THE WHITE HOUSE

WASHINGTON

August 16, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: 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. This memorandum is intended to summarize some of the basic strategic elements that have been discussed in past memos to you and in recent NEC meetings. Those elements include:

I. Our fundamental goals
II. How to "set the table" through public education efforts and bipartisan support
III. Process for the real deal
IV. Scenarios and timing
V. The large substantive issues

I. FUNDAMENTAL GOALS

- Long-term viability: 75-year or perpetual balance? Is the year-to-year path important?
- Keep some social insurance/progressivity in system: How much of a conflict is there between individual accounts and the social insurance role of the Social Security system?
- Establish Presidential leadership

Key issues/other goals
- Increase national savings: some proposals "fix" Social Security without raising savings
- Impact on budget: some proposals raise unified deficit for extended periods of time
- CPI reform: Will reform involve more accurate measurement of the COLAs?
- Acceptability of partial solutions: Is there value to reforms that address part, but not all, of the long-run problem?

II. HOW TO SET THE TABLE

There are a variety of ways of "setting the table" for real proposals. One element of setting the table is building bipartisan support. We should remember that even if the Republican leadership does not support an effort on Social Security, there may be ways of building Republican support from outside sources (e.g., Dole and Rudman) and from Republican members of Congress. In addition, we need to decide how much of a public education effort is necessary to prime the pump for reform. The AARP and Pew Foundation are already planning extensive year-long public education efforts, with multi-million dollar budgets.

We could build support for reform through a variety of means, including:

- **Expert commission:** One downside is that the Gramlich commission just reported.
- **CPI commission:** Upside is that Republicans will support. Potential danger is that outside broader reform effort, could highlight benefit cuts without "saving Social Security." May be better to mix in with other reforms as part of overall "Save Social Security" reform.
- **Public education advisory board:** The public education effort could involve a panel of prominent Americans -- such as Bob Dole, Warren Rudman, and George Mitchell -- in addition to AARP and the Pew Foundation efforts.

III. EVENTUAL PROCESS FOR PUTTING REAL PROPOSALS ON THE TABLE AND GETTING THEM PASSED

Regardless of how we "set the table," we still need to have a specific process for forging viable proposals. In the budget negotiations, the process we come up with encouraged <u>trust</u>. Similarly, we will need an effective process for Social Security reform:

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

Note: The substance may affect the best process. For example, a bipartisan approach is likely to involve individual accounts. If we decide we don't want individual accounts, it could therefore be better to seek a different process.

IV. SCENARIOS FOR TIMING

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. Two possibilities:

I. To release a whole package in the State of the Union 1998; or
II. To release a partial plan or a process plan in the State of the Union, and wait until the post-election/State of the Union 1999 period to take any further action.

Scenario 1: Specific full package in the State of the Union 1998

Pre-Announcement

- **Policy making:** Intense internal process from September until December

- **Significant Listening Outreach:** Unless aiming for complete surprise, extensive outreach to Hill and interest groups

- **FY 1999 Budget:** Incorporation of proposals into FY 1999 budget

Positive Ramifications

- Elite media credit you with strong courage and leadership points

- Likely to spur significant national dialogue

Negative ramifications

- Out alone, with no bipartisan cover for controversial proposals.

- May cause Democrats to lock in to "no Social Security tax hike or benefit cut" pledges -- undermining further reform efforts.

- If this initial foray proves unsuccessful, could call for long-term commission to report back after election. But potential lock-in pledges could prove a substantial barrier.

Possible Responses to Type of Plan

- **With individual accounts or COLA adjustments:** Could split liberals. AARP position is critical.
- **Without individual accounts or COLA adjustments:** Conservatives could criticize the package for putting emphasis on tax hikes and benefit cuts rather than privatization. Could perhaps pressure Democrats into locking into "no Social Security tax" pledges.

Post-Announcement Process

- Public reaction forces breakdown
- Members call for commission for cover
- Best case: Supercommittee or key member negotiation process
- POTUS goes for all-out public education effort to sell initiative

Scenario 2: Partial announcement in State of the Union

Pre-Announcement

- **Early marker:** POTUS states in September that we need to deal with Social Security -- an ounce of prevention to help our children's futures. He hopes Republicans will work with him.
- **Policy making:** Intense internal process from September until December
- **State of the Union:** POTUS announces at State of the Union-- some of the following:
    - Detailed national campaign with bipartisan advisory group (Mitchell, Rudman). Asks Lott and Gingrich for special session after election to pass reforms;
    - Announces a commission on CPI to report back after election, with or without Social Security commission
    - Announces one specific proposal, such as accelerating the existing increase in the normal retirement age (could include specific Medicare proposal to extend Medicare age with proposal for expanding coverage for 60-67)
- **Key issue:** If no real deal process until after 1998 elections, how to show movement and progress. One specific proposal helps, as do public education efforts.

Possible responses

- **Commission or advisory board only**
  1. Elite hit: "Commission-itis," perhaps unless accompanied by very specific reporting date and process
  2. Republicans may argue that we should address Medicare first -- 2008 vs. 2029
  3. AARP will likely support, especially given their own education efforts
- **One specific proposal**
  1. Elite support for demonstrating Presidential leadership
  2. Depending on proposal, seniors groups may criticize -- potentially splitting Democrats and endangering further efforts
  3. Republicans could try to attack by saying that the President should step up to the plate with a significant reform, not a paltry single reform that doesn't move the ball very far.

Post-Announcement Process

- If announcement of single measure: Either use as first step to show leadership, and ask for bipartisan process to address larger challenge. Or focus on the single measure and leave larger issues alone for now.
- Key is ability to create bipartisan process that forces legislative proposals after 1998 or <u>willingness</u> to announce own proposal in 1999 State of Union.
- Ability to create bipartisan process outside of Republican congressional leadership.

Notes

- Interactions between Medicare and Social Security: more specific we are on Medicare proposals -- high-income premium, or raising Medicare eligibility age with expanded coverage 60-67 -- the less pressure for specific Social Security proposals during 1998.

V. 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.

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.

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12-1-97

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THE WHITE HOUSE

WASHINGTON

November 25, 1997

— Lots of goal ideas
well → Sen mtg
— announce Monday
on IRS reform passed by Senate
+ on House-passed charter
school bill

MEMORANDUM FOR THE PRESIDENT

FROM: BRUCE REED
GENE SPERLING
ELENA KAGAN

SUBJECT: State of the Union Ideas

As you requested, this memorandum provides a brief description of new ideas we are seriously considering for the State of the Union. Most of these ideas involve increased spending and you will have to make choices among them as you consider the FY 99 budget. Options relating to social security and tax reform are not included in this memo.

Education

go to Oreg w/ school choice and/or charter schools / would increase campaign

1. Class size / 100,000 teachers: We are working with the Vice President's office and others on an ambitious initiative to reduce class sizes in the early grades by providing money to hire up to 100,000 new teachers, perhaps paid for by reducing the federal work force by another 100,000 positions. We estimate that 100,000 new teachers in grades 1-3 would reduce average class size from roughly 21 to roughly 18. The initiative would have three main elements: 1) grants to help states or communities hire new teachers (as in the COPS program, these grants would be time-limited (3-4 years) and the federal share would be 50-75%); 2) funds for teacher training, with a special emphasis on reading; and 3) provisions to ensure accountability, such as requiring testing of new teachers and/or ensuring the removal of bad teachers from the classroom. A serious proposal along these lines would cost $5-10 billion over five years, depending on the size of the federal match and the target date for reaching 100,000. We also would need to accompany the proposal with a school construction initiative (see below).

This has accountability and cost management

2. Education Opportunity Zones: As we outlined in an earlier memo on policy proposals for the race initiative, we are working with the Education Department on a plan that would reward 10-15 poor inner city and rural school districts for agreeing to adopt a school reform agenda that includes: ending social promotions, removing bad teachers, reconstituting failing schools, and adopting district-wide choice and/or public school vouchers. Our goal is to give school districts incentives to hold students, teachers, and schools accountable, in essentially the way Chicago has done. In our working proposal, each urban grant would be worth $10-25 million and each rural grant would be worth up to $2 million, for a total request in FY99 of $320 million.

3. National Public School Choice Law: We are exploring the possibility of proposing

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legislation to require that states and communities allow public school choice as a condition of receiving federal education funding. Together with a strong endorsement of bipartisan charter school legislation (bound to pass next year), this measure will show that we firmly support choice and competition. We are also looking into the concept of a parents' right-to-know law that would require states and communities to make key information on school performance available, so that parents can make informed choices.

4. University-School Partnerships: As we also outlined in our earlier memo on the race initiative, we are working on a grant program to promote strong partnerships between colleges and high-poverty middle and high schools, with the goal of enabling more youth to go on to college. This initiative would encourage colleges to adopt the Eugene Lang model for helping disadvantaged youngsters. Colleges would encourage students to take demanding courses, while providing academic enrichment and intensive mentoring, tutoring, and other support services. The students would receive special certificates for participating in the program, somewhat along the lines of Chaka Fatah's proposal. The Department of Education has requested $200 million for FY 99 for this initiative.

5. Campaign on Access to Higher Education: We are preparing to conduct an intensive publicity campaign on the affordability of higher education. The goal of the campaign would be to make every family aware that higher education is now universally accessible, as well as to reiterate that higher education is the key to higher earnings.

6. School Construction: We will need to re-propose a school construction initiative this year. We are currently considering the appropriate size and duration of this initiative, as well as the possibility of structuring this initiative as a tax credit.

7. Teacher Training for Technology: We are currently weighing several options on training teachers to use educational technology. These include (1) expanding various innovation grants to ensure that within four years, all new teachers will be ready to use educational technology, or (2) using the Technology Literacy Challenge Fund to train and certify at least one "master teacher" in every school, who can then train other teachers in the use of educational technology.

8. Hispanic Education Dropout Plan: We have developed a plan to improve educational opportunities for Hispanic Americans (or limited English proficient students generally), with the goal of decreasing the current disparity in dropout rates. The draft plan includes a number of administrative actions, as well as targeted investments of roughly $100 million to programs for migrant, adult, and bilingual education.

9. "Learning on Demand": We are developing an initiative, related to some of Governor Romer's ideas, to encourage the use of technology (e.g., the internet, CD-ROM, interactive TV) for lifelong learning. The initiative will begin the process of giving all Americans "anytime, anywhere" access to affordable and high-quality learning opportunities. The initiative is still in the developmental stage, and at this time we recommend only a small investment.

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Child Care

1. **Affordability:** We are developing a proposal that will help working families afford child care by (1) increasing funding for federal child care subsidies through the Child Care and Development Block Grant, and (2) changing the Child and Dependent Care Tax Credit by raising the percentage of child care expenses for which taxpayers of certain income levels may take a credit. On the subsidy side, every additional $100 million in the block grant will pay child care costs for at least 35,000 more children with incomes below 200 percent of poverty. On the tax side, we are considering raising the maximum credit rate to 50 percent for taxpayers with adjusted gross income (AGI) of less than $30,000 (from a current high of 30 percent for taxpayers with AGI of less than $10,000), and adjusting the income slide accordingly.

Should double — what's the cost? Any potential new approach

2. **Safety and Quality:** We are also considering targeted investments to improve the safety and quality of care. Our current proposal adds funding to the scholarship program for child care providers that you announced at the child care conference (which was very well received); provides resources for states to improve their enforcement of health and safety standards; and funds efforts to educate parents on quality child care.

3. **Early Childhood Learning and Afterschool Programs:** Our current proposal also expands early learning opportunities by increasing investment in Early Head Start and creating a new 0-5 Early Education Fund. The new fund will provide grants for innovative early learning programs for both working and stay-at-home parents. We are also considering ways of ~~expanding and streamlining~~ afterschool programs.

4. **Helping Parents Stay Home:** To support parents who wish to stay at home with their children, we are working on ways to expand the FMLA -- to six months instead of 12 weeks and to smaller-sized employers. We are also looking at a variety of ways to provide financial assistance, whether through a modified version of the Child and Dependent Care Tax Credit or through paid family leave administered under the unemployment insurance system. The cost of these financial proposals, however, may be prohibitive.

Health

1. **Consumer Protection Legislation:** We should reiterate our support for three pieces of health care consumer protection legislation: (1) the Quality Commission's Consumer Bill of Rights, which has strong public and elite support and arguably is more moderate than a bill in the House that already has attracted over 85 Republicans; (2) our genetic anti-discrimination legislation, which has attracted bipartisan support on both sides of the Hill as a way to protect Americans

from the misuse of new advances in genetics; and (3) privacy protection legislation, which would establish strong federal standards to ensure the confidentiality of medical records. Although these consumer protections would benefit the entire population, women's health advocates are especially supportive of them, because the Consumer Bill of Rights would ensure direct access to OB/GYNs and our genetic anti-discrimination legislation would protect women who undergo new tests for the breast cancer gene.

2. Medicare Reform and Program Improvements: To build on the Medicare reforms in the balanced budget agreement, we are considering two reform initiatives: additional anti-fraud initiatives (perhaps providing $2-3 billion in savings over five years) and an income related premium (providing another $7-8 billion in savings assuming it kicks in at an income around $50,000). We are also considering a number of Medicare improvements to which we could apply the above savings: (1) a Medicare (or COBRA) buy-in for pre-65 year olds (or some targeted subset of this age group), the cost of which would depend on whether we decide to subsidize this benefit; (2) Medicare coverage of cancer clinical trials, which could substantially increase investment in the treatment and cure of cancer, including prostate cancer; and (3) a new mechanism to provide Medicare beneficiaries with information about private long-term care insurance that meets appropriate standards.

3. Doubling the NIH Research Budget with Proceeds from Tobacco Legislation: We (along with the Republicans) are considering a proposal to double the NIH budget, which would cost about $20 billion over five years. Such an investment could lead to breakthroughs in research that would greatly improve our ability to prevent and treat diseases like diabetes and cancer -- and substantially lessen the costs associated with these diseases. Because the discretionary caps are so tight, the only realistic way to pay for such an initiative is through dedicated savings from the tobacco agreement. This link between tobacco legislation and health research should resonate strongly with the public.

