Briefing Book on Social Security and the Unified Budget Surplus

December 29, 1997

THE WHITE HOUSE

WASHINGTON

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MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING AND LAWRENCE SUMMERS

SUBJECT: Social Security

Following our previous two meetings with you, we thought it would be helpful to provide you with this packet of memoranda on various aspects of using the projected surpluses for Social Security and retirement needs. These papers benefitted from the excellent work of staff at the NEC, Treasury, OMB, Social Security Administration, and CEA.

The overview memorandum provides an overall, broad perspective on the issues involved. The other attached memoranda cover:

- Tab A: Social Security reform and national saving
- Tab B: How much credit would the actuaries grant for transferring the surpluses to the Trust Fund
- Tab C: The mechanics and meaning of the Trust Fund
- Tab D: Investing Social Security assets in private securities
- Tab E: An examination of individual accounts, including a comparison to equity investments of the Trust Fund
- Tab F: Traditional reforms to Social Security
- Tab G: The "double counting" problem
- Tab H: Talking points in support of the return under the Social Security system

We do not ask you to make any decisions based on these memoranda, but they will provide the basis for our discussions at the beginning of January on this topic. As your advisers have studied this difficult issue further, our views have evolved. We will have an intensive NEC process in January to come up with recommended options. Erskine is planning to find us time for meetings with you on this issue during the first couple of weeks in January.

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FROM: GENE SPERLING AND LAWRENCE SUMMERS

SUBJECT: The surplus and Social Security

The overview memorandum is organized into six sections:

- Part I provides a strategic overview of the current environment, including the interactions between the surplus and tax reform packages;
- Part II discusses possible Republican strategies;
- Part III explains why an Administration strategy of using the surplus for tax reform is not recommended at this time;
- Part IV explores the generic pros and cons of devoting the surplus to Social Security;
- Part V examines key issues that will have to be addressed in the course of this process;
- Part VI describes some options on the process for Social Security reform.

I. OVERVIEW OF THE SURPLUS, SOCIAL SECURITY, AND TAX REFORM

The issues we have been discussing — the projected unified surplus, tax reform, and Social Security — will define much of your economic agenda for the second term. All three are vital issues, and together could have a profound impact on the long-run fiscal situation of the Nation. The importance of the decisions involved in tax reform and Social Security reform is clear. The immensity of the surplus-related issues is conveyed by their size: Last summer's Mid-Session Review showed the surpluses for 2002-2007 totalling $620 billion, while those for the ten-year period 2002-2012 amount to $1,784 billion. The forecast to be released early next year with the FY 1999 Budget is likely to show slightly larger surpluses. (However, the size of future surpluses depends critically on our forecast of non-defense discretionary spending in the outyears; if we expect NDD spending to grow at the rate of nominal GDP, instead of inflation, the surpluses will be smaller.)

Your economic strategy thus far has emphasized deficit reduction (to raise national saving and spur private investment) and key public investments (in education and other productivity-enhancing areas). The results thus far have been substantially more encouraging than anyone could have expected in 1992:

- The deficit has fallen from $290 billion to $23 billion,
- The 1997 budget agreement secured the largest increase in higher education spending since the G.I. bill,

- Net national saving has risen from 3.4 percent of net national product in 1992 to 7.2 percent now, and
- The unemployment rate has fallen from 7.5 percent to 4.6 percent without igniting inflation.

Although our national saving rate is much higher than it was in 1992, it remains low relative to that of many other major economies and of the U.S. itself from the 1950s through the 1970s. Further increases in the saving rate would spur additional investment, which would lift future productivity and help to reduce pressures on the budget and better prepare the country for the looming retirement of the baby boomers. At the same time, as our budget discussions have underscored, we have not come close to exhausting high-return public investments in education, R&D, infrastructure, and other areas. Thus, while we have made substantial strides, there is much more to be done.

A central question we face is for what purpose the nation will use the projected surpluses between 2002 and 2012. They could be used for some combination of:

- Cutting taxes;
- Raising national saving (by reducing the debt held by the public or transferring the surpluses to Social Security); and
- Increasing spending in high-priority areas.

In a world free of constraints, it is likely that we would devote the projected unified surpluses to a combination of debt reduction to help increase private investment, and additional spending to improve core government functions and make targeted public investments.

As we know all too well, however, we must focus not just on our ideal use of the surplus, but the best use in light of the prevailing political environment. Many of your advisers fear that the surpluses will be used for consumption-oriented tax cuts (primarily benefitting higher-income taxpayers) or low-priority spending programs. Given the strong antipathy to the IRS, and the argument that "it's your money," tax reform could become a strong political force. It has been constrained thus far by <u>the box of tax reform</u>.

The "box" of tax reform

For some time, those advocating radical reform of the tax code have been constrained because their proposals would be substantially regressive, cause a significant increase in the deficit, or both. Put simply, it is impossible to simultaneously cut taxes for upper-income people, ensure revenue neutrality, and not raise taxes on lower-income people. <u>All *revenue-neutral* tax plans must create millions of losers, in addition to millions of winners</u>.

The Armey-Shelby flat tax proposal provides a vivid example of the tax reform box. As you know, the flat tax would eliminate almost all existing deductions and exclusions -- and would thus tax mortgage interest, health care benefits, and other items currently favored under the tax code. Such a substantial change in the tax code would adversely affect millions of Americans, while benefitting millions of other Americans. And the impact would be quite regressive: the Treasury Department estimates that at the 21 percent revenue-neutral tax rate, the Armey-Shelby flat tax proposal would reduce taxes by 28 percent on average for families with incomes over $200,000, and increase taxes on average by between 5 and 71 percent for families with income under $200,000. Even if the projected surpluses were used to provide progressive tax rebates to lower-income families, the package as a whole would undoubtedly remain substantially regressive. And as you know, those who lose from a policy change are often more vocal than those who win. Similar problems would arise with a retail sales tax or VAT proposal. And there could be policy and political difficulties with implementing rebates involved in any attempt to limit the regressivity of these proposals.

