benefits with basic flat benefit equivalent to $410 per month (3.82);
- Accelerate the increase in the normal retirement age, index to life expectancy, raise early retirement age, and limit disability benefits (1.25);
- Increase payroll tax by 1.52 percent of taxable payroll from 1998 to 2069 (1.42)
- Phase out the low-income thresholds for taxation of Social Security benefits (0.16);
- Replace the surviving spousal benefit with highest of spouse's benefit, own benefit, or 75 percent of combined benefit (-0.39); and
- Cover all state and local employees (0.22)

While the three plans clearly adopt different approaches to fundamental aspects of Social Security -- differences with which we will have to grapple in formulating an Administration position -- they do share several common elements. It is often argued that these elements could form the basis for an Administration approach to Social Security reform. It is important to recognize, however, that these steps would not suffice to address the long-run actuarial imbalance by themselves. And many of them could prove quite controversial -- we had difficulty passing raising taxes on benefits for high-income beneficiaries in 1993, and state and local government workers in California and Ohio will resist inclusion in the Social Security system. The common elements of the plans include:

Provision	**Percent of 75-year taxable payroll**
Measures included in all three plans:	
Expand coverage to state and local workers	0.22
Remove low-income thresholds for taxing benefits	0.16
Sub-total, provisions included in all three plans	*0.38*
Measures included in two of three plans:	
Tax benefits like other pensions	0.15
Change averaging period for calculating benefits, reducing average benefit by 3 percent	0.28
Accelerate increase in normal retirement age	0.10
Index normal retirement age to life expectancy	0.40
TOTAL	*1.31*
PROJECTED 75-YEAR DEFICIT	*2.23*

The Gramlich Commission plans illustrate two points:

- There is substantial controversy over whether to allow individual accounts or investments of the Trust Fund in equities.
- Even the steps that are common to the plans -- including changes in the coverage of the system and the tax treatment of benefits -- could be very controversial and would not by themselves eliminate the 75-year deficit in the program.