4. Other Coverage Options -- Children's Health, Workers In-Between Jobs, Voluntary Purchasing Cooperatives: We are working on a public/private outreach effort to ensure that every child eligible for health insurance under Medicaid or our new program actually gets covered. The public side of this effort could include proposals to: give bonuses for enrolling more children in Medicaid; expand the kinds of places where children can enroll; and simplify eligibility processes. In addition, we are considering whether to propose a demonstration of our old policy to provide coverage to workers who are in-between jobs. Finally, we are continuing to pursue proposals relating to voluntary purchasing cooperatives, as a way to help small business gain access to and afford health insurance coverage.

5. Racial Disparities in Health Care: We are working on a proposal to address racial disparities in six carefully selected areas of health care: infant mortality, breast and cervical cancer, heart disease and stroke, diabetes, AIDS, and immunization. This proposal will include nationwide actions to reduce these disparities, as well as focused pilot projects in thirty communities (say, a project on diabetes on an Indian reservation or a project on AIDS in an inner

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city). The stated aim of the proposal will be to eliminate racial disparities in these six areas by 2010.

Crime

And community courts too – [illegible] courts for [illegible]

1. Community Prosecutors: We are working on a proposal, costing up to $100 million, to provide grants to prosecutors for innovative, community-based prosecution efforts. A number of jurisdictions already have embraced such efforts; for example, community prosecution is an essential component of Boston's juvenile crime strategy. These jurisdictions have found that a "problem-oriented" (rather than incident-based) approach to prosecuting, using a wide variety of enforcement methods and attending to the concerns of victims and witnesses, can pay real dividends. A grant program could spread these innovative programs across the country.

2. Juvenile Crime Initiative: Although we got funds for much of our youth violence strategy in last year's appropriations bills, we should continue to press for the passage of juvenile crime legislation -- especially for a juvenile Brady provision, which will stop violent juveniles from owning guns as adults. We also should challenge the four cities leading the nation in juvenile crime (New York, Los Angeles, Chicago, and Detroit) to replicate Boston's successful strategy and target resources to these cities to help them meet this challenge.

Welfare/Housing

1. Welfare-to-Work Housing Vouchers: We are working with OMB and HUD on a proposal for 50,000 new housing vouchers to help welfare recipients in public housing who need to move in order to find employment. We would distribute these vouchers on a competitive basis to public housing authorities working with local TANF agencies and/or grantees of the new $3 billion welfare-to-work program. We are working on a number of proposals to increase housing mobility (see below), and linking this issue to welfare reform may increase the chance of attracting congressional support. At the same time, we should reiterate our support for welfare-to-work transportation funds as part of NEXTEA.

Good

Housing

1. Housing Portability/Choice: In addition to the new welfare-to-work housing vouchers discussed above, a package on housing portability and choice could include: increasing the number of Regional Opportunity Counseling (ROC) sites; encouraging the use of exception rents (rents up to 120 percent of the "fair market rent") as a tool for opening up more expensive suburban housing markets; and eliminating obstacles to portability of Section 8 vouchers.

2. Fair Lending/Fair Housing: This proposal could include: an examination of the impact of credit scoring and risk-based pricing on the availability of credit/capital to lower-income and minority individuals; issuance of guidance by banking regulators on certain key credit scoring issues and, possibly, on risk-based pricing; a Presidential call to the FDIC and the Federal

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Reserve to obtain more data on reasons for home mortgage loan denials (OCC and OTS already collect such information); and collection of race and income data as part of the Equal Credit Opportunity Act/CRA small business and small farm lending reporting requirement.

3. Downpayment Reduction: We are working on a proposal to increase homeownership by reducing the barriers to buying a new home. Many low- and moderate-income families find a downpayment the largest hurdle to buying a new home; this initiative would lower this cost and help more families become homeowners. In 1992, Congress authorized the National Homeownership Trust, but never appropriated any money. We are investigating whether we should request money for this program or whether it is better policy to expand the existing HOME program (which serves a similar purpose).

Labor/Workforce

yes !!

1. Child Labor: We are working on a comprehensive Child Labor Action Plan, anchored by a $100 million commitment to the International Program on the Elimination of Child Labor (IPEC) -- a voluntary program of the International Labour Organization which is dedicated to the elimination of child labor. The funds, which would be managed by the Department of Labor in accordance with criteria we would develop, would go to programs attacking the most intolerable forms of child labor. The initiative also might include a stepped up Customs program to enforce U.S. law banning the import of goods made with forced or bonded child labor; increased support for the Migrant Education Program to support elementary and secondary education to the hardest-to-serve migrant children; and a call for prominent organizations, such as the Boy Scouts and Girls Scouts, to adopt a "No Sweat" code for uniforms and an accompanying label.

yes

further work on details

2. Pensions: We have developed an expanded pension coverage initiative that focuses on a simplified defined benefit plan for small businesses, based on the SAFE plan proposed by the American Society of Pension Actuaries (ASPA). We are also looking at a payroll deduction IRA proposal, a three-year vesting requirement for employer matching contributions in 401(k) plans, a women's pension initiative, and a pension right-to-know proposal.

3. Community Adjustment: As part of the Fast Track debate, we proposed the creation of the Office of Community and Economic Adjustment (OCEA). As you know, this office will be modeled after the Defense Department's Office of Economic Adjustment (OEA) -- the Administration's first point of contact with communities experiencing a military base closure or defense plant closing. The OCEA would coordinate the Administration's response to regions impacted by a major plant closing or trade, by working with Labor, Commerce, SBA, HUD, Treasury, and other government entities. This group would provide planning grants and expertise to help communities develop comprehensive economic adjustment strategies. Since this program will be part of the Economic Development Administration (EDA), we are investigating whether we could initiate this proposal by executive memorandum, while awaiting Congressional appropriations.

yes – v. important if can do before bringing up Fast Track again +

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Climate Change

1. **Tax Incentive and R&D Package:** You already have committed to a $5 billion package over five years for tax incentives and R&D to promote low-carbon technologies. The Treasury Department is working on a possible package of tax incentives to be included in the FY 1999 budget, and DOE has a proposal on the expenditure side. We are working to develop final options.

Race

A number of the above proposals -- e.g., education opportunity zones, university-school partnerships, housing vouchers -- can be presented as part of the race initiative, because they target predominantly minority areas or provide disproportionate benefits to members of minority groups. Other proposals described above -- the Hispanic dropout plan and the race and health initiative -- have obvious and explicit race connections. In addition:

1. **Civil Rights Enforcement Initiative:** We are working on a coordinated package of reforms for the EEOC and the civil rights offices at DOJ, HUD, HHS, Education, and DOL. Among other things, this proposal would expand dramatically the EEOC's mediation program, substantially increasing the average speed of resolving complaints and reducing the EEOC's current backlog. Similarly, the proposal would promote the increased use of non-adversarial techniques by the agencies' civil rights offices. The proposal also would provide a mechanism for better coordination among the various civil rights offices.

Yes — worth doing
something big & appealing
to press

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12-1-97

THE WHITE HOUSE

WASHINGTON

'97 NOV 25

November 25, 1997

TB | Rahm | Reed | Sperling
Blumenthal | Begala

Information

MEMORANDUM FOR THE PRESIDENT

FROM: MICHAEL WALDMAN MW

SUBJECT: ATTACHED MEMORANDUM FROM BILL GALSTON

Read this
It's excellent
circulate to me—

At Sylvia's suggestion, we have begun to solicit ideas from outside scholars and advisers, earlier than usual, for the State-of-the-Union.

In advance of this larger and later compendium, Bill Galston asked that this memorandum be forwarded to you. It was written before the withdrawal of fast track, but he says that he would only make these points more emphatically. Other suggestions from an array of outside advisers will be compiled and sent to you in December.

We will be meeting with you next week to discuss State-of-the-Union themes and process.

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COS
Emanuel
Reed
Sperling
Blumenthal
Begala
Currie
Hernreich

October 23, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: BILL GALSTON WAG

SUBJECT: 1998 STATE OF THE UNION

The purpose of this memorandum is to offer some strategic suggestions for you 1998 State of the Union address, and to place those suggestions within the broader historical context of your administration.

Background: The Context of Your Presidency

Every president must play the hand he is dealt. You have not been called upon to address economic depression, war, or even a cold war. Rather, you have been asked to end a generation of fiscal irresponsibility at home, build a democratic peace abroad, and restore the broad moral center in social policy based on shared American values such as opportunity, responsibility, community, nondiscrimination, and the centrality of faith in our civil society.

For what it is worth, my assessment is that you have succeeded in this endeavor to a greater extent than your adversaries (and even some of your friends) are willing to admit. Nonetheless, there much left to be done. My overall counsel is to define these undone tasks broadly and expansively, and to offer the boldest possible proposals to address them.

You do not need any advice from me about building a democratic peace. The basic elements of your legacy--a more open world economy, an expanded NATO, intelligent engagement with multilateral institutions old and new, and the selective use of American power to end barbarity and rebuild civility--are all well launched. With luck, key legislative battles in this arena will be waged and won by early next year. It is necessarily only to be firm, and to persevere.

In the domestic arena, by contrast, there is more left to be done. Let me sketch four areas--suitable for emphasis in the 1998 State of the Union--where bold proposals and presidential leadership could make a real difference.

The Domestic Arena: Policy Development and Presidential Leadership

1. Entitlements. The sad but simple truth is that in the three decades after the end of World War Two, every Western democracy made promises to its citizens that it cannot wholly

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keep. The challenge now is scale these promises to reality in a manner that meets essential needs, modernizes and stabilizes key programs for the longterm, and gains the consent of the governed.

I know that the risks are great and that the timing is never quite right. But I am convinced that if you take the lead in defining the debate, the prospects for real progress are bright. (I attach a forthcoming article of mine that lays out in some detail the argument for addressing Social Security now, along some of the key moral, social, and policy considerations.)

2. Education and training. You have begun a long overdue debate on standards and testing this year. The facts are on your side, as are the people. It would be a mistake to back off in response to short-term political setbacks. Instead, use the State of the Union to restate the basic rationale for your initiatives and intensify the pressure on their foes.

In preparing for the State of the Union, you should also consider even bolder approaches, such as linking federal educational funding to the willingness of states to adopt rigorous testing regimes. I believe you should also establish as an explicit national goal that every state should have meaningful charter school legislation by the year 2000, and make it clear that federal support will back up such legislation.

We do not have one system of public education in this country; we have two. One, principally white and based in the suburbs, is mediocre but modestly successful and improving somewhat; the other, principally minority and based in the cities, is failing and condemning millions of kids to lives of restricted opportunity. It is time to declare an urban education emergency and to make it clear that business as usual will not do. You will lend your support to bold breaks with the status quo, as are now under way in Chicago, Washington DC, Philadelphia, and elsewhere. You are prepared to work with state and local leaders who are determined to put student achievement first, even at the cost of considerable broken political crockery.

Finally, it is time to renew the battle for lifelong learning. The GI Bill for American Workers was a good idea when you proposed it almost three years ago; it remains a good idea today. In particular, the hodge-podge of ineffective training programs should be turned into a voucher system that individual workers could tap for the training and retraining they need at various stages of their careers. Yes, there is opposition from some Democrats who like the programmatic status quo, and from some Republicans who want to devolve the programs and funds to the governors. But there is a latent coalition of the center that could be mobilized for the GI Bill.

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3. **Expanding the winners' circle.** There is a substantive (as opposed to narrowly political) reason why your fast-track initiative has run into trouble: a more open economy may improve outcomes for the nation as a whole, but it will leave some sectors worse off. The classic theory of the open economy suggests that the winners can and should compensate the losers. This makes good political sense, and it also honors the basic moral proposition that we're all in this together.

Unfortunately, over the past decade our system has done an inadequate job of compensating the losers. The result is concentrated resentment, and stiff resistance to further movement down the road toward a global economy.

It is important--substantively as well as politically--to send a credible signal that you are determined to bring as many Americans as possible into the winners' circle. Beyond the expanded training agenda sketched above, I believe you should explore the feasibility of an unemployment insurance system that is expanded to serve as a "wage insurance" program. The basic idea is a contributory system that provides transitional assistance to workers experiencing downward mobility in the new economy. In one version of this plan, a worker who loses a $12/hour job and can only find an $8/hour job to replace it would receive payments from the insurance fund equal to half his or her lost wages for a period of up to two years. There are some experts who could help flesh out this plan if you are interested in the basic concept.

4. **Race.** There is no deeper issue in America, nor one with which you are more closely identified. I believe you should be prepared to jump-start your race initiative with some concrete announcements in the State of the Union. In my judgment, the current public focus on affirmative action is a substantive and political loser. Rather than breaking new ground, it merely exacerbates existing lines of division. Instead, the focus should shift to other areas--such as housing and criminal justice--where there is more room for public education and policy innovation.

For example, I believe most Americans are largely unaware of--and would be shocked to learn about--the level of housing discrimination that minorities routinely experience. And as Harvard Law School's Randall Kennedy (whom you met at the White House at a pre-State of the Union dinner in January 1996) has persuasively argued, the myriad ways in which our criminal justice system fails the test of color-blindness is a daily affront to millions of our citizens. These are areas where the Advisory Council could be directed to develop policy options on an accelerated basis for review by the Domestic Policy Council.

Conclusion

I do not mean to suggest that these four areas should be the sole focus of the State of the Union, let alone the next three years. No doubt there are other areas (child care, for example) where expedited policy development could help flesh out the agenda for the remainder of your administration. My objective in singling out four areas for special attention was to indicate ways in which, building on the foundation laid down in the past five years, new proposals can be advanced that are both consistent with past commitments and bold enough to capture the imagination of the American people. With leadership and a bit of luck, you could help create a system of public education on the path to excellence, a panoply of entitlements modernized and secured for generations to come, an economy in which fewer and fewer Americans feel left out, and a society in which the curse of racial and ethnic division is honestly confronted and addressed as rarely before in our history.

WHAT THE SOCIAL SECURITY DEBATE SHOULD BE ABOUT

William A. Galston

Multiple Challenges

Over the past six decades, the United States has built its own distinctive system of social insurance and protection for its elderly citizens. As a direct result, tens of millions of Americans have enjoyed health, security, and independence. But today, the cornerstones of this system--Social Security and Medicare--are under intense fiscal, demographic, and (in the case of Medicare) technological pressure.