More progressive plans, such as the Representative Gephardt's, also suffer from the "box of tax reform." Gephardt's proposal would lower income tax rates (for example, cutting the 15 percent rate to 10 percent). But it would also broaden the base by eliminating all itemized deductions except home mortgage interest. Thus, it would add, for example, charitable contributions, employer contributions for health insurance, and Medicare Part B benefits to the tax base. And even this broadening of the tax base — well beyond what may be politically viable — was not sufficient to pay for all that Gephardt wanted to accomplish: Treasury staff found that the proposal would raise roughly $30-$50 billion less revenue than then-current law. After completion of this budget cycle, Treasury staff plans to re-evaluate the package to incorporate the effects of the Tax Reform Act of 1997.

Does the surplus grease the wheels of tax reform?

The major issue now is whether the projected surpluses change the dynamic for tax reform by removing the revenue-neutral constraint. The funding from the surpluses, in effect, could hold a sufficiently large number of people harmless to get reformers out of the previous box. A critical question is whether the loss of popular deductions, fear of change and uncertainty, and the regressivity that is likely to remain part of any such proposal is enough to undermine its political attractions. The prevailing opinion among your advisers, discussed in more detail below (see Section III), is that it is not advisable at this time to offer a full-blown tax reform package.

II. POSSIBLE REPUBLICAN STRATEGIES

Our discussions have focused on the possibility that the Republicans will use the surplus to get out of the box of tax reform. But our best strategy in this area depends on what the Republicans do, and it is not clear that they will stick to a simple surplus-for-tax-reform message. Instead, they could potentially adopt any of several stances on uses of the surplus. Possible Republican strategies include:

- **Full tax reform.** Under this approach, the Republicans would base their surplus strategy on tax cuts/reform. They could open by offering tax cuts — perhaps eliminating the marriage penalty, and further reducing the estate tax — based loosely on the good budget news of the past few years. They could call for the elimination of the tax code by 2000 or so, and use the surpluses accruing at that time to finance their broad-based tax reform. The surplus would provide the additional financing needed to get them out of the tax reform box discussed above.

- **Mix tax reform and Social Security/retirement.** If we link the surplus to Social Security, the Republicans could shift to a position that some of the surplus should finance broad-based tax cuts or tax reform, and that the rest should address the Social Security challenge by financing a set of mandatory retirement accounts funded through individual tax cuts, in a manner similar to the Feldstein proposal. Their message would be that they were "giving your money back, while setting up individual accounts as a downpayment to give Americans a better deal for retirement security." They could also continue to talk about broad-based tax reform in a general way.

- **Coalition mix/logrolling.** Finally, the Republicans could attempt to put together a coalition mix. One strategy could involve using the bulk of the surpluses for broad-based tax reform, but holding a small share aside for highways, biomedical research, and other priorities. An alternative, that would not include broad-based tax reform, would likely involve some modification to budget rules that would allow the package to spend both the surplus and some of the good budget news from the past few years. On the surplus, Speaker Gingrich has said that he has a three-step approach: (1) try to maintain a \$10-\$20 billion surplus; (2) use additional surplus funds for broad-based tax reform; and (3), if any funds remain, use them for investments in technology and R&D.

With these possible Republican strategies in mind, we now turn our attention to *our* possible strategies.

III. AN ADMINISTRATION TAX REFORM PROPOSAL

If the Republicans decide to offer a broad-based tax reform financed by the surplus, our response could be to offer our own broad-based tax reform — also financed by the surplus. Such a strategy would be consistent with an approach that has often proven quite successful in the past: coming forward with an alternative proposal that is more consistent with our priorities and values. But despite the past successes of similar strategies, and despite the possibility that tax reform could become quite popular, your advisers have serious concerns about fighting Republican tax proposals with our own tax proposals. In particular, <u>we believe that responding to a Republican tax proposal with our own tax proposal is likely to produce an outcome very far from our preferred use of the surplus.</u>

While Treasury, NEC, and other relevant agencies have looked at progressive proposals for tax reform, many suffer from major political — and often substantive — drawbacks. For example, any proposal that gets rid of the income tax will likely tax health-care benefits, interest on home mortgages, and charitable contributions, while eliminating credits such as the HOPE Scholarship and the new child tax credit. Many would argue that eliminating the mortgage interest deduction would decimate housing prices for millions of homeowners. As noted above, even progressive proposals, like Representative Gephardt's, require getting rid of popular deductions, while leaving a moderate hole in the budget. These political and substantive drawbacks are inherent even in plans that include net tax cuts and use the surplus to fill the resulting budgetary hole.

However, we should emphasize that we are still actively examining a wide variety of tax reform options. We believe that some more modest simplification proposals look promising, though they also have costs that force you to use the surplus. We would be eager to meet with you to discuss these possibilities.

IV. GENERIC STRATEGY OF USING THE SURPLUS TO BOLSTER SOCIAL SECURITY AND RETIREMENT

In light of the above considerations, we have evolved toward an Administration strategy of devoting all, or at least a majority, of the surpluses to Social Security and retirement needs — allowing you to seize the fiscally conservative high ground while also advancing Social Security reform. This section briefly examines the pros and cons of the generic strategy of using Social Security to pre-empt Republican plans.

The precise mechanisms for transferring the surplus in some way to Social Security and other retirement needs are explored in Section V below.