Modernizing and stabilizing these programs for future generations is perhaps President Clinton's greatest remaining domestic policy challenge. He has the opportunity and (I believe) the responsibility to catalyze a public dialogue on the best ways of attaining these objectives. That dialogue could yield the Clinton administration's most significant and enduring domestic legacy. But if it is to succeed, the President must lead it.

The new Social Security Commissioner, Ken Apfel, recently stated observed that the coming debate over Social Security "will test this nation--test its values and what we stand for." That is clearly correct, and an important counterweight to those who see this issue in narrow fiscal or actuarial terms. But this debate will also test our capacity for responding to changing conditions by finding new ways of realizing enduring values. This will, in turn, challenge everyone to distinguish more clearly between means and ends, to consider new ideas on their merits in a spirit of hope rather than of fear, to avoid the reflexive political rhetoric that turns every reform proposal into a plot to "gut" the program, "shred" the safety net, and "abandon" the elderly.

Enduring Values

At the heart of Social Security is a basic social compact: As fellow citizens, we are connected to one another in ways that transcend individual choice. Our individual lives will take very different courses. Nonetheless, in some respects we agree to share a common fate.

Social Security rests on reciprocity--a balance between individual and social responsibility. All individuals must seek gainful employment and, when working, contribute their fair share to the system. In return, society helps every worker achieve a decent and secure retirement, by providing a reasonable (not necessarily optimal) return on contributions.

But Social Security is intended as a foundation for--not the totality of--retirement security. All individuals are expected to take responsibility for building on that foundation--by saving, investing, or contributing to a private pension plan when available. Of course, workers at different income levels will be able to save privately to different degrees. Social Security necessarily represents a larger share of retirement income for lower-income than for higher-income workers--a fact that our society must take into account as we consider how to honor our continuing responsibility to one another.

Beyond reciprocity, Social Security reflects a balance between what differentiates us as individuals and what we have in common with our fellow citizens. One could imagine a retirement system in which everyone receives the same benefits, regardless of the size of one's contributions; or alternatively, a system in which benefits are in strict proportion to contributions. Social Security is at neither extreme: wage earners who make larger contributions do receive larger benefits in retirement, but most lower-income earners receive a higher rate of return on their contributions. That is, the system's benefits relative to contributions are progressive and pay special attention to the needs of lower-income workers. In part, this reflects the fact that we are not entirely sure where we will end up in life's economic lottery; we are willing to give up some portion of maximum returns to ensure ourselves against the possibility that we will retire on less favorable terms than we now think most likely.

Social Security is mandatory. This reflects our shared understanding that left to their own devices, not all individuals would adequately provide for their retirement--and that it is thus appropriate for government to require all of us to do so. The classic image is of Ulysses lashed to the mast to prevent the Sirens' call from diverting him from his longterm objective. (For the most part, even the most severe critics of the current structure of Social Security acknowledge that it is necessary and proper for the government to require individuals to provide for their retirement.)

Social Security also reflects our shared understanding that in a modern society and economy, public programs must play a leading role in helping us honor the Biblical injunction to honor our parents. Neither retirees nor their working-age children would willingly return to an era when the elderly were directly dependent on younger family members. Social Security thus represents a combination of generational interdependence (through the system's contributory provisions) and generational independence (funds flow directly and reliably from the government to individuals rather than from family members at their discretion).

Finally, Social Security embodies the understanding that government has a role to play in creating and maintaining a framework of stable expectations on which individuals can rely as they make the choices that define their lives. The point is not to eliminate uncertainty altogether, but to confine it within reasonable bounds.

This principle imposes some constraints on programmatic changes that disrupt stable expectations. Individuals should not be required to make changes to which they lack the time and resources to adjust. It is not only prudent, but also morally necessary, to structure changes to Social Security in a way that does not affect workers at or near retirement.

Changing Conditions

Key changes since Social Security was invented more than six decades ago require us to reconsider the means we use to promote a secure and decent retirement for all Americans. Let's begin with demography. Americans are living much longer than they did before World War Two, and some analysts believe that our longevity will increase at an even more rapid rate in coming decades. The aging of the baby boom generation will impose huge new costs, which begin to accelerate after the year 2010 and which must be financed by the payroll taxes of the much smaller "baby bust" generation born between 1965 and 1960. And a system designed in an era with low rates of divorce and female labor force participation is not well suited to a new relaity in which these rates are far higher.

There have been important economic changes as well. The shift from an industrial to a service economy reduces the importance of attributes (such as physical strength and endurance) that once limited the ability of aging Americans to remain effective in the workforce. While policymakers in the 1930s coping with high unemployment sought ways of promoting the retirement of aging workers to make room for younger workers, we now face the opposite problem: low unemployment, coupled with a workforce whose size will soon begin to shrink relative to the number of elderly Americans to support if current retirement patterns continue. And thanks in large part to Social Security, the economic circumstances of older Americans has improved dramatically, both absolutely and relative to younger workers.

Social Security itself is changing. Unlike in earlier decades, the system is now mature, with workers contributing for their entire working lives before receiving benefits. It is no longer possible, as it once was, for all workers to receive windfalls--returns far in excess of contributions. Rates of return are declining for most workers, and are turning negative for some. The failure of the celebrated 1983 Greenspan Commission to deliver on its promise of longterm financial stabilization has

THE PRESIDENT HAS SEEN
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called attention to the system's structural deficit, now placed at more than 2 percent of total payroll over the next 75 years.

The policy context is changing as well. Now, unlike sixty or even thirty years ago, Social Security issues must be addressed in tandem with other large questions affecting the elderly. In particular, the fiscal crisis of the Medicare system is more imminent, and far more acute. If, as many analysts believe, Medicare cannot be stabilized without (among other changes) a large infusion of new public resources, it would be irresponsible to commit new tax dollars to Social Security without carefully considering the programmatic and political opportunity costs.

Finally, public opinion is shifting. By this I do not mean the much-debated loss of confidence in Social Security, but rather: an increased understanding (fueled by the surge in the stock market) of the longterm disparity between return on equities as opposed to bonds; the readier availability of timely investment information and effective choices to individuals, not just large institutions; and changing attitudes (especially among younger workers) toward self-reliance, the appropriate role for individual choice, and acceptable levels of risk in retirement programs.

Conclusion

Within this context of changed conditions and enduring values, there is room for significant debate about the steps we should take to both modernize and stabilize Social Security. Should we phase in a significant increase in the retirement age, over and above the increases contemplated in current law? Should we reverse longstanding incentives for early retirement, which have reduced by more than two-thirds labor force participation rates by men older than 65 over the past half-century? Should we make the system fairer for women who work outside the home and for younger families with dependent children? Should we increase the role for individual management of retirement strategies? Should we invest new public resources in Social Security, or rather focus on structural adjustments of benefits?

These and many other questions call, not only for technical expertise and policy experience, but also for public understanding, judgment, and consent. As Social Security Commissioner Apfel has rightly said, this issue cannot be resolved without an "educated citizenry, corny as that sounds."

During the past five years, President Clinton has demonstrated his ability to master complex policy issues and explain them to the American people. He should use his personal gifts, harnessed to the powers of his office, to foster the kind of public dialogue that can help reform Social Security is a genuinely democratic way. In so doing, he can help restore the public's trust in the capacity of our tattered democratic institutions to conduct the people's business fairly and honorably.

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EB
Someone will have to assure the ball goes forward in this regardless of what happens after [illegible]
BC

Gene —
please respond to POTUS
Thx
E

Copied
Bowles

CHIEF OF STAFF TO THE PRESIDENT

Send to Gene Sperling

DRAFT: CLOSE HOLD *December 4, 1997, Version 2*

SOCIAL SECURITY AND THE UNIFIED SURPLUS

Options

The following options are intended to reflect what the President could potentially announce over the next month or so.

- **Option 1: No specificity.** Earmark the surplus for Social Security and retirement needs, but do not provide any precise details. Indicate that this use of the surplus was only a down-payment in a larger Social Security process.

- **Option 2: Declare specific use of surplus.** Define how the surplus will be used to bolster the Social Security Trust Fund by indicating split between (a) Trust Fund and (b) retirement accounts or other uses. But indicate that this use of the surplus was only a down-payment in a larger Social Security process. A critical issue if individual accounts are involved is to what extent they are linked to "Social Security."

- **Option 3: Provide entire plan.** Announce complete Social Security and retirement plan.

Option 1: No specificity: Earmark surplus for Social Security and retirement, but do not provide any precise details

Description: Under this option, the President would announce that the working man's surplus should not be frittered away through wasteful spending or tax cuts, but rather should be earmarked to bolster the Social Security system and the nation's retirement security. The President would *not* provide details on precisely how the surplus would be used -- for the Trust Fund or individual accounts, etc. He would also announce the creation of a commission or bipartisan process to report back by January 1999 on Social Security. The precise way in which the surplus would be used could be considered either separately from, or as part of, the overall Social Security process.

Three critical issues surrounding this approach are:

- Defining the underlying goal of the process (e.g., to achieve 75-year balance, etc.)

- Creating budgetary rules to ensure that the projected surpluses are actually used to bolster Social Security and retirement income security

- Considering whether a trigger-like mechanism is sensible (e.g., make other adjustments to Social Security if necessary) to ensure that the goal of the process is met

PROS

- Offers a first line of defense against tax cuts.

- Allows the President to suggest a substantial down-payment on fixing the Social Security system (e.g., "For example, if the surpluses between 2002 and 2007 were devoted to purchasing private securities for the Trust Fund, the exhaustion date would be delayed from 2029 to 2037 and the 75-year actuarial deficit would fall from 2.23 percent to 1.47 percent.")

- Avoids the difficult issues involved in individual accounts, including their connection (if any) to the Social Security system.

CONS

- May not provide a sufficient defense if opposition moves aggressively to tax cuts linked to individual accounts (e.g., a Feldstein-like approach).

- Lack of details may not be sustainable -- may quickly be pressured to identify potential specifics. Therefore, the lack of specificity may quickly become a liability.

Option 2: Declare specific use of surplus

Description

Under this option, the President would declare how the surplus will be used to bolster the Social Security Trust Fund by indicating split between (a) Trust Fund and (b) retirement accounts or other uses. But he would indicate that this use of the surplus was only a down-payment in a larger Social Security process. For example, he could also announce the creation of a commission or bipartisan process, to report back by January 1999 on Social Security, to address the remainder of the imbalance in the Social Security system.

PROS

- Provides a *specific* down-payment on the retirement challenge.
- Potentially allows the President to point to a specific down-payment, although making such a specific claim could intensify concerns over whether the surpluses will materialize (e.g., SSA vs. OMB, NDD assumptions) and, even if so, whether the transfer into the Trust Fund is necessarily protected.

CONS

- Provides specifics for opponents to attack.
- If Trust Fund does not redeem special purpose bonds to offset purchases of securities, then effectively general revenue transfer to Trust Fund.

One generic alternative of implementing this option would be to offset any transfers to the Trust Fund with corresponding redemptions of special purpose bonds. The benefit of this approach is that it eliminate the double-counting phenomenon and the use of general revenue to finance the Trust Fund. The cost is that it provides significantly less to the Trust Fund, because of the offsetting reductions in special purpose bonds.

2(A): 100 percent of the surplus for Trust Fund

Description: Under this option, the President would announce that the surplus should be earmarked solely for the Social Security Trust Fund, as a down-payment on fixing the Social Security system. The President could specify whether the surpluses would be invested in Treasury or private securities, or leave that decision open.

PROS

- May not alienate the Ball camp or split the Democracts.
- If investments take the form of private securities, may reduce double counting criticism and provide "real" assets to Trust Fund.

CONS

- Does not involve individual accounts, and thus may be vulnerable to tax cut/individual account attack, especially if invested all in Treasury securities, so that rate of return much lower on Social Security than individual accounts.
- If investments take the form of bonds, could be especially prone to double counting criticism and attacks of a mere accounting fix that obscures and does not address bulk of underlying problem.

2(B): Specific share for Trust Fund, residual for individual accounts

Description: Under this option, the President would announce that the surplus should be earmarked for Social Security, but would also announce that some portion of the surplus would be used to fund individual accounts. Within this option, ***one critical issue is to what extent the individual accounts are linked with "Social Security," or are seen to be distinct from Social Security. Another critical issue is the progressivity (or lack thereof) of the system.***

Potential size of contributions to individual accounts with 30 percent of surplus devoted to individual accounts (1997 dollars, flat contribution per worker or adult)

	Per worker	Per adult 20-64
2002	$111	$97
2007	$248	$216
2012	$338	$292
2022	$178	$153

Note: These numbers do not adjust the projected unified surplus for any increase in publicly held debt caused by the funding of individual accounts or the purchase of private securities by the Trust Fund.

If the contributions above were invested half in equities and half in Treasury bonds, the value of the account would accumulate to approximately $9,500 (in 1997 dollars) by the end of 2026.

PROS

- Stakes out more of the middle ground on retirement reform, by including some form of individual account for every American. Provides more protection against extreme individual account proposals.
- Existence of individual accounts could improve norms on saving behavior, and thus have a "magnification" effect.
- If designed as a flat benefit per person, more progressive than Social Security.

CONS

- Could split Dems, especially if Ball et. al. view as first step toward privatization. *Characterization of whether accounts are "part" of Social Security or not could potentially play a critical role.*
- If designed as a flat percentage of payroll, would be regressive relative to Social Security.
- Pension contributions stop after surpluses run out.
- Size of pension contributions would likely vary from year to year.
- Individual accounts could reduce national saving — relative to using the surplus entirely for Social Security — by encouraging individuals to save less in other accounts, or by encouraging employers to drop or reduce pension plans.

2(C): Specific share for Social Security, residual for other priorities (Children's Fund, tax reform)

Description: Under this option, the President would specify a given share of the surplus as a defined down-payment for Social Security reform, and ask for a commission or bipartisan process to report back on the Social Security problem by January 1999. The rest of the surplus would be used to fund other priorities — possibly including a Children's Fund, targeted tax cuts, and/or tax reform.

PROS

- Provides funding for other priorities.

CONS

- Muddies the "don't spend the surplus" message.

Option 3: Complete Social Security plan

Description: Under this option, the President would announce a complete Social Security plan, perhaps including some sort of individual accounts. The plan would incorporate both the surplus and "real" reforms (e.g., changing the normal retirement age).

There are several motivations for doing more than merely using the surplus in some way to shore up the Social Security system. First, transferring the surplus to the Trust Fund in and of itself does nothing to attenuate the long-run pressures on the budget, or to reduce the burden implied by changing demographics. Thus, additional steps are warranted. Second, although the precise impact depends on how the surplus is split (between the Trust Fund and individual accounts, and between Treasury and private securities within the Trust Fund), devoting some or even all of the surplus to Social Security is likely to leave some actuarial imbalance in the program. Under this option, the President would therefore announce both how the surplus was to be used, and other steps to eliminate any remaining imbalance.

The double-counting issue (or "logic" problem) is crucial to analyzing any options to eliminate the remaining gap in the program. Specifically, assume that the chosen surplus mechanism reduces the 75-year actuarial imbalance in the Social Security program from 2.23 percent of taxable payroll to 1.0 percent of taxable payroll. Then because of the double counting issue, reforms that have the direct effect of reducing the imbalance by only 0.5 percent of payroll will (to a first approximation) be sufficient to eliminate the entire deficit. Any reform will have both a direct and an indirect effect: it will first affect the actuarial imbalance directly, and then affect it indirectly because of feedback from the unified surplus.

PROS

- Support from elites for announcing specific steps to address Social Security imbalance.

CONS

- Specific steps almost invariably involve benefit cuts.
- 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 reform effort.

Based on proposals put forward by others, the following are *illustrative* examples. Their presence here does not imply that they are being proposed by any members of the group.

Illustrative Package 1	Impact on 75-year deficit
Invest 100 percent of surpluses between 2002 and 2012 in bonds for the Trust Fund.	0.60
Cover state and local workers	0.23*
Accelerate increase in normal retirement age, index thereafter	0.48*
Modify benefit formula by reducing adjustment factors by 5 percent	0.5*
Extend computation period from 35 to 38 years	0.26*
CPI changes already announced	0.2*
TOTAL	2.27**
Current 75-year actuarial imbalance	2.23

Illustrative Package 2	Impact on 75-year deficit
Invest 70 percent of surpluses between 2002 and 2007 in Trust Fund, with equity investments up to 40 percent of Trust Fund. Other 30 percent of surplus funds individual accounts.	0.59
Modify benefit formula by reducing adjustment factors by 5 percent	0.5*
Accelerate increase in normal retirement age, index thereafter	0.48*
Extend computation period from 35 to 38 years	0.26*
Additional COLA changes beyond those already announced, amounting to 0.15 percentage points per year	0.2*
CPI changes already announced	0.2*
TOTAL	2.32**
Current 75-year actuarial imbalance	2.23

* Not counting indirect effect through unified surplus

** Not counting interaction effects, which are likely to reduce total to about 2.2 percent

POSSIBLE ELEMENTS OF COMPLETE PLAN

Below are illustrative elements that have been proposed by others as elements of a Social Security plan. The pros and cons are from the Gramlich commission analysis, and comments made by members of the Hill. These proposals have not been subject to any review within the Administration.

(A) Implications of Various Financial Options for the Actual Imbalance in the Trust Fund

1. Transfer surpluses into Trust Fund; buy bonds only

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.25	0.17	0.12
2002-2012	0.60	0.39	0.27
2002-2026	1.12	0.67	0.43

2. Transfer surpluses into Trust Fund; buy private securities (cap at 40 percent)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.75	0.59	0.46
2002-2012	1.19	0.93	0.74
2002-2026	1.64	1.16	0.88

3. Invest in bonds only, until on-budget balance moves into surplus (cap at 40 percent)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.25	0.17	0.12
2002-2012	0.80	0.59	0.46
2002-2026	1.37	0.92	0.70

3. "Use" surpluses to buy private securities (no transfers into Trust Fund)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
use only 2002-2007	0.46	0.41	0.33
use until hit portfolio cap	0.46 (2008)	0.44 (2010)	0.42 (2012)

Source: Social Security Actuary. Private securities are assumed to earn 3.4 percent per year more than Treasury securities.

(B) Cover All State and Local Government Employees

The proposal below has been put forward by outside experts. The pros and cons are from the Gramlich commission analysis, and comments made by members of the Hill. The proposal has not been subject to any Administration review.

Direct impact (% of payroll):	**0.23**
Included in:	**All three Gramlich commission alternatives**

Description: 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. Not counting student employees, 18 percent of state and local government employees are not covered by Social Security (these state and local government employees belong to other public retirement systems). Covering such employees within the Social Security system would improve the actuarial imbalance by 0.23 percent of taxable payroll (largely because newly covered workers pay in before receiving benefits).

PROS

- Included in all three plans from the Gramlich commission -- perhaps providing some cover.

- State and local government employees are the last major group of workers not uniformly covered by Social Security.

CONS

- State and local government workers, particularly in California and Ohio, will resist inclusion in the Social Security system. Approximately three-fourths of the future employees who would be affected by the proposal participate in plans in seven States: California, Colorado, Illinois, Louisiana, Massachusetts, Ohio and Texas.

(C) Raise Normal Retirement Age

The proposal below has been put forward by outside experts. The pros and cons are from the Gramlich commission analysis, and comments made by members of the Hill. The proposal has not been subject to any Administration review.

Direct impact (% of payroll): **0.10 from accelerating scheduled increase**
0.38 from indexing thereafter

Included in: **Gramlich and PSA plans (different forms)**

Description: Since 1940, life expectancy at age 65 has increased from 11.9 years to 15.6 years for males, and from 13.4 years to 19.2 years for females. To reflect this increase in life expectancy, the normal retirement age (the age at which the beneficiary is entitled to full retirement benefits) will gradually increase under current law 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.

Life expectancy at age 65 is projected to continue increasing, to 18.0 years and 21.5 years respectively, by 2055. This option would therefore eliminate the present law "hiatus" scheduled to occur when the NRA reaches age 66 (for workers born in 1943). Instead, the NRA would continue to increase at a rate of 2 months per year until reaching 67 for workers born in 1949. Thereafter, the NRA would be indexed to longevity (the estimated increase in NRA would be one month every two years).

A crucial issue is whether the earliest eligibility age would also be increased in line with the normal retirement. Under current law, the earliest eligibility age is 62, and does *not* change as the NRA increases. (Workers retiring at the earliest age receive reduced benefits -- currently 20 percent below what they would receive if they waited until the normal retirement age.)

PROS

- Recognizes increased longevity.
- Still a benefit cut, but both somewhat hidden and also justified by the increased longevity.

CONS

- Could place burden on many workers, particularly manual workers. Currently, approximately half of workers retire before 63. Therefore, even if there is no change in the earliest eligibility age, workers retiring at 63 would receive lower benefits (approximately 6.5 percent for each year that the NRA is raised).

- Could induce more people to file for DI, rather than OASI, thus reducing beneficial impact on OASDI system as a whole.

- Increased longevity may not necessarily imply increased capacity to work at any age. Historical example: despite increase in longevity, retirement ages have been declining.

(D) Expand Computation Period for Average Indexed Monthly Earnings

The proposal below has been put forward by outside experts. The pros and cons are from the Gramlich commission analysis, and comments made by members of the Hill. The proposal has not been subject to any Administration review.

Direct impact (% of payroll): **0.26**

Included in: **Ball and Gramlich plans**

Description: Currently, Social Security retirement benefits are linked to a recipients' average wage over the 35 highest-earning years of employment. This proposal would extend the period to 38 years, thereby adding in more relatively low-earning years. Under this proposal, those with longer earnings histories are hurt less than those with shorter, more sporadic attachment to the labor force.

PROS

- Still a benefit cut, but somewhat hidden.

CONS

- Cuts benefits: The change would reduce retiree benefits by an average of 3 percent. The reduction is slightly higher for females.

- Regressive: Because high-earning workers have a lower marginal benefit factor, this change is regressive -- reducing high-earner benefits by less than low-earner benefits.

(E) Modify Taxation of Social Security Benefits

The proposal below has been put forward by outside experts. The pros and cons are from the Gramlich commission analysis, and comments made by members of the Hill. The proposal has not been subject to any Administration review.

Direct impact (% of payroll): 0.36

Included in: **All three Gramlich alternatives (some version)**

Description: Currently, the partial tax on Social Security benefits does not apply to seniors with incomes below \$25,000 if single or \$32,000 if married and filing jointly. In calendar year 1997, according to CBO estimates, only 25 percent of beneficiaries will be subject to taxes on their Social Security benefits.

The proposal 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, benefits would be taxed -- 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 approximately 0.13 percent of payroll, would mirror the tax treatment of other defined benefit pension plans.

The proposal would phase 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. This change would reduce the long-run actuarial deficit by approximately 0.23 percent of taxable payroll.

PROS:

- Eliminates tax distortion between Social Security benefits and other sources of income.

CONS:

- Raises taxes.

- Hits the middle of the elderly income distribution. The upper end already pays taxes, and the lower end will continue to be sheltered by other provision in the tax code (zero bracket).

(F) Modify the Benefit Formula
The proposal below has been put forward by outside experts. The pros and cons are from the Gramlich commission analysis, and comments made by members of the Hill. The proposal has not been subject to any Administration review.

Direct impact (% of payroll): **1.32 for this specific plan, but any size could be accomplished under similar approaches**

Included in: **Gramlich plan**

Description: Under current law, a three-step weighted benefit formula is applied to a worker's average earnings. For example, in 1997, benefits for a worker retiring at the normal retirement age were calculated as 90 percent of the first $455 in average indexed monthly earnings. 32 percent of earnings between $455 and $2,741, and 15 percent of any earnings above $2,741.

The proposal would reduce the 32 percent and 15 percent factors in present law Social Security benefit formula gradually, until the factors were 22.4 percent and 10.5 percent for newly eligible beneficiaries. Would result in benefits cuts ranging from 8 percent for low earners, 17 percent for average earners, and 21 percent for high earners. Proposal is estimated to save 1.32 percent of taxable payroll.

The proposal could be scaled down, to produce a less dramatic movement in the benefit formula (and a correspondingly smaller improvement in the actuarial balance). The specific details provided here were developed in conjunction with a small (1.6 percent of payroll) individual account. The details of this approach could be modified depending on the existence or size of such accounts.

For example, all the current factors could be reduced by a given proportion (e.g., 5 percent). An immediate 5 percent reduction in the factors would amount to an improvement in the actuarial imbalance of approximately 0.5 percentage points. Such an approach would perpetuate the current progressivity of the benefit structure.

PROS:
- Progressive: Reductions for high earners more substantial than for low earners.

CONS:
- One of the more explicit means of cutting benefits.
- Would likely by opposed by Bob Ball, and could therefore split left.
- Could undermine long-run support for Social Security, especially among high-earners, by reducing their rate of return.

(H) Changes in Cost-of-Living Index

The proposal below has been put forward by outside experts. The pros and cons are from the Gramlich commission analysis, and comments made by members of the Hill. The proposal has not been subject to any Administration review.

Direct impact (% of payroll): **Up to 0.15 for every 0.1 percentage point reduction in CPI**

Description: The BLS has already announced its intention to address "lower level" substitution bias in the CPI, starting in 1999, by adopting a geometric mean formula for aggregating price quotations within the index's strata. The expected reduction in COLAs from this change is approximately 0.15 percentage points per year -- implying a reduction in the actuarial imbalance of approximately 0.2 percent of taxable payroll. *This change is not included in the current Social Security actuarial assumptions.* Since the BLS has already announced its intentions in this area, it would be relatively uncontroversial to include a correction for this factor in any reform plan.

The BLS is also considering other additional technical changes in CPI as well -- including, for example, an official superlative index at the upper level of the index, and more frequent benchmarking of the index. Such changes could amount to 0.2 to 0.4 percentage points per year.

PROS:

- Recognizes corrections to the CPI that are fully sanctioned by BLS.

CONS:

- Cuts benefits.
- BLS has only formally announced its intention to correct lower-level substitution bias. It may therefore be difficult to claim more than 0.15 percentage points per year, without raising difficult questions to answer.

THE WHITE HOUSE

WASHINGTON

December 7, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING AND LAWRENCE SUMMERS

SUBJECT: The unified budget surplus and Social Security

Following our previous meeting with you, we have further analyzed the possible options involving the unified surplus and Social Security. As you know, we have been holding an NEC process on these questions, and this memorandum reflects input from participants in that process, including Ken Apfel, Bob Rubin, Frank Raines, Jack Lew, Ron Klain, Janet Yellen, as well as some of your political advisers, including Rahm and Paul Begala. We have also been keeping Erskine up to date, and responding to his input.

This issue brings together three of the most important economic issues facing the Administration: the unified surplus, Social Security, and tax reform. Devoting the surplus in some way to Social Security could prove to be constructive on both policy and message grounds. From a policy perspective, it is desirable now -- when we are doing well -- to prepare for the budgetary challenge that will come with an aging population. And the Social Security problem is more analytically and politically tractable than the Medicare problem. From a message perspective, strengthening the Social Security system may be our best way to beat back proposals to use the surplus for substantial tax cuts or dramatic tax reforms with adverse distributional implications. Any of the approaches delineated below must thus be judged not only in terms of Social Security policy, but also in terms of the wider debate over possible uses of the surpluses.

Since you indicated that you wished to see how a complete package could fit together before evaluating the larger strategic and policy questions, this memorandum first presents the building blocks for reform, then presents a series of illustrative packages, and finally returns to the difficult strategic issues inherent in any of the possible approaches to this issue.