PROS:

- Devoting the surplus to Social Security would likely take away the "free money" aspect of the surplus — so that every dollar used to finance ill-advised tax cuts or any other proposals would be seen as a dollar less for Social Security reform.
- Democrats will be able to argue that Republicans are "raiding" funds raised from Social Security payroll taxes to pay for ill-advised tax cuts. The surpluses, at least through 2007, are "workers' surpluses" because they arise entirely from the Social Security surplus. Thus there would be a connection between the source and use of the funds under our proposal.
- This proposal would result in higher national saving relative to consumption-oriented tax cuts, and thus would reduce pressures on the budget and better prepare the country for the demographic burden of the next century.

CONS:

- It may be difficult to trump proposals that offer an immediate tax cut and the promise of fundamental tax reform with proposals that address a problem that does not materialize until well into the future.

- Once we have declared definitively that the surplus should only be used for Social Security (or should not be spent until Social Security is fixed), we will have curtailed our flexibility to use any of the surplus now for any other purpose. This could make it difficult to come to a negotiated compromise, or to use any funds for key investments (e.g., children, R&D). And if we decide to propose more sweeping tax reform in 1998, we will have put ourselves into the "box of tax reform" by precluding use of the surplus (except perhaps for tax cuts linked to individual accounts).

- Some choices for using the surplus could involve a "double counting" problem. This issue is discussed in detail in Tab G.

- You should be mindful that if the proposal to use the surplus for Social Security passed, it could curtail the role of government in the long run:

  - If the surpluses are used to fund individual accounts, there would likely be substantial pressure for continuing such funding even after the surpluses end (which is currently projected to occur in 2026). Over the longer run, we may therefore be creating a popular program that would crowd out other budget priorities or raise the overall unified deficit.

  - Merely transferring the surpluses to the Trust Fund, in and of itself, may make the Trust Fund look more healthy, but would not raise future revenue. However, the transfer would effectively earmark a larger portion of future revenues for the Social Security system. And with total future revenue unchanged, any funds that are earmarked in this way must therefore come at the expense of other budget areas, if future budget balance is to be maintained.

  - Emphasizing that the unified surpluses arise from Social Security and should therefore be devoted to Social Security could shift the focus of budget discussions from the unified budget to the non-Social Security budget. Such a shift could lead people to claim that we don't really have a balanced budget yet and put pressure for deeper and deeper cuts to reach a non-Social Security budget balance. For example, between 2002 and 2007, the non-Social Security budget is expected to run a deficit totaling $382 billion.

V. KEY CHOICES FOR MOVING FORWARD ON SOCIAL SECURITY REFORM

This section briefly examines three crucial choices that will have to be made as we move forward on this issue:

A. *Should you offer a full plan for Social Security reform or only a downpayment?*

B. *Should surpluses be earmarked for retirement needs only or should non-retirement investments be included also?*

C. *How should a downpayment, if any, be designed?*

A. FULL PLAN VERSUS DOWNPAYMENT

As we discussed in our previous meeting, using the surplus to provide additional funding for the Social Security system, and possibly investing part of the Trust Fund in equities or establishing a system of individual accounts, makes it conceivable that you could put forward a complete solution to the Social Security problem that would not look draconian.

Providing such a complete plan would be seen as a strong sign of leadership. Both the elites and the public would likely give you much credit for having made a bold statement to the country, regardless of whether your proposal is ultimately adopted. And when Social Security reform is finally accomplished, you will likely be remembered for having galvanized the process. But these leadership points would come at a cost. As we have seen, even with the use of the surplus it is extremely difficult to come up with complete plans that do not harm some people, and that avoid being portrayed as cutting benefits or raising taxes.

In a partisan framework, any full plan will be subject to close scrutiny, as opponents attempt to reveal benefit cuts relative to current law. For example, extending the number of years used to compute benefits from 35 to 38 — a typical component in most reform plans — would produce an average benefit cut of 3.8 percent when fully phased in (or an estimated $442 in 2015). Furthermore, reforms that might not be attacked if you later joined forces with Senators Lott and Daschle — such as covering all state and local government workers — could be attacked if you go out alone.

Choosing a downpayment strategy rather than a full plan would also have some risk attached to it. In pursuing this strategy, you would have to confront a fundamental trade-off involving the specificity of any plan you might choose to offer. In particular, a more specific plan would be more likely to be seen as involving strong Presidential leadership. On the other hand, it would also give critics a firmer target to aim at. Conversely, a relatively vague plan might attract less opposition, but could also leave you with a weaker claim on having "solved" the Social Security problem and less ammunition to counter Republican plans for tax reform.

B. Should Surpluses Be Earmarked for Retirement Needs Only or Should Non-retirement Investments Be Included Also?

Specifying that the entire surplus should be devoted to retirement needs would provide a clear, strong message -- not muddied by leaving the door open for non-retirement uses of the surplus. If we give up the moral high ground that surpluses should all be used for Social Security, we could go down a slippery slope in which popular tax cuts and low-priority spending initiatives will beat out commitments to the Trust Fund.

The problem with committing all of the surpluses for retirement needs is that it would preclude funding other non-retirement priorities. In particular, it may be hard to explain why we can't use even 10 percent of the projected surpluses for non-retirement priorities, especially when we have always emphasized public investments as a complement of private investment and saving. Our position could prove particularly awkward if the Republicans reject a pure tax reform approach, and instead pursue a coalition approach to the surpluses. In that case, we could be put in the position of opposing their proposals to boost spending on biomedical research, children's issues, infrastructure and other areas consistent with our priorities. A commitment to provide a portion of the surplus to non-retirement needs would be more consistent with our overall economic philosophy (which emphasizes both national saving and targeted public investments) while still allowing a strong Social Security message. Every 10 percent of the projected surpluses we devote to non-retirement priorities means $62 billion more funds between 2002 and 2007, and about $180 billion between 2002 and 2012. Therefore, devoting 30 percent of the surpluses to other priorities would amount to approximately $185 billion between 2002 and 2007, and $540 billion between 2002 and 2012.