I. Building blocks

The Social Security problem is usually analyzed in terms of the Trust Fund. Under the current intermediate projections of the Social Security actuaries and with no change in policies, revenues and interest on the Trust Fund are sufficient to fund full benefits through 2029. At that point, revenues are expected to be sufficient to fund only about three-quarters of currently promised benefits -- that is, in order to avoid the Social Security system's contributing to the unified deficit, it would be necessary at that point to either reduce benefits by 25 percent or increase revenues by 25 percent, or some combination thereof. In the context of Social Security reform, the long-term gap between revenues and benefits is typically framed in terms of the 75-year actuarial imbalance, which compares the present value of revenues plus the assets currently in the Trust Fund, to the present value of benefits. The result is generally expressed as a fraction of taxable payrolls over the same period. At present, the actuarial imbalance is estimated at 2.23 percent of taxable payrolls. This means that actuarial balance could be restored by raising the Social Security payroll tax to 14.63 percent from its current level of 12.4 percent. To the extent that actions are deferred, the policy corrections would have to be more severe.

A complete package of reforms to the Social Security system that would address the structural imbalance in the program would comprise some combination -- though not necessarily involving all -- of the following four building blocks:

- Traditional solutions, such as benefit reductions or revenue increases;
- Funding from the unified surplus;
- Investments in private securities to raise the rate of return on the Trust Fund; and
- Individual accounts, which provide an alternative source of retiree income.

A. Traditional solutions

The first building block comprises benefit cuts or revenue increases within the Social Security system:

1. Benefit reductions. The entire imbalance could be eliminated on the benefit side, but that would imply approximately a 25 percent cut in benefits. Reforms that are often proposed and that would have the effect of reducing benefits include increasing the number of years used to compute benefits, raising the normal retirement age, reducing annual COLAs, and reducing the adjustment factors used in the benefit computation formula. Actions of this type could be adjusted to achieve differing degrees of progressivity. A more complete menu of such reforms is provided in the appendix.

2. Revenue increases. A second traditional alternative is to raise revenue for the Social Security system. Common proposals in this area include expanding the coverage of the system to include all state and local government employees; treating Social Security benefits like other defined benefit pensions for income tax purposes; raising the payroll tax; or expanding earnings covered by the existing payroll tax. Again, the appendix provides more information about such possibilities.

B. The unified surplus

A second building block is the projected surpluses, which could be used to plug some of the financing gap in the Social Security system or to fund small individual accounts. The appendix provides a menu of possible ways to use the surplus to address the actuarial imbalance in Social Security. But there are two critical issues surrounding the surplus:

1. The perception of a "double counting" problem. Until 2008, the entire unified surplus results from surpluses within the Social Security system. The logic of contributing the unified surpluses to the Social Security Trust Fund could therefore be questioned, since the excess of Social Security taxes over benefits is already credited to the Trust Fund. In effect, the simplest proposals would credit that excess to the Trust Fund twice (producing what many of us have been referring to as the "double counting" problem).

An alternative approach would eliminate the double counting problem by purchasing private securities for the Trust Fund (which would be scored as an outlay), but offsetting those purchases with reductions of the bonds currently held by the Trust Fund (which would *not* be scored). In effect, this approach would eliminate the surplus while merely shifting the allocation of assets held by the Trust Fund (more private securities, less Treasury securities) -- and would not represent double counting because it would not immediately affect the total size of the Trust Fund. It thus has the attraction of eliminating the double counting problem. But the disadvantage is that it relies heavily on a scoring rule that could be changed in the future, especially if those scoring rules are attacked as taking away funds for tax cuts.

2. The fiduciary problem. If specific proposals for the surpluses are put forward, it is far from clear how much of the projected surpluses will be creditable to the Social Security system. The assessment of the impact of policy changes on the Social Security system is the responsibility of the Social Security actuaries, who are likely to find it difficult to credit in current calculations projected surpluses that are not locked in by current budget rule (e.g., paygo and discretionary caps), but are freely at the discretion of future Congresses. Any earmarking of the surplus would require an extension of the budget rules, but such an extension probably could not be taken out beyond the next 10 or 15 years. Therefore, many of your advisers strongly prefer to restrict attention to the near-term surpluses.

Even within the period in which outcomes are constrained by the budget rules, is doubtful that credit could be taken for surpluses of the magnitude now projected for two reasons: First, the benchmark assumption of constant real non-defense discretionary (NDD) may seem implausible and undesirable. Official OMB projections of the surplus are predicated on the assumption that non-defense discretionary (NDD) spending grows at the rate of inflation after 2002. If instead such spending were assumed to remain a constant share of GDP, the projected surpluses would be significantly smaller: $167 billion in 2010, for example, relative to $237 billion if NDD grows at the rate of inflation. (The figures in this memorandum rely on the OMB projections, in which NDD spending is assumed to grow with inflation, not GDP.) Second, although OMB's economic assumptions have proven to be too conservative for five years in a row, the assumptions used by the Social Security actuaries are more pessimistic than those used by OMB, and these differences in assumptions imply a substantially less favorable budgetary outlook.

C. Raising the rate of return earned

Another alternative would be to raise the rate of return earned within the Social Security system. Since 1959, the nominal rate of return to the special purpose bonds held by the Trust Fund has averaged 6.95 percent per year, while the rate of return on equities has averaged 11.06 percent per year. Thus one possible approach to improving the financial status of the Trust Fund would be to allow it to invest in private securities (the appendix provides a menu of possibilities). But purchasing private securities raises a series of difficult issues related to government intrusion in the economy and volatility in the financial markets. For example, who would decide which shares to purchase, how those shares would be voted, which investments would be prohibited (e.g., tobacco) or mandated (e.g., environmental or social concerns), which categories of investments would be excluded by investing solely in indexes (e.g., small businesses that are not publicly held), and how the exposure of the Trust Fund to volatility in financial markets would be handled. Secretary Rubin is particularly concerned about investing the Trust Fund in equities.

Some experts may complain that investing the Trust Fund in private securities is an accounting gimmick, with no real economic consequences. The critical question is what the baseline is: If experts agree that using the unified surpluses to purchase private securities for the Trust Fund prevents them from being dissipated in low-priority spending or consumption-oriented tax cuts, then they are not likely to criticize the strategy (since it produces a positive impact on national saving). If, however, they believe that the baseline is that the surpluses would be used to reduce debt, they could attack the proposal as a shell game. As Chairman Greenspan and others have repeatedly emphasized, allowing the Trust Fund to hold private securities would mean that fewer such securities were held by the private sector. In effect, in the first instance, the proposal involves a simple reallocation of portfolios: the private sector would hold more government debt, and less equity, and the Trust Fund would hold less government debt and more equity.

D. Individual accounts

A final potential building block is individual accounts, which arise frequently in discussions of Social Security reform. From a purely economic perspective, individual accounts have a variety of both attractions and disadvantages. On one hand:

- Small individual accounts could improve norms on saving behavior, and thus have a "magnification" effect.

- The accounts give people a tangible benefit that they can see.

- Such accounts would offer a higher rate of return than the traditional Social Security system, which for today's 30-year olds is likely to have a very small rate of return.

On the other hand:

- Individual accounts could reduce national saving -- relative to using the surplus entirely for Social Security -- by encouraging individuals to save less in other accounts, and perhaps by encouraging some employers to reduce pension plans.

- Many individuals are unsophisticated investors, and

- Administrative costs would be higher for individual plans than for centralized investment.

The major objection to individual accounts has been that they would be seen as an opening wedge to privatizing Social Security, with adverse implications for the preservation and progressivity of the public retirement system. In particular, Bob Ball and others argue that many people will prefer the higher returns earned on individual accounts relative to those earned on traditional Social Security, and that the social compact supporting the system will therefore erode -- undermining the social insurance inherent in the Social Security program. In the context of using the unified surplus to fund such accounts, however, it may be possible to mitigate some of these concerns. For example, if the individual accounts were funded by the government as a flat contribution per person, the accounts would be even *more* progressive than Social Security. (The appendix provides a menu of options on using the surplus to fund such flat contributions per person.) In addition, the new accounts could be designed to be available for cushioning the impact of life emergencies, such as catastrophic medical events or long-term unemployment. A provision of this type could advance your message that the government can help limit the risks of full participation in the global economy, although it could reduce the beneficial impact on national saving.

II. Illustrative packages

The three illustrative packages presented below, which involve elements put forward by others, combine these building blocks into complete plans. The appendix provides further information on the potential constituent parts, to allow you to see more of the possible combinations. The tables present the impact of the package on the Social Security Trust Fund (all four are currently estimated to at least eliminate the 75-year actuarial imbalance, although the estimates are still preliminary), as well as the impact on the retirement benefits for a hypothetical 65-year old retiree in 2015 with an average earnings history, and a similar retiree in 2040.

For purposes of discussion, the analysis uses the 75-year actuarial balance, which is the traditional metric used to judge reforms to the system. Many of your economic advisers, however, prefer other metrics -- such as ensuring perpetual (not just 75-year) balance in the system, putting more of an emphasis on the unified budget balance in the outyears, using the rate of return earned by the average person, or placing a lower bound on the Trust Fund as a ratio of benefits. It is worth noting that under all the approaches, the Trust Fund is declining rapidly at the end of the 75-year period (implying that a 75-year deficit will reappear over time).

Based on proposals put forward by others, the following is an *illustrative* example. Its presence does not imply in any way that it is being proposed by the Administration.

Illustrative package 1

Description: This package invests 70 percent of the surpluses in private securities for the Trust Fund and creates small individual accounts with the other 30 percent. Its other steps do not include covering all state and local government employees, or indexing the normal retirement age. But it also suffers from the double counting problem.

	Impact on 75-year deficit in Social Security system	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
Invest 70 percent of surpluses between 2002 and 2012 in Trust Fund, with equity investments up to 40 percent of Trust Fund.	1.08	NA	NA
Other 30 percent of surplus funds individual accounts.	NA	+$168 (1.4 percent)	+$398 (3.0 percent)
Modify benefit formula by reducing adjustment factors by 6 percent	0.6	-$700 (6.0 percent)	-$807 (5.0 percent)
Accelerate increase in normal retirement age, but do *not* index thereafter	0.1	-$833 (7.1 percent)	-$0
Extend computation period from 35 to 38 years	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
TOTAL, without interaction effects. Actuarial balance includes 0.22 percent for CPI changes already announced.	2.23	-$1,807* (15.9 percent)	-$919* (6.9 percent)
Current 75-year actuarial imbalance	2.23		
Benefit reduction consistent with current-law financing		$0	-$3,363 (25 percent)

Note: Does not account for indirect effects through unified surplus.
* Including annuity provided by individual account

Based on proposals put forward by others, the following is an *illustrative* example. Its presence does not imply in any way that it is being proposed by the Administration.

Illustrative package 2

Description: This package retains the bonds-only structure of Trust Fund and adopts several other steps that were prominent in proposals made by some members of the Gramlich commission to eliminate the actuarial imbalance in the system. But it suffers from the double counting problem, and leaves the unified surplus "on the books."

	Impact on 75-year deficit in Social Security system	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
Invest 100 percent of surpluses 2002-2007 in Treasury securities for the Trust Fund*	0.25	NA	NA
Reduce adjustment factors used to calculate PIA by 8 percent, phased in between 2002 and 2011	0.82	-$933 (8.0 percent)	-$1,076 (8.0 percent)
Cover state and local workers hired after 1999	0.22	NA	NA
Accelerate scheduled increase in normal retirement age, index thereafter	0.48	-$833 (7.1 percent)	-$1,164 (8.7 percent)
Extend benefit computation period from 35 to 38 years	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
TOTAL, without interaction effects. Actuarial balance includes 0.22 percent for CPI changes already announced.	**2.28**	**-$2,208 (18.9 percent)**	**-$2,750 (20.4 percent)**
Current 75-year actuarial imbalance	**2.23**		
Benefit reduction consistent with current-law financing		$0	-$3,363 (25 percent)

Note: The figures do not account for indirect effects of the reforms through the unified surplus.
* Transferring Treasury securities to the Trust Fund, under current budgetary accounting, leaves the unified surplus on the books.

Based on proposals put forward by others, the following is an *illustrative* example. Its presence does not imply in any way that it is being proposed by the Administration.

Illustrative package 3

Description: This package also involves private investments by the Trust Fund, but it does not create individual accounts. Unlike all the previous packages, it does not double count the surplus.

	Impact on 75-year deficit in Social Security system	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
Invest 100 percent of surpluses between 2002 and 2007 in Trust Fund, with equity investments up to 40 percent of Trust Fund. Offset with redemptions of special purpose bonds (eliminates double-counting).	0.57	NA	NA
Subject Social Security benefits to taxation as other defined benefit pensions and phase out lower-income thresholds	0.33	-$350 (3.0 percent)	-$404 (3.0 percent)
Recognize additional changes likely to be adopted by BLS is measuring consumer price inflation (reducing COLAs by 0.2 percentage points per year after 2000)	0.29	-$70* (0.6 percent)	-$81* (0.6 percent)
Extend computation period from 35 to 38 years	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
Accelerate scheduled increase in normal retirement age, index thereafter	0.48	-$833 (7.1 percent)	-$1,164 (8.7 percent)
TOTAL, with interaction effects. Actuarial balance includes 0.22 percent for CPI changes already announced.	**2.31**	**-$1,695 (14.5 percent)**	**-$2,159 (16.0 percent)**
Current 75-year actuarial imbalance	**2.23**		
Benefit reduction consistent with current-law financing		**$0**	**-$3,363 (25 percent)**

Note: Does not reflect indirect effect through unified surplus.

* Has more substantial effects on older retirees.

III. Strategic issues

(A) Key issues

In addition to deciding on the substance of any approach, we face many difficult strategic issues. This section reviews three of them: whether to offer a full or partial plan in the next month, and if the plan is partial, how much specificity to provide; whether to include individual accounts in your initial plan; and whether to earmark a small share of the surpluses for non-retirement priorities.

1(A). Initially offer full plan or only down-payment

Using the surplus to provide additional funding for the Social Security system, as well as potentially achieving higher returns (either through investing the Trust Fund in private securities, or through creating individual accounts), makes it conceivable that you could put forward a complete solution to the Social Security problem that would not look excessively harsh or draconian.

Providing a complete plan would be seen -- by both the elites and the general population -- as a very strong sign of leadership. But the some token, it may attract heavy fire. While the use of the surplus could make a full plan seem relatively mild to those intimately familiar with the Social Security problem, most full proposals will still involve some pain (as the illustrative packages illustrate). In particular, most such proposals could be attacked as cutting benefits for average people. Furthermore, on both the left and the right, we can expect prominent officials to make the argument that we can grow our way out of the Social Security problem -- despite the fact that the increase in growth would have to be implausibly large to make a substantial difference -- and that we are therefore unnecessarily hurting retirees.

The only way of not including *any* pain in a full package is to use all of the projected surpluses over the next two decades for equity investments or individual accounts, as illustrated in the table below. But such a strategy, which uses unified surpluses well beyond the 10-year budget window and is predicated on a falling share of NDD relative to GDP, is likely to lack credibility. It could therefore be severely attacked by both media elites and budgetary experts.

Assuming that some traditional solutions are necessary to maintain credibility, announcing your own complete plan could also subject it to partisan attack. Such partisan attacks could potentially be avoided if we pursue a bipartisan approach over the next year or so. In particular, reforms that may not be attacked under a Clinton-Daschle-Lott plan could be attacked if you go out alone. Examples include covering all state and local government workers, and taxing benefits like other defined benefit pensions.

	Impact on 75-year deficit in Social Security system	Impact on 65-year old's income, 2015	Impact on 65-year old's income, 2040
Invest 100 percent of surpluses between 2002 and 2023 in Trust Fund, with equity investments up to 40 percent of Trust Fund	1.82	NA	NA
Cover state and local workers hired after 2007	0.19	NA	NA
TOTAL, without interaction effects. Actuarial balance includes 0.22 percent for CPI changes already announced.	**2.23**	**-$0**	**-$0**
Current 75-year actuarial imbalance	**2.23**		
Benefit reduction consistent with current-law financing		**$0**	**-$3,363 (25 percent)**

1(B). Specificity of down-payment

If you decide to pursue a down-payment approach rather than a full plan, you need to decide how specific you should be over the next month or so about various details of the down-payment. In particular, you could, if desired, offer specific proposals on the following issues:

- Whether we were supporting use of the surplus to fund individual accounts;
- Whether we support purchases of private securities for the Trust Fund; and
- If we set aside some share of the surplus for non-retirement priorities, what those priorities are.

A general commitment to using the surplus for Social Security and retirement needs, without any details, may not be sustainable and may lack credibility. General statements could also be useful in engaging the country and the Hill in a debate over how to approach the problem -- it could jump-start the discussions. On the other hand, too much specificity may inevitably involve offering something could be attacked.

2. Individual accounts

As discussed in the first section above, individual accounts involve numerous policy questions. Crucial issues include whether the contributions should be a flat amount per person, how the contributions would be linked to the unified surplus (and what would happen after the surpluses run out), whether loans would be allowed against the accounts for life emergencies, whether individuals would be allowed to make their own contributions in addition to those made by the government, whether new accounts would be created for this purpose (or whether these accounts would be combined with existing IRAs), and whether any tax cut would be refundable (and if not, how low-income taxpayers would benefit).

be

Strategic advantages. The strategic advantage of using individual accounts is that they are likely to be a more effective means of neutralizing Republican tax cut proposals: An individual account can be portrayed as a tax cut or a payroll tax rebate. Including such accounts as part of an Administration proposal therefore allows us to present a broader Social Security proposal that incorporates tax cuts. And tax cuts linked to individual accounts could neutralize and trump ill-advised Republican tax cut proposals. Those who support individual accounts also fear that without such an option, Republicans could claim to addressing Social Security through proposals such as Feldstein's regressive approach to individual accounts. The logic of this argument is that we would be at a disadvantage if we only supported the Social Security Trust Fund, while the opposition was "addressing" Social Security through accounts that provide a higher return.

Strategic disadvantages. There are also serious strategic problems. Individual accounts may be seen by Moynihan and the AFL-CIO as a first step toward privatization. More broadly, individual accounts could split the Democrats, as Bob Ball and others raise concerns about whether such accounts would undermine long-term support for the Social Security system. Even some of those who would accept individual accounts in the end would argue that starting there is giving away the store -- without locking in a Republican guarantee that the overall package be progressive. Also, some argue that we could get the same advantages in terms of higher returns through equity investments in the Trust Fund, and avoid many of the political difficulties involved in individual accounts.

If we decide to support individual accounts, a major strategic question is how closely any such accounts should be linked with "Social Security":

> *Link with Social Security.* The logic here is that the Social Security message has power, so if we do have individual accounts, they should be linked to that message. The argument that individual accounts will necessarily lead to privatization may not seem as strong when the accounts involve only a fraction of the surplus, and are not financed by diverting funds from the 12.4 percent payroll tax. Another argument in favor of this approach is that even if try to separate accounts from "Social Security" reform, we will not necessarily be believed.

No Link with Social Security. The logic of distinguishing the accounts from "Social Security" is that we would have a better chance of keeping the Democrats from revolting if we describe the accounts as part of a universal pension approach, and promise to fix Social Security separately. We could state that we would not accept a smaller Social Security system merely because of the accounts.

3. Devoting the entire surplus to retirement needs

Another policy and strategic question is whether we should devote the entire surplus, or only part of it, to Social Security and retirement. The advantage of devoting the entire surplus is that it provides a clear "don't spend the surplus, we need it for Social Security and retirement" message. That message is muddied if we devote any part of the surplus to non-retirement needs. In addition, using the near-term surpluses for anything but retirement needs would imply that we were financing such non-retirement items through the regressive payroll tax.

The downside of specifying that the entire surplus should be devoted to retirement needs is that it precludes funding other, non-retirement priorities (e.g., Children's Fund, biomedical research, or tax reform). The attractions of providing such funding, especially in a relatively tight budgetary world, are clear. It may be hard to explain why we can't use even 10 percent of the projected surplus for such high priorities, when we have always emphasized public investments in addition to private investment/saving. Others might argue that devoting a small percentage of the surpluses could allow us to repeat our successful 1996 strategy of defeating ill-advised, large tax schemes with small, targeted tax cuts.

(B) Illustrative strategic options

This section provides a very brief summary of some illustrative strategic options.

Timing

The first dimension of the strategic options involves timing:

- **December/Early January option.** Some would like an announcement as early as possible -- even in December if ready. We all agree, however, that this is too important an issue to make an announcement until we are sure of our policy. When we have reached agreement on the policy, some feel it may be worthy of an Oval Office announcement either in December or January prior to the State of the Union.

- **State of the Union:** Some feel that if would be better to save until the State of the Union -- because this issue could be the "big idea" that would lift the entire State of the Union.

- **1998 Strategy:** If you announce less than a full plan, another timing question involves whether you announce some form of process for dealing with the rest of the Social Security problem. One aspect of that process could involve "setting the table" for real reforms after the fall 1998 elections -- for example, through a Social Security commission reporting in December 1998; a bipartisan advisory commission to issue papers forums and papers; a nationwide forum with 7 regional Presidential Social Security Conferences, or other steps. Another aspect could involve setting up some sort of process for the real deal -- for example, a special session of Congress, a special committee of Administration and Hill representatives, or other possibilities.

Announcements

In addition to timing questions, there are different options for what we announce. The proposals below do not reflect any specific recommendation, but they do reflect the type of strategies that key adviser have been putting on the table for discussion.

- **Whole Plan Announcement: Announce a full plan in January 1998.** Take a combination of a surplus strategy and a set of traditional reforms, and announce the whole deal in January. We still must confront all of the issues. As mentioned above, this approach may imply that we have to avoid some options on the revenue side.

- **Downpayment Strategy: Devote entire surplus between 2002-2007 (or 2002-2012) to Social Security as a downpayment, but make divisions between the Trust Fund and individual accounts part of an ongoing dialogue.**

- **Devote entire surplus between 2002-2007 (or 2002-2012) to the Social Security Trust Fund as a downpayment, but make clear that the Trust Fund would invest in private securities to raise return and counter individual accounts.**

- **70% to Social Security Trust Fund and 30% Payroll Rebate to Individual Accounts as Downpayment.**

- **60% to Social Security Trust Fund, 30% Individual Accounts and 10% for a Future Fund for Children and Biomedical Research.**

APPENDIX: POSSIBLE ELEMENTS OF COMPLETE PLAN

Below are illustrative elements that have been proposed by others as elements of a Social Security plan. They have not been subject to any formal review within the Administration.

(A) Menu on Traditional Solutions

	Effect on 75-year actuarial imbalance in Trust Fund	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
COVERAGE:			
Cover all state and local government workers hired after 1999	0.22	NA	NA
Cover all state and local government workers hired after 2007	0.19	NA	NA
BENEFITS:			
Reduce adjustment factors used to calculate PIA by 5 percent, phased in between 2002 and 2011	0.51	-$583 (5 percent)	-$673 (5 percent)
Increase benefit computation years from 35 to 38, phased in 2002-2004	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
Accelerate increase in normal retirement age to 67, by eliminating current 11-year hiatus in increase between 66 and 67	0.10	-$833 (7.1 percent)	0
Index normal retirement age after it reaches 67 under current schedule	0.30	0	-$604 (4.5 percent)
Accelerate scheduled increase in normal retirement age, index thereafter	0.48	-$833 (7.1 percent)	-$1,164 (8.7 percent)

Recognize additional changes likely to be adopted by BLS is measuring consumer price inflation (reducing COLAs by 0.2 percentage points per year after 2000)	0.29	-$70 (0.6 percent), with more substantial effects on older retirees	-$81 (0.6 percent), with more substantial effects on older retirees
Reduce spousal benefit from 50 percent to 33 percent of PIA	0.16	-$1,283 (22 percent of spousal benefit)	-$2,287 (34 percent of spousal benefit)
BENEFITS TAXATION:			
Beginning 2002, subject OASDI benefits to personal income tax in same manner as applied to other DB pensions	0.12	-$105 (0.9 percent)	-$202 (1.5 percent)
Phase out thresholds for taxation of OASDI benefits 2002-2011 (85 percent of benefits subject to tax after 2010)	0.21	-$309 (2.6 percent)	-$357 (2.6 percent)
CONTRIBUTION BASE:			
Raise taxable earnings base to 90 percent of covered earnings, phased in between 2002 and 2006 (equivalent to an increase in taxable earnings limit from $65,400 to roughly $110,000)	0.54	NA	NA

Note: Dollar figures are in 1997 dollars, percentage cuts are relative to future projected benefit

(B) Menu on Using the Surplus (Impact on Actuarial Balance of Trust Fund)

1. Transfer surpluses into Trust Fund; buy bonds only

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.25	0.17	0.12
2002-2012	0.60	0.39	0.27
2002-2026	1.12	0.67	0.43

2. Transfer surpluses into Trust Fund; buy private securities (cap at 40 percent)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.88	0.70	0.56
2002-2012	1.36	1.08	0.86
2002-2026	1.82	1.30	1.02

3. Invest in bonds only, until on-budget balance moves into surplus (cap at 40 percent)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.25	0.17	0.12
2002-2012	0.86	0.63	0.50
2002-2026	1.47	0.97	0.73

4. "Use" surpluses to buy private securities (no transfers into Trust Fund)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
use only 2002-2007	0.57	0.51	0.43
use until hit portfolio cap	0.57 (2008)	0.55 (2010)	0.52 (2012)

Note: Private securities are assumed to earn 3.8 percent per year more than Treasury securities.

(C) Menu on Investing the Trust Fund in Private Securities

Percentage of Trust Fund assets under current law invested in private securities, phased in between 2000 and 2014

	Effect on 75-year actuarial imbalance
10 percent	0.15
20 percent	0.29
30 percent	0.43
40 percent	0.56
50 percent	0.68

Note: Figures assume that the rate of return on private securities is 3.84 percent per year higher than on special purpose bonds. Figures presented in table are very approximate.

(D) Menu on Individual Accounts: Impact on Retiree Income

The figures below give the annual annuity income in the given year that would obtain from investing either 30 or 50 percent of the projected surpluses, for the years given, in individual accounts. The figures assume a flat contribution per worker, and that half of account balances are invested in bonds, with the other half in private securities.

Surpluses, 2002-2007

	2015	% of Social Security benefits for average earner	2040	% of Social Security benefits for average earner
30 percent of surpluses	$81	0.6 percent	$192	1.4 percent
50 percent of surpluses	$135	1.2 percent	$320	2.4 percent

Surpluses, 2002-2012

	2015	% of Social Security benefits for average earner	2040	% of Social Security benefits for average earner
30 percent of surpluses	$168	1.4 percent	$398	3.0 percent
50 percent of surpluses	$281	2.4 percent	$663	4.9 percent

Surpluses, 2002-2023*

	2015	% of Social Security benefits for average earner	2040	% of Social Security benefits for average earner
30 percent of surpluses	$194	1.7 percent	$534	4.0 percent
50 percent of surpluses	$323	2.4 percent	$891	6.6 percent

* Using the surpluses for individual accounts and/or purchases of non-Treasury securities implies higher debt servicing payments relative to the baseline surplus projections. The surpluses thus end earlier than under the baseline.

SOCIAL SECURITY AND THE UNIFIED SURPLUS
December 8, 1997

I. Building blocks

A complete package of reforms that would address the structural imbalance in Social Security would comprise some combination -- though not necessarily all -- of the following four building blocks:

- Traditional solutions, such as benefit reductions or revenue increases;

- Funding from the unified surplus;

- Investments in private securities to raise the rate of return on the Trust Fund; and

- Individual accounts, which provide an alternative source of retiree income.

II. Illustrative packages

III. Strategic issues

Key issues

- Whether to offer a full or partial plan in the next month
  -- If the plan is partial, how much specificity to provide;
- Whether to include individual accounts in any initial plan; and
- Whether to earmark a small share of the surpluses for non-retirement priorities.

Illustrative strategic options

- Timing

- Announcements:
  -- Whole Plan Announcement: Announce a full plan in January 1998.
  -- Downpayment Strategy: Devote entire near-term surpluses to Social Security as a downpayment, but make divisions between the Trust Fund and individual accounts part of an ongoing dialogue.
  -- Devote entire near-term surpluses to the Social Security Trust Fund as a downpayment, but make clear that the Trust Fund would invest in private securities so that the Trust Fund can earn a higher return to counter individual accounts.
  -- 70% to Social Security Trust Fund and 30% Payroll Rebate to Individual Accounts as Downpayment.
  -- 60% to Social Security Trust Fund, 30% Individual Accounts, and 10% for a Future Fund for Children and Biomedical Research.