An alternative approach to an explicit split of the projected surpluses would declare that a conservative estimate of the surpluses should go to Social Security. In constructing the baseline, we would leave room for other domestic needs. For example, if we assume the non-defense discretionary (NDD) spending after 2002 grows at the rate of nominal GDP, instead of the rate of inflation (as under present methodology), we would allow significantly more room for non-retirement spending: roughly an additional $70 billion in 2010, depending on our assumptions. We could then devote the remaining surplus to Social Security.

This approach would allow us to retain a relatively clean message ("we should devote a conservative estimate of the surplus to Social Security"), while still funding non-retirement priorities. However, it may have an adverse long-run impact on the deficit. Allowing NDD spending to grow at the same rate as nominal GDP would be a substantial departure from policy in recent years. With higher NDD spending built into agency expectations, it would be difficult to rein in spending when the budget is no longer in surplus. Moreover, we may wind up in the worst of all worlds, with the Republicans charging that we favor more government spending, while we cannot talk about an explicit "Investment Reserve Fund for the Future."

C. How Could A Downpayment Be Structured?

If you decide to use the surpluses as a downpayment, there are many different approaches you could take. Possibilities include the following three approaches where the Social Security commitment is more general, and two where the use of the surpluses are more defined:

General Commitment 1: Declare that the surplus should be used for Social Security and other retirement needs, but provide no details.

Under this approach, you would declare that the entire surplus should be used for Social Security and other retirement needs, but you would not provide any details (e.g., on individual accounts or equity investments) immediately. This approach could be useful in catalyzing a national dialogue about the surpluses and Social Security reform, but it would limit our flexibility in spending money on non-retirement investments. You would probably get points from the elites and media for declaring that the surpluses should go for retirement needs, but without specifics it may not create substantial attention. Moreover, its lack of specificity may not be sustainable.

General Commitment 2: Declare that the surpluses should not be spent until the Social Security problem has been dealt with.

Under this approach, you would declare that it is not responsible to use the surpluses until we have demonstrated our capability to deal with the Social Security problem. This approach could provide us more flexibility at some point in the future, since it would allow alternative uses of the surplus once it is determined how Social Security will be addressed. A downside of this approach is that if Social Security reform is not passed until after the fall elections, we will likely limit our flexibility to come out with surplus-financed proposals until 1999 or later.

General Commitment 3: Set up a commission or national dialogue on the surplus and perhaps link with Social Security process.

Under this approach, we would set up a commission or a national dialogue to address possible uses of the surpluses, including Social Security and tax reform. The commission or national dialogue could be coordinated with our process on Social Security. While a commission is being established and is undertaking its work or a national dialogue is happening, we could emphasize that the surplus should not be used until Social Security is addressed. A national dialogue could consist of a series of nationwide forums which would complement the millions of dollars that the Concord Coalition, AARP, and Pew Foundation are spending to promote the issue of Social Security reform.

The advantage of stressing Social Security as a use of the surplus is that it would put us in a position of being for Social Security reform, instead of against their tax reform proposal. By linking Social Security and tax reform, we ultimately block their tax reform efforts because each dollar for taxes would compete with a dollar for Social Security.

The cost of this position is that some people would say there is already a "commission" to deal with tax and spending issues: the United States Congress. And the public and elites may grow frustrated with the idea of a national dialogue or the number of commissions we are creating. The commission or national dialogue may also prevent us from using the surpluses for our own initiatives next year, since it probably locks up the surplus past the fall 1998 elections.

In addition to the general commitment approaches delineated above, you could adopt a more specific down-payment strategy:

Defined Commitment 1: Declare that the surpluses should be used for the Social Security Trust Fund only.

This approach would protect us from charges that we gave away the store by even considering individual accounts in our initial proposal.

- **Alternative A:** We declare that the surplus should be used for the Trust Fund, but we deliberately remain vague on whether any of the Trust Fund should be invested in equity investments, to avoid the difficult issues associated with that decision.

- **Alternative B:** We declare that the surplus should be used for the Trust Fund, but we specify that at least some of the investments would take the form of private securities. This approach would facilitate providing a larger downpayment on the overall Social Security problem. However, it would commit us to investing some of the Trust Fund in private securities — a course of action with costs and benefits (see Tab D).

  - A decision to invest incremental Social Security Trust Fund assets in private-sector equity securities would raise the projected rate of return to the Trust Fund. This approach would help extend the projected life of the Trust Fund and lessen the need for benefit cuts and tax increases; the number of years it is pushed back depends, of course, on how much of the Trust Fund we devote to investments in private securities. This idea would also be seen as new and would ensure that it is a subject of attention.

  - Investing in equities raises issues about Federal government intervention in private markets. For example, future governments may be tempted to express social or political agendas by seeking or avoiding certain investments (e.g., tobacco, alcohol, companies that are downsizing, firms that cover abortions under their health insurance). There are also concerns about the risks associated with investing in equities. As discussed in Tab D, some will claim that the risks can be controlled through a variety of methods. Nonetheless, the issue of "risk" would be a central part of the debate. Moreover, a shift in the portfolio of the Trust Fund to private securities in and of itself would have no effect on national saving and the future burden imposed by changing demographics. Allowing the Trust Fund to hold equities — and consequently less debt — would simply mean, in the first instance, that the private sector would hold less equity and more debt.

Defined Commitment 2: Declare that the surpluses should be used for both the Trust Fund and individual accounts.

Some of your advisers are attracted to the possibility of using the surpluses to fund individual accounts as *supplements* to the existing social security system (see Tab E). The benefit of including individual accounts in the proposal is that it offers a double pre-emption: First, the general Social Security and retirement message could trump a broad-based tax reform attack. Second, including individual accounts allows us to offer *tax cuts* linked to retirement. Individual accounts would also move the nation's public retirement system away from a pay-as-you-go approach and toward a pre-funded approach, thereby raising national savings and insulating the system from future demographic fluctuations.

The cost of this approach is that it could split the Democrats, who fear that it could lead to a slippery slope toward Social Security privatization. Even some Democrats who could accept individual accounts in a final deal would complain that by leading with individual accounts we gae the Republicans their top priority in Social Security reform without getting any progressive concessions. Finally, if the government uses the surplus to fund individual accounts in the near-term, it might face pressure to continue such funding even after the budget moves back into deficit. Such continued funding would either exacerbate the deficit or squeeze other budget areas, including the existing Social Security program.

VI. PROCESS FOR SOCIAL SECURITY REFORM

Regardless of what our outward process may be, we will continue to have an intensive NEC process to develop our positions on Social Security reform and broader fiscal and budget issues related to this topic. However, we need to decide on our outward process to get Social Security reform accomplished. It may be best to think about this in three stages: first, the 1998 State of the Union; second, action we can take during 1998 prior to the election; and third, action we can take in 1999. In each time period, we can move forward to ensure that we achieve real reform in the Social Security system.

- **First Stage: 1998 State of the Union.** You could announce either a full plan or one of the downpayment options described above. This would show your commitment to achieving reform.

- **Second Stage: 1998 — Setting the Stage.** In 1998, we would try to set the stage for a long-term solution. This could take the form of either a commission that would report back by January 1999 or through a national dialogue, complementing the work done by private groups such as the Concord Coalition, AARP, and Pew Foundation.

- **Third Stage: 1999 — Finishing The Job.** In 1999, we could then seek to have the "real deal" process, in which some mechanism was created to lead to a bipartisan agreement for reform. There are a number of ways we could seek to achieve this end: first, we could establish a negotiating process, like the Balanced Budget, between you and the Congressional leadership; second, we could form a "Super" committee in the House and

Senate; third, we could establish a commission which would have some kind of negotiating process at its end; or fourth, we could simply propose legislation and send it to Congress, just like any other proposal.

TAB A:
SOCIAL SECURITY REFORM AND NATIONAL SAVING

I. Pay-As-You-Go versus Funded System

Despite the appearance created by the benefit formula, the current Social Security system remains fundamentally a pay-as-you-go system, in which the benefits of each generation of retirees are funded by the contributions of succeeding generations.

- During its early years, when many new workers were entering the system and productivity was rising rapidly, the Social Security system could pay a high implicit rate of return on contributions. The most extreme example of this phenomenon occurred in the case of the first participants, who were granted full benefits in retirement even though they contributed little to the system.

- Since the early 1970s, productivity growth has slowed and the ratio of beneficiaries to contributing workers has climbed. As a result, implicit rates of return on participation in the system have declined dramatically. (For further discussion of rates of return, see Tab C.)

The current Social Security benefit levels are not adequately financed by current tax rates: Annual contributions from workers are projected to fall short of annual benefits payable under current law beginning in 2012, and the Trust Fund is projected to be fully depleted in about 2029. It is important to note that scheduled tax rates will still cover 75 percent of costs. This leaves two choices:

- *Stay with the current pay-as-you-go structure.* Under this approach, there are two basic methods of restoring sustainability to the Social Security system: cut benefits and/or increase taxes.

  - Making adjustments of this type will mean that the system will continue to provide relatively low rates of return, because it will remain essentially a pay-as-you-go scheme.

- *Move to a more funded system.* Individual accounts are one example of a funded system; building up the Trust Fund further (possibly by contributing the unified surpluses) is another. The virtues of a funded system include that:

  - It could be designed to raise national saving in the short run, and

  - It could be designed to offer a higher rate of return than the current pay-as-you-go system.

The major challenge in moving from a pay-as-you-go system to a funded system is that the transition can be costly. For example, with individual accounts, today's workers would pay for both their own benefits (e.g., through individual accounts) and the benefits of today's retirees (through the current pay-as-you-go system).

II. PREPARING FOR THE DEMOGRAPHIC CHALLENGE

As noted above, a funded system could be designed to raise national saving.

- Further increases in national saving would spur additional investment (which would lift future productivity, help to reduce pressures on the budget, and thus, better prepare the country for the looming retirement of the baby boomers) and reduce dependence on foreign capital (which would also raise income in the future by reducing servicing costs on the foreign borrowing).

- The most direct way for us to raise national saving is to raise Federal saving; this is accomplished by running larger unified surpluses.

Any policy that protects the projected surpluses will increase national saving dollar-for-dollar provided private individuals do not react to the increase in Federal saving by reducing their own saving. The likelihood and magnitude of such a reaction probably depends on the form of Federal saving.

- If the Federal saving takes the form of reducing publicly-held debt, the response is likely to be minimal. Similarly, if the saving takes the form of transfers to the Social Security system, the private response may be small.

- On the other hand, if the Federal saving takes the form of deposits into tangible, highly visible individual accounts, the response could be much stronger.

- The response of private saving will also depend on the distributional characteristics of the Federal saving. Households that own few financial assets would not be in a position to offset Federal actions by reducing their own saving. These households are overwhelmingly low- and middle-income households. Therefore, the risk of a reduction in personal saving may be lower the more progressive the distribution of the actions taken to effect the Federal saving. Many U.S. households never accumulate significant financial assets.

    - For example, even among those aged 55-64 and therefore close to retirement (who should be at the peak of their net asset accumulation), fully one quarter hold $1,400 in financial assets or less.

    - 38 percent of all households in this near-retirement age group have less than one year's worth of income in non-housing wealth.

    - 56 percent of households with less than a high-school education in this near-retirement age group have less than one year's worth of income in non-housing wealth.

- It is also possible that an increase in Federal saving could actually increase national saving *more* than dollar-for-dollar. For example, if the increase in Federal saving helps sensitize the public to the importance of saving in general, it could have a "magnification effect" by raising private saving.