Based on proposals put forward by others, the following is an *illustrative* example. Its presence does not imply in any way that it is being proposed by the Administration.

Illustrative package 1

Description: This package invests 70 percent of the surpluses in private securities for the Trust Fund and creates small individual accounts with the other 30 percent. Its other steps do not include covering all state and local government employees, or indexing the normal retirement age. But it also suffers from the double counting problem.

	Impact on 75-year deficit in Social Security system	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
Invest 70 percent of surpluses between 2002 and 2012 in Trust Fund, with equity investments up to 40 percent of Trust Fund.	1.08	NA	NA
Other 30 percent of surplus funds individual accounts.	NA	+$168 (1.4 percent)	+$398 (3.0 percent)
Modify benefit formula by reducing adjustment factors by 6 percent	0.6	-$700 (6.0 percent)	-$807 (5.0 percent)
Accelerate increase in normal retirement age, but do *not* index thereafter	0.1	-$833 (7.1 percent)	-$0
Extend computation period from 35 to 38 years	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
TOTAL, without interaction effects. Actuarial balance includes 0.22 percent for CPI changes already announced.	**2.23**	**-$1,807* (15.9 percent)**	**-$919* (6.9 percent)**
Current 75-year actuarial imbalance	**2.23**		
Benefit reduction consistent with current-law financing		**$0**	**-$3,363 (25 percent)**

Note: Does not account for indirect effects through unified surplus.
* Including annuity provided by individual account

Based on proposals put forward by others, the following is an *illustrative* example. Its presence does not imply in any way that it is being proposed by the Administration.

Illustrative package 2

Description: This package retains the bonds-only structure of Trust Fund and adopts several other steps that were prominent in proposals made by some members of the Gramlich commission to eliminate the actuarial imbalance in the system. But it suffers from the double counting problem, and leaves the unified surplus "on the books."

	Impact on 75-year deficit in Social Security system	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
Invest 100 percent of surpluses 2002-2007 in Treasury securities for the Trust Fund*	0.25	NA	NA
Reduce adjustment factors used to calculate PIA by 8 percent, phased in between 2002 and 2011	0.82	-$933 (8.0 percent)	-$1,076 (8.0 percent)
Cover state and local workers hired after 1999	0.22	NA	NA
Accelerate scheduled increase in normal retirement age, index thereafter	0.48	-$833 (7.1 percent)	-$1,164 (8.7 percent)
Extend benefit computation period from 35 to 38 years	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
TOTAL, without interaction effects. Actuarial balance includes 0.22 percent for CPI changes already announced.	**2.28**	**-$2,208 (18.9 percent)**	**-$2,750 (20.4 percent)**
Current 75-year actuarial imbalance	**2.23**		
Benefit reduction consistent with current-law financing		**$0**	**-$3,363 (25 percent)**

Note: The figures do not account for indirect effects of the reforms through the unified surplus.
* Transferring Treasury securities to the Trust Fund, under current budgetary accounting, leaves the unified surplus on the books.

Based on proposals put forward by others, the following is an *illustrative* example. Its presence does not imply in any way that it is being proposed by the Administration.

Illustrative package 3
Description: This package also involves private investments by the Trust Fund, but it does not create individual accounts. Unlike all the previous packages, it does not double count the surplus.

	Impact on 75-year deficit in Social Security system	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
Invest 100 percent of surpluses between 2002 and 2007 in Trust Fund, with equity investments up to 40 percent of Trust Fund. Offset with redemptions of special purpose bonds (eliminates double-counting).	0.57	NA	NA
Subject Social Security benefits to taxation as other defined benefit pensions and phase out lower-income thresholds	0.33	-$350 (3.0 percent)	-$404 (3.0 percent)
Recognize additional changes likely to be adopted by BLS is measuring consumer price inflation (reducing COLAs by 0.2 percentage points per year after 2000)	0.29	-$70* (0.6 percent)	-$81* (0.6 percent)
Extend computation period from 35 to 38 years	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
Accelerate scheduled increase in normal retirement age, index thereafter	0.48	-$833 (7.1 percent)	-$1,164 (8.7 percent)
TOTAL, with interaction effects. Actuarial balance includes 0.22 percent for CPI changes already announced.	**2.31**	**-$1,695 (14.5 percent)**	**-$2,159 (16.0 percent)**
Current 75-year actuarial imbalance	**2.23**		
Benefit reduction consistent with current-law financing		**$0**	**-$3,363 (25 percent)**

Note: Does not reflect indirect effect through unified surplus.
* Has more substantial effects on older retirees.

APPENDIX: POSSIBLE ELEMENTS OF COMPLETE PLAN

Below are illustrative elements that have been proposed by others as elements of a Social Security plan. They have not been subject to any formal review within the Administration.

(A) Menu on Traditional Solutions

	Effect on 75-year actuarial imbalance in Trust Fund	Impact on average 65-year old's income in 2015, 1997$ (as % of benefits)	Impact on average 65-year old's income in 2040, 1997$ (as % of benefits)
COVERAGE:			
Cover all state and local government workers hired after 1999	0.22	NA	NA
Cover all state and local government workers hired after 2007	0.19	NA	NA
BENEFITS:			
Reduce adjustment factors used to calculate PIA by 5 percent, phased in between 2002 and 2011	0.51	-$583 (5 percent)	-$673 (5 percent)
Increase benefit computation years from 35 to 38, phased in 2002-2004	0.25	-$442 (3.8 percent)	-$510 (3.8 percent)
Accelerate increase in normal retirement age to 67, by eliminating current 11-year hiatus in increase between 66 and 67	0.10	-$833 (7.1 percent)	0
Index normal retirement age after it reaches 67 under current schedule	0.30	0	-$604 (4.5 percent)
Accelerate scheduled increase in normal retirement age, index thereafter	0.48	-$833 (7.1 percent)	-$1,164 (8.7 percent)
Recognize additional changes likely to be adopted by BLS is measuring consumer price inflation (reducing COLAs by 0.2 percentage points per year after 2000)	0.29	-$70 (0.6 percent), with more substantial effects on older retirees	-$81 (0.6 percent), with more substantial effects on older retirees

Reduce spousal benefit from 50 percent to 33 percent of PIA	0.16	-$1,283 (22 percent of spousal benefit)	-$2,287 (34 percent of spousal benefit)
BENEFITS TAXATION:			
Beginning 2002, subject OASDI benefits to personal income tax in same manner as applied to other DB pensions	0.12	-$105 (0.9 percent)	-$202 (1.5 percent)
Phase out thresholds for taxation of OASDI benefits 2002-2011 (85 percent of benefits subject to tax after 2010)	0.21	-$309 (2.6 percent)	-$357 (2.6 percent)
CONTRIBUTION BASE:			
Raise taxable earnings base to 90 percent of covered earnings, phased in between 2002 and 2006 (equivalent to an increase in taxable earnings limit from $65,400 to roughly $110,000)	0.54	NA	NA

Note: Dollar figures are in 1997 dollars, percentage cuts are relative to future projected benefit

(B) Menu on Using the Surplus (Impact on Actuarial Balance of Trust Fund)

1. Transfer surpluses into Trust Fund; buy bonds only

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.25	0.17	0.12
2002-2012	0.60	0.39	0.27
2002-2026	1.12	0.67	0.43

2. Transfer surpluses into Trust Fund; buy private securities (cap at 40 percent)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.88	0.70	0.56
2002-2012	1.36	1.08	0.86
2002-2026	1.82	1.30	1.02

3. Invest in bonds only, until on-budget balance moves into surplus (cap at 40 percent)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
2002-2007	0.25	0.17	0.12
2002-2012	0.86	0.63	0.50
2002-2026	1.47	0.97	0.73

4. "Use" surpluses to buy private securities (no transfers into Trust Fund)

Transfer surpluses from:	All surpluses	70 percent of surpluses	50 percent of surpluses
use only 2002-2007	0.57	0.51	0.43
use until hit portfolio cap	0.57 (2008)	0.55 (2010)	0.52 (2012)

Note: Private securities are assumed to earn 3.8 percent per year more than Treasury securities.

(C) Menu on Investing the Trust Fund in Private Securities

Percentage of Trust Fund assets under current law invested in private securities, phased in between 2000 and 2014

	Effect on 75-year actuarial imbalance
10 percent	0.15
20 percent	0.29
30 percent	0.43
40 percent	0.56
50 percent	0.68

Note: Figures assume that the rate of return on private securities is 3.84 percent per year higher than on special purpose bonds. Figures presented in table are very approximate.

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THE WHITE HOUSE

WASHINGTON

December 13, 1997

Copied
Reed
Sperling
Jennings
Bowles

MEMORANDUM TO THE PRESIDENT

12-29-97

FROM: BRUCE REED
GENE SPERLING
CHRIS JENNINGS

SUBJECT: Reforms that Prepare Medicare for the Retirement of the Baby Boom Generation

The Balanced Budget Act (BBA) that you enacted took necessary steps to modernize the Medicare program and prepare it for the twenty-first century. It extended the life of the Trust Fund to 2010, invested in preventive benefits, provided more choice of plans for beneficiaries, strengthened our ongoing fraud activities, and lowered cost growth to slightly below the private sector rate through provider payment reforms and modest beneficiary payment increases. However, the BBA's policies were not intended to solve Medicare's long-term problems.

The Medicare Commission was established to address the demographic challenges posed by the retirement of the baby boom generation. The question is whether we should take action prior to the March 1999 Commission deadline to further strengthen the program and lay the groundwork for implementation of likely Commission recommendations.

The NEC and DPC have led an interagency examination of several policy options. This memo examines options to insure pre-65 year olds, to extend Medicare coverage of patient care costs associated with clinical trials, and to increase private long-term care insurance. Financing options to pay for these proposals follow this description.

Your advisors have differing views on whether to pursue any new proposals while the Medicare Commission is active and which proposals to pursue if you choose to do so. OMB and to some extent Treasury have concerns about a pre-65 option, because it may open the door to subsidies for a costly population and have the unintended effect of reducing employer coverage. Both OMB and Treasury oppose the clinical cancer trials proposal because it could set a precedent for every other disease group to ask for the same treatment.

Should only [illegible] retirees allowed to buy-in

Should you decide to pursue all of the options, traditional Medicare savings alone may not be sufficient to offset the costs and a Medicare income-related premium may be necessary. Such a premium will be politically contentious, although possibly more acceptable to our Democratic base if linked to a benefit expansion. Given the complexity of any decision to adopt an income-related premium, we outline here some of the issues, but defer a recommendation until we can meet with you on the subject.

THE PRESIDENT HAS SEEN
12-29-97

A. PRE-65 HEALTH INSURANCE OPTIONS

Although people between 55 and 65 years old are more likely to have health insurance than others, they often face greater problems with access to affordable health insurance, especially when they are sick. Individuals in this age group are at greater risk of having health problems, with twice the probability of experiencing heart disease, strokes, and cancer as people ages 45 to 54. Yet their access to affordable employer coverage is often lower because of work and family transitions. Work transitions increase as people approach 65, with many retiring and shifting to part-time work or self-employment as a bridge to retirement. Some of this transition is involuntary. Nearly half of people 55 to 65 years old who lose their jobs when firms downsize or close do not get re-employed. At the same time, family transitions reduce access to employer-based health insurance, as individuals are widowed or divorced, or as their spouses become eligible for Medicare and retire.

As a result, the pre-65 year olds, more than any other age group, rely upon the individual health insurance market. Because their costs are not averaged with younger people's (as in employer-based insurance), the pre-65 year olds often face relatively high premiums and may face exorbitant premiums if they are sick. While the Kassebaum-Kennedy legislation improved access for people with pre-existing conditions, it did not restrict costs.

These access problems will increase because of two trends: the decline in retiree health coverage and the aging of the baby boom generation. Recently, firms have cut back on offering pre-65 retirees health coverage; in 1984, 67 percent of large and mid-sized firms offered retiree insurance but in 1997, only 37 percent did (although this decline may be slowing). In addition, in several small but notable cases (e.g., General Motors and Pabst Brewery), retirees' health benefits were dropped unilaterally, despite the firm's prior commitment. These "broken promise" retirees do not have access to COBRA continuation coverage and could have difficulty finding affordable individual insurance. An even more important trend is demographic. The number of people 55 to 65 years old will increase from 22 to 30 million by 2005 and to 35 million by 2010. Assuming current rates of uninsurance, this trend could raise the number of uninsured in this age group from 3 million today to 4 million by 2005, without even taking into account the decline in retiree health coverage.

The last reason for considering the coverage issues of this age group is the likelihood of proposals to raise Medicare eligibility age to 67, consistent with Social Security. The experience with covering a pre-65 age group now will teach us valuable lessons if we need to develop policy options for the 65 to 67 year olds.

Policy Questions

Two central questions determine the policy options for the pre-65 year olds: what is the target population, and what is the best way to cover these people.

THE PRESIDENT HAS SEEN
12-29-97

Whom to Target. As with any incremental reform, targeting is essential to reduce the chance that the policy unintentionally offsets or reduces employer health coverage. While this policy will not affect employers' decisions to offer coverage to their current workers, it may affect employers' decisions to cover retirees, as well as employees' decisions to retire early. To protect against substitution, your advisors recommend limiting eligibility to a subset of the pre-65 year olds. There are two ways to limit eligibility.

The first approach is to limit eligibility to people ages 62 to 65. The 6 million people ages 62 to 65 work less than to people ages 55 to 59 (48 percent versus 74 percent), are more likely to have fair to poor health (26 versus 20 percent), and are more likely to be uninsured or buy individual insurance (28 versus 21 percent). In addition, 62 is the age at which Social Security benefits can be accessed. Within this 6 million, we could limit eligibility to the 2 million without access to employer or public insurance, and require that they exhaust COBRA coverage. These steps should reduce the likelihood that the policy will lead individuals to retire or drop retiree coverage.