III. Conclusion

In general, policy changes will have larger effects on national saving to the degree that they feed directly through to the unified budget, and to the degree that the movement in the unified budget does not provoke a reduction in private saving.

Table: Selected Elements of National Saving
(Billions of dollars, FY 1997)

Social security income	446.6
+ Social security expenses	-365.2
= Social security surplus	81.3
+ Non-social security surplus	-103.3
= Unified surplus	-22.6
+ Adjustment to National Accounts concepts	-23.2
= Federal surplus on National Accounts basis	-45.5
+ Other national saving (personal, business, state and local government)	544.7
= National saving	499.2

TAB B:
HOW MUCH CREDIT WOULD THE ACTUARIES GRANT FOR TRANSFERRING THE SURPLUSES TO THE TRUST FUND?

Traditionally, the Social Security Actuaries have been responsible for projecting only Social Security Trust Fund expenditures, receipts, and balances. They have not forecasted the size of the unified surplus or deficit. In making their projections of the Trust Fund, the actuaries use economic assumptions which are currently more conservative than either OMB's or CBO's. Proposals to transfer the unified surplus to the Social Security Trust Fund would therefore involve a set of novel issues for the Actuaries. This memorandum explores these issues.

ISSUE 1: ASSUMPTION FOR GROWTH OF DISCRETIONARY SPENDING AFTER 2002:

- OMB's long-run projections of the unified budget assume that discretionary spending grows only at the rate of inflation after 2002. Others have suggested that it may be more reasonable to assume that discretionary spending grows at the same rate as nominal GDP.

- The choice of assumption for the growth rate of discretionary spending makes a big difference in the size of the projected surplus. For example, if discretionary spending were to grow at the same rate as GDP, the surplus in 2010 would be only $167 billion, rather than the $237 billion shown in the OMB projections.

- While using the higher growth rate for discretionary spending reduces the size of the surpluses somewhat, it provides a conceptual basis for the Administration to support less restrictive limits on discretionary spending for the future.

ISSUE 2: POLICY CHANGES COULD LOWER THE SURPLUSES:

- Current budget enforcement rules — discretionary caps and deficit neutrality for tax cuts and mandatory spending increases — essentially expire in 2002. In the absence of such rules, spending and tax policy changes could dissipate the surpluses. In the absence of any additional budget enforcement measures, the actuaries would be extremely reluctant to assume that surpluses would materialize —even if they were projected now.

- To preclude the possibility that the surpluses would be dissipated, the Budget Enforcement Act could be extended beyond 2002. With such enforcement measures, the actuaries would probably show the outcome two ways: (1) assuming that the surpluses materialize, and (2) assuming that they do not.

- It is unlikely that enforcement measures would be extended for more than a modest period of time into the future. For this reason many of your advisors feel that the number of years for which transfers of the surpluses is made should be somewhat limited.

ISSUE 3: ECONOMIC ASSUMPTIONS:

- The Social Security Actuaries' economic assumptions are more conservative than OMB's and result in projected surpluses that are somewhat smaller than OMB's assumptions.

- It appears that surpluses estimated by the actuaries may still be large enough to form the basis for a proposal to transfer them to the Social Security Trust Fund.

- Also, the media would tend to rely much more on CBO than on the actuaries for projection of budget surpluses for the next ten years. CBO is very likely to be projecting larger surpluses than the actuaries. This will amplify the credibility of surplus estimates based on OMB assumptions.

TAB C:
THE MECHANICS AND MEANING OF THE TRUST FUND

Historically, Social Security was designed as a pay-as-you-go system: to a close approximation, benefits each year were paid out of current payroll tax receipts, rather than out of previously accumulated assets. Despite the appearance created by the benefit formula, beneficiaries were not in any real sense receiving back the contributions they had put in; those contributions had already been paid out to previous cohorts of retirees.

In 1983, benefits were reduced, payroll tax receipts were increased, and the excess of such receipts over benefits was credited to the Trust Fund.

- For example, in FY 1996, the total income of the Social Security system amounted to $416 billion, and expenditures were $350 billion, leaving a surplus of $66 billion. That surplus was credited to the Trust Fund, which rose from $483 billion at the end of FY 1995 to $550 billion at the end of FY 1996. Since then, the system has run a surplus of approximately $100 billion more, and the Trust Fund now stands at roughly $650 billion.

The creation of a significant Trust Fund changed the Social Security system in two crucial ways:

- First, it ostensibly moved the system toward pre-funding. Although one objective of such pre-funding was to raise national saving, there is some question as to whether this objective was accomplished, given the large unified deficits that were run during the 1980s. To the extent that the accumulation of the Trust Fund did raise national saving, the pre-funding was both apparent and real.

- Second, the accumulation of assets in the Trust Fund gives the Social Security system a strong legal and moral claim on future revenues. This claim helps to protect the system regardless of the general budgetary environment.

I. MECHANICS OF THE TRUST FUND

Social Security taxes are not literally "deposited" into the Trust Fund, and benefits are not literally "paid" from the Trust Fund. Rather, Social Security taxes are deposited into the Treasury like any other tax, becoming part of the general pool of funds through which the government functions, and benefits are paid as any other expenditures.

The difference between Social Security receipts and other government revenue is that the Treasury issues a special-purpose security to the Trust Fund after receiving Social Security receipts.[1] The issuance of special-purpose securities does not remove the funds from the general pool of Treasury revenues, however.

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[1] Similarly, issuance of special-purpose securities held by the Trust Fund are reduced when Social Security benefits are paid. For simplicity, we focus here on the treatment of receipts.

The crucial question for the issue of whether the build-up of the Trust Fund represents an increase in national saving is whether a surplus in the Social Security system — as reflected in the accumulation of issuance of special-purpose securities by the Trust Fund — effectively allows more non-Social Security spending or tax cuts, by making the unified budget position look more favorable.