A second approach is to limit eligibility within a broader age group — e.g., 55 to 65 year olds — to individuals who lack access to employer-based insurance for particular reasons: (1) Displaced workers: About 60,000 people ages 55 to 65 lost their employer insurance when they lost their job because a firm closed, downsized, or eliminated their position. (2) Medicare spouses: As many as 420,000 people lost employer-based family coverage when their spouses (almost all husbands) turned 65 and retired. This number could grow if employers drop retirees' dependent coverage for these spouses as a result of this policy. (3) "Broken promise" people: A small but visible and vulnerable group is the pre-65 retirees who lost retiree health coverage due to a "broken promise" (i.e., when the employer unexpectedly terminated coverage).

How to Provide Coverage. The second question is: what is the best way to increase access to affordable insurance? One approach is to extend COBRA continuation coverage for longer than 18 months. Currently, COBRA allows insured workers in firms with 20 or more employees to continue that coverage for 18 months by paying 102 percent of the premium. The major problems with extending COBRA are that (1) people in small firms are not eligible, (2) businesses will consider the policy an unfunded mandate, and (3) the policy could lead to discrimination against hiring older workers. In addition, firms could use this longer COBRA mandate as an excuse to not cover any employees.

A second approach is a Medicare "buy-in." Eligible people could buy into Medicare by paying a premium. Since Federal premium assistance for this group is prohibitively expensive, your advisors agree that participants should pay the full premium: the age-adjusted Medicare payment rate, plus an add-on for the extra risk of participants. This add-on could be high if, as the actuaries expect, most participants will be sicker than average. To attract healthier people and make it possible for more people to take advantage of the benefit, we could defer payment of part of the premium (e.g., this risk add-on) until age 65 by "amortizing" the payment. Under this option, Medicare would pay part of the premium as a loan up front, with repayment by the beneficiaries with their Part B premiums. This loan would be a Medicare cost in the short term.

Govt?
Min tax

THE PRESIDENT HAS SEEN
12-29-97

Option 1. "Broken Promise" People Only. The minimal option, with no Federal cost, is to require employers to offer COBRA coverage to retirees whose coverage they have dropped. This would allow retirees to buy into their active employer plan until age 65 at a premium (possibly 150 percent of the group rate, as has been done for other special COBRA populations). Even taking into account the premium payments, employers would bear some of the costs of their decision to terminate coverage, given the higher costs of people in this age group.

Option 2. Medicare Buy-In for Select Groups. The second option is to allow a Medicare buy-in for a subset of 55 to 65 year olds who have limited access to employer insurance. One group is the "Medicare spouses" — primarily uninsured women ages 55 to 65 whose husbands are already on Medicare. An alternative (or complement) is displaced workers. Since these groups are small, Medicare costs would be low.

Option 3. Medicare Buy-In for 62 to 65 Years Old Plus Selected Groups. The third option is to allow 62 to 65 year olds, plus a group like displaced workers, to buy into Medicare. This group is representative of the 65 to 67 year old population, giving a sense of what would happen if Medicare eligibility were postponed to 67 years old. The HCFA actuaries estimate that the Medicare cost of the worst-case scenario — 300,000 sick participants —is $1.1 billion per year, not taking into account any beneficiary pay-back. Their initial estimate for the 62 to 65 year olds' costs, using more realistic assumptions, is about $300 million per year. They assume that 160,000 people will participate: 70,000 currently uninsured and the remainder previously insured by expensive, individual insurance. Note that OMB has not yet cleared these estimates.

Discussion

Despite likely business opposition, your advisors all support a COBRA option for the "broken promise" retirees. Beyond this, your advisors have not yet reached a consensus. OMB and CEA are concerned that any unsubsidized entitlement for pre-65 year olds will not stay that way for long because pressure will build to lower the premiums. To test a buy-in for the pre-65 year olds, OMB and CEA would recommend covering only Medicare spouses, because doing so would probably have a smaller effect on the general trend in retiree health coverage and retirement. The Department of Labor supports a general Medicare buy-in. It feels strongest about covering displaced workers because of its broader goal of improving workers' security. Treasury shares OMB and CEA's concerns but would not object to a general Medicare buy-in if there were strong incentives for participants to enroll in managed care. This policy would make insurers, not Medicare, bear the risk, but could be politically difficult. HHS supports the broadest option and is concerned about only covering select groups since the enrollment may not be sufficient to justify the administrative effort.

NEC/DPC recommend a package that includes (1) a Medicare buy-in for 62 to 65 year olds; (2) a Medicare buy-in for displaced workers; and (3) COBRA for the "broken promise" people. We think that this package is sufficiently narrow to limit effects on retiree health coverage or retirement. At the same time, the policy responds to the concerns of pre-65 year olds who feel vulnerable to losing employer coverage and/or facing unaffordable premiums.

THE PRESIDENT HAS SEEN
12-29-97

B. PRIVATE LONG-TERM CARE OPTIONS

A second idea to improve access to insurance focuses on long-term care. Unlike acute care, long-term care is not primarily financed by private insurance, which pays only 6 percent of its costs. Medicaid pays for 38 percent, Medicare pays for 21 percent, and families pay for 28 percent of the costs out of pocket. This large government role may not be sustainable as the baby boom generation retires. Today, one in four people over age 85 lives in a nursing home. This could increase substantially as the proportion of elderly living to age 90 is projected to increase from 25 percent to 42 percent by 2050. Thus, it is important to encourage the development of private insurance options. The Kassebaum-Kennedy legislation took a step in this direction by clarifying that certain long-term care insurance is tax deductible. But because many people incorrectly assume Medicare covers all of their long-term care needs and do not know about private long-term care insurance, more action is needed. This action could include providing information to Medicare beneficiaries about private insurance, funding a demonstration program to improve the quality and price of private insurance, or both. None of these options includes a new Medicare entitlement or subsidy.

Information on Quality Private Long-Term Care Insurance

We propose to leverage our role in Medicare to improve the quality of and access to private policies. HCFA would work with insurers, state regulators, and other interested parties to develop a set of minimum standards for private long-term care policies. If a plan met these standards, Medicare would approve its inclusion in the new managed care information system. (As a reminder, the BBA included provisions to provide annual information on managed care choices to beneficiaries.) This proposal would build upon that system and cost up to $25 million in discretionary funds over 5 years ($5 million in FY 1999), distinct from the user fees currently authorized for the managed care information system. We also could propose a demonstration that would test the feasibility of a partnership between Medicare and private long-term care insurance on a limited basis. Alternatively, we could experiment in providing more long-term care through Medicare managed care. The cost of a demonstration would depend on its size and policy parameters, but could be limited to $100 to 300 million over 5 years.

Discussion

Ok

We believe this proposal has significant potential and is worth further development. There is some concern at HHS that coming to an agreement on a set of standards could be difficult and that insurers may argue that our standards drive up the cost of the policies, making them unaffordable. HHS also would prefer that any demonstration be funded through the mandatory budget. However, these concerns may not be insurmountable, especially since one objective of a demonstration could be to investigate high-quality private options that are affordable. Finally, we are still looking into the feasibility and advisability of using tax incentives to encourage the purchase of private long-term care policies and/or the use of IRAs for long-term care financing, although Treasury has strong concerns about the effectiveness of such options.

THE PRESIDENT HAS SEEN
12-29-97

C. MEDICARE COVERAGE OF CANCER CLINICAL TRIALS

Medicare has not traditionally covered patient care costs associated with clinical trials. Scientists and advocates believe that we are not making sufficient progress in treating cancer, in part because the lack of Medicare coverage limits participation in these trials. HHS and DPC have been working on an approach that covers patient care for a limited number of these trials. Because of concerns about its cost, OMB and Treasury strongly oppose this option.

Nearly half of all cancer patients are covered by Medicare, yet Medicare does not cover patient care costs associated with these trials. This care can often be prohibitively expensive for cancer patients and their families. Expanding Medicare coverage could increase access to trials for the many beneficiaries with cancer. Historically most insurers have covered clinical trials for children. As a consequence, nearly 70 percent of children with cancer participate in clinical trials. Scientists agree that this participation rate has helped improve cancer treatments for children, and some argue that it is one reason for the dramatically higher survival rates for children cancer patients.

The lack of participation in trials, related to lack of Medicare coverage, has significant implications for research in all cancer areas, particularly for those cancers like prostate cancer where clinical trials are particularly undersubscribed. According to a former National Cancer Institute director, if 10 percent of all cancer patients participated in such trials, trials that currently take three to five years would take only one year. Additionally, as the nation's largest insurer, Medicare plays a significant role in setting the standard for the insurance companies. A commitment from Medicare to cover clinical trials would go a long way to encourage private insurance companies to cover these trials.

Proposal

We have developed a proposal to expand Medicare to cover patient care costs of cancer clinical trials conducted at the NCI and trials with comparable peer review. In addition, we would require a National Cancer Policy Board to make further coverage recommendations, and HHS to assess the incremental costs of such trials compared to conventional Medicare-covered therapies. Assuming the true incremental costs are substantially less than the actuaries project, as we believe, additional trial coverage as recommended by the Board could occur. The initial coverage would cost $1.7 billion over five years. Senators Mack and Rockefeller have developed a more expansive and expensive proposal (co-sponsored by 26 Senators), which covers all FDA trials, many of which the experts believe do not meet a scientifically-meritorious standard.

12-29-97

A possible alternative way to cover clinical cancer trials' patient care costs is to dedicate resources from any significant increases that NIH / NCI receive in the upcoming budget. NCI could use these increases to simplify and centralize its clinical trials system, which has the potential to increase patient access. Although this option may be effective, the cancer community has clearly stated its preference for extending Medicare coverage. Another possibility is to require drug companies desiring Medicare coverage of additional clinical trials to contribute to part of the patient costs.

Maybe need to pay for it

Discussion

HHS is supportive of this policy and believes that it would not only give Medicare beneficiaries choices, but would encourage the private industry to cover clinical trials as well. HHS notes that this proposal is the highest priority for most of the cancer community as well as many in the women's community who believe it is an essential step to improve breast cancer treatment. The advocates have made it clear that they would strongly prefer the more expansive and expensive Rockefeller/Mack approach. But, the Senators might well support our proposal as an important first step and this would matter greatly to patient groups and the cancer community.

OMB and Treasury strongly oppose the Medicare coverage option. They note that Medicare would incur a large cost to provide medical services that are experimental and, therefore, unlikely to help the majority of beneficiaries. They also believe it will create enormous pressure to cover more types of cancer trials as well as non-cancer trials. Congress would likely expand the proposal beyond coverage of NCI trials, which will be very costly (up to $3 billion over five years). Moreover, similar support will be demanded for trials of treatments for Alzheimer's, Parkinson's, and other maladies. OMB also believes drug companies — not Medicare — should take the lead in improving Medicare beneficiaries' access to clinical trials.

While recognizing the OMB and Treasury concerns, DPC/NEC believes that Medicare coverage has potential to contribute to expansions of clinical trials and possible break-throughs in cancer treatment. Our recommendation to include it in the FY 1999 budget depends on other decisions. If resources are limited, we would propose the pre-65 initiative instead of this one. In addition, a major increase in the NIH — and NCI — budgets could lessen the need for this policy. But, if sufficient resources are available, we would recommend that you support this benefit as a reinvestment in Medicare and an enhancement of our biomedical research package.

THE PRESIDENT HAS SEEN
12-29-97

D. MEDICARE ANTI-FRAUD POLICIES AND INCOME-RELATED PREMIUM

Funding for Medicare initiatives will probably require Medicare offsets. One approach is to use Medicare anti-fraud initiatives. HHS and OMB believe that these offsets could total about $2 billion over 5 years. This amount could fund some, but not all of the initiatives described above. To fund a more expansive series of initiatives, you may have to consider an income-related premium, which generates at least $8 billion over 5 years.

ANTI-FRAUD PROVISIONS

In our ongoing efforts to reduce Medicare fraud, we have identified a number of small but important policies that could total about $2 billion over five years. Several of them address problems identified by the HHS Inspector General, such as the overpayment by Medicare for certain cancer drugs, that you highlighted in your radio address today.

INCOME-RELATED PREMIUM

Medicare subsidizes 75 percent of the Part B premium for all beneficiaries, including the wealthiest. Higher income beneficiaries, who actually receive more Medicare benefits than do poor beneficiaries, could afford premiums without subsidies. However, the addition of an income-related premium would make Medicare less of a social insurance program.

As you know, the Administration has publicly supported an income-related premium. It is not clear, however, that we should include this policy in our budget. Because this issue is very complicated, we will not make a recommendation until we meet with you on the subject.

Policy Options

Building from our position last summer, the income-related premium would be administered by the Treasury Department, not HCFA or the Social Security Administration. Eligible people would fill out each year a Medicare Premium Adjustment form (a separate form or a line on the 1040 form) and send a check to "The Medicare Trust Fund." Revenue from this premium, which is at least $8 billion over 5 years, depends on who pays and how much they pay.

Who pays. The income thresholds determine how many people are paying the higher amount. We proposed thresholds of $90,000 for singles and $115,000 for couples in the Health Security Act. Last summer, the Senate, including most centrist Democrats, passed a policy that began the extra premium payment at $50,000 for singles and $65,000 for couples. During the budget debate, we did not express support for particular thresholds.

How much. The amount of the payment for the wealthiest beneficiaries is a second question. In the budget debate, we argued that a 100 percent premium (no subsidy) would cause some healthy and wealthy people to opt out of Medicare. However, an analysis by the Treasury Department this fall found that the effects of a 100 percent premium would be smaller. HHS would strongly object to changing our position to support an income-related premium that completely phases out the Part B subsidy. If we decide to change our past policy, we should have a strategic discussion about the timing of announcing such a change.

Discussion

The decision to propose an income-related premium is complicated, and your advisors have differing views about its timing and, to some extent, advisability. Some believe that we made a decision last summer to support this policy, regardless of circumstances. However, its introduction may provoke criticism. Many Democrats and possibly AARP will oppose the income-related premium (though this opposition may soften if the premium is linked to a Medicare investment). In addition, Republicans might label it a new tax and use our support for it as an issue during the 1998 campaign. The Medicare Commission almost certainly will recommend this policy if you do not in the spring of 1999. Leaving it to the Commission has the advantage of providing both Democrats and Republicans with political cover, but the disadvantage of decreasing your control over the structure of the premium and how it will be spent. DPC/NEC will prepare for a separate meeting to discuss this issue.