II. Rate of Return to Social Security Contributions vs. Rate of Return to the Trust Fund:

In any new pay-as-you-go system, workers who retire in the early years of the program are likely to earn high rates of return: their benefits are paid in full, but their contributions were paid for only a few years.

- The earliest retirees participating in the Social Security system received phenomenally high rates of return on their contributions, because benefits were quite generous relative to total contributions.

- For example, retirees turning 65 in 1945 enjoyed a real rate of return on their contributions of over 30 percent per year (see Table 1).

More recently, retirees have had more years of wages subject to taxation at higher rates, and benefit increases have been limited relative to the increase in cumulative contributions, so the rate of return has declined. The system has now reached full maturity — current retirees have generally been alive long enough to have their entire work history covered by the system. <u>Under a mature pay-as-you-go system financed by a fixed tax rate, the rate of return to contributions is equal to the rate of growth of aggregate real taxable earnings (real earnings growth per worker plus the growth rate in the number of workers)</u>.

Therefore, current generations of workers will experience much lower rates of return than their parents experienced, even if their promised benefits are paid in full. For illustration, <u>Table 2 below shows estimated rates of return under the assumption that future benefits are paid in full without any increase in tax rates. Table 3 presents the estimated rates of return under a plan similar to the one proposed by Ned Gramlich, but omitting the individual account feature — see footnote at bottom of next page</u>.

Table 1: Historical real rate of return per year on Social Security contributions

Year cohort turns 65	One-earner couple			Two-earner couple		
Income	Low	Average	High	Low/low	Avg/low	High/avg
1945	46	37	30	41	35	27
1965	14	12	10	11	10	8
1985	8	6	6	5	5	4
1995	6	5	4	4	4	2

Source: Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century*, Table A.9.

*Table 2: Prospective real rate of return per year on contributions under present law**

Year cohort turns 65	One-earner couple			Two-earner couple		
Income	Low	Average	High	Low/low	Avg/low	High/avg
2008	4.92	3.92	3.42	3.07	2.73	1.95
2020	4.84	3.85	3.20	3.11	2.76	1.92
2038	4.76	3.78	3.12	3.12	2.78	1.93
2062	4.80	3.83	3.19	3.24	2.89	2.06

* Simply assumes away actuarial imbalance in program. Source: Advisory Council Report.

*Table 3: Prospective real rate of return per year under program to eliminate actuarial imbalance**

Year cohort turns 65	One-earner couple			Two-earner couple		
Income	Low	Average	High	Low/low	Avg/low	High/avg
2008	4.75	3.73	3.21	3.02	2.62	1.76
2020	4.37	3.26	2.56	2.83	2.31	1.40
2038	4.14	2.88	2.12	2.94	2.23	1.13
2062	4.03	2.76	2.02	2.97	2.24	1.13

* The Gramlich plan, without the individual account component: Includes increasing normal retirement age to 67 by 2011 and indexes thereafter; modify benefit formula; increase the number of years for benefit computation to 38; reduce benefit for spouses to 33 percent of primary benefit; increase payments to some surviving spouses; cover new state and local government workers hired after 1997; tax benefits like other defined benefit pensions and phase out the taxation of benefits threshold. Source: Advisory Council Report.

The prospective rates of return to Social Security contributions look significantly smaller than those possible on individual accounts. On the other hand, as discussed in Tab H, Social Security offers features not likely to be part of individual accounts (e.g., annuitization with greater returns for low-wage workers), and moving to a pre-funded system of individual accounts raises difficult transition issues.

We also emphasize that the rate of return earned by the Social Security Trust Fund is not the same thing as the rate of return to Social Security contributions.

- The rate of return on contributions, for any given level of contributions, depends on the system's benefit schedule — not how the benefits are ultimately financed.

- To put the point another way, the vast majority of Social Security benefits will continue to be financed through the payroll tax, not the Trust Fund. This financing system, which differs from private-sector defined benefit plans that are financed primarily through previously accumulated assets rather than current contributions, means that the rate of return earned by the assets in the Trust Fund does not necessarily bear any close relation to the rate of return on contributions.

- In the first instance, investing the Trust Fund in equities does not directly raise the rate of return to contributions, since that return is defined by the benefit and tax structure. Such investments do, however, help to narrow the financing gap between promised benefits and current taxes — thus facilitating the promised rates of return listed in Table 2 above. In other words, equity investments could help to ensure that the system can afford to pay promised benefits, which might need to be lowered in the absence of such investments.

TAB D:
INVESTING THE TRUST FUND IN PRIVATE SECURITIES

This section addresses issues involved in how the Social Security Trust Fund is invested. It focusses on how a given portfolio should be allocated, and does not address whether the size of the portfolio should be augmented — as could be done by transferring the unified surpluses to the Trust Fund.

A decision to invest incremental Social Security Trust Fund assets in private-sector equity securities would raise the projected rate of return to the Trust Fund. From 1959 to 1996, the difference in the average annual returns for the stock market and the special purpose Treasury securities held by the Trust Fund was 3.84 percent.

As Chairman Greenspan has often emphasized, a shift in the portfolio of the Trust Fund in and of itself would have no effect on national saving and the future burden imposed by changing demographics. Allowing the Trust Fund to hold equities — and consequently less debt — would simply mean, in the first instance, that the private sector would hold less equity and more debt.

The rest of this memorandum discusses various issues with investing the Trust Funds in private securities.

I. Investing Criteria:

Investing Social Security Trust Funds in equities raises the issue of whether future governments may be tempted to express social or political agendas by seeking or avoiding certain investments, some of which we would support but others of which we would strongly oppose. For example:

- Investments to avoid (tobacco, alcohol, rogue nations, companies that are downsizing, firms that cover abortions under their health insurance, firms that provide benefits to unmarried partners of employees)
- Investments to seek (environmental, small business, promoting particular industries such as biotechnology and venture capitalism)
- Investments to smooth market fluctuations.

This issue could be addressed by restricting investment choices to broad market indices. For example, funds could be invested only in the broad stock market proportionately as reflected in indices, such as the Russell 3000 (98 percent of the current market) or the Wilshire 5000 (more than 99 percent). Of course, such indexes do not include small businesses. Additionally, a new, strong, Board of Trustees could be established, with the sole fiduciary concern of maximizing the benefits to future Social Security recipients.

Currently, 47 states invest some portion of their pension funds in equities. Most state boards of trustees appear able to resist politically or socially driven investments, because they have clear fiduciary responsibilities. In addition, pension funds like those run by California and

New York for their public employees (CALPERS and NYCERS) have delegated voting rights to third parties. Not all investment, however, has been optimal. According to one study, politically motivated investments cost public funds $5.6 billion annually from 1985 to 1989.

Between 1989 and 1994, almost 2/3 of all states reportedly reduced budget deficits, at least in the short run, by altering the actuarial assumptions used to compute their public employee pension obligations. The result was to provide, temporarily, higher revenues or lower costs for the states. While some of these shifts in actuarial assumptions may have been justified, many were instituted in order to meet individual states' budget needs.

Canada recently decided to invest the Canada Pension Plan (CPP) trust fund in equities, property, and foreign assets. Canada's arms-length board of trustees will have fiduciary responsibility to serve CPP contributors' and beneficiaries' interests exclusively. By contrast, Singapore's mandatory individual accounts system was recently used to fund Singapore's contribution to Indonesia's IMF-backed package.

The Thrift Savings Plan (TSP) for federal employees is managed by the Thrift Investment Board (TIB). TSP contributors currently have the option to invest in a broad bond index fund, a broad stock index fund, and non-marketable Treasury fund; this menu of choices will soon be expanded to include small cap and foreign equity index funds. The TIB contracts with Barclays Global Investment to manage the non-Treasury investments. The TIB delegated to Barclays the right to vote the proxy ballots.

II. Risks

Investing in equities would likely generate higher returns for the Trust Fund *on average*. Many analysts have argued, however, that these higher average returns would be accompanied by substantial additional risk. They note, for example, that eight times in the past 70 years, the S&P 500 index has declined in *nominal* terms by more than 10 percent during a single calendar year. On three occasions, the decline over a year or two was more than 35 percent. Some international indices have declined by even more, and on a more sustained basis: the Nikkei has fallen by more than 50 percent since 1989.

These facts probably overstate the true implications of investing part of the portfolio in equities for the riskiness of the overall Social Security system. As is discussed further in Tab C, the Trust Fund largely pays for benefits out of current payroll taxes. In addition, only a limited portion (say, at most 40 percent) of the Trust Fund would be invested in equities. Calculations performed by the Social Security Actuary indicate that even a 50-percent decline in equity prices, at a peak time of Trust Fund accumulation, would reduce the actuarial balance in the overall system by only about 0.5 percent of taxable payroll. (For comparison, the 75-year imbalance is currently 2.23 percent of payroll.) An important reason for this result is that the loss induced by the stock market decline would be amortized over many generations of beneficiaries and workers.

Beneficiaries may demand to be insured against even this risk. They could demand that larger-than-expected returns be devoted to building up the Trust Fund. Alternatively, they might demand higher benefit levels, and that declines be covered from general revenues.

The Trust Fund could protect itself from extreme price changes by limiting the share of its portfolio invested in equities, or by always holding no less than one year's worth of benefits in highly liquid securities such as Treasuries.

III. Budget Issues

Under current scoring guidelines, purchases of private-sector equities would be scored as outlays, and sales and dividends would correspondingly score as revenues. During the decumulation phase, unified deficits (OMB projects surpluses only through 2026) would be reduced because the sale of securities would be scored as generating receipts. Of course, government accounting rules are not fixed for all time and may be changed for political or other reasons.

IV. Capital Markets

As noted above, a decision to invest Social Security assets would reduce the amount of equities held by the public and correspondingly increase the amount of Treasury securities held by the public. This shift is likely to cause the price of equities to go up and the price of bonds to go down. As a result, the prospective return on equity could decline, and the return on government debt could rise. Corporate borrowing rates could move in line with the change in Treasury yields. What is less certain is how significant these effects would be.

Some statistics may serve to put the investment magnitudes into context.

- The size of the equity market was $11.4 trillion as of September 30, 1997 (excluding foreign securities and netting out corporate cross-holdings).
- Currently, the Old Age and Survivors Insurance Fund is equivalent to about 5% of the equity market. Adding the Disability Insurance Trust Fund and Hospital Insurance Fund brings the share to about 6.5% of the equity market.
- If 40% of the Trust Fund were invested in the equity market, it would hold just 2-3% of outstanding public securities.
- Net inflows (from all sources) into mutual funds were $220 billion during the year ending September 1997. The increase in the Social Security Trust Fund in FY 1997 was $81 billion.

In addition, to the extent that the government's investment and proxy voting were not entirely neutral, distortions could appear in the capital markets. This would diminish the ability of the financial markets to effectively and efficiently allocate capital.

TAB E:
INDIVIDUAL ACCOUNTS

Individual accounts are often discussed in the context of Social Security reform. Some of your advisers are attracted to the possibility of using the unified surpluses to fund individual accounts as *supplements* to the existing social security system. Among the advantages of individual accounts are the following considerations:

- **Rate of Return.** Even if currently promised benefits are paid, the rate of return to an individual on his or her Social Security contributions will be significantly lower than that offered by individual accounts (see Tab C for a discussion on rates of return to Social Security). Allowing individuals to make their own investment decisions with respect to these accounts may be popular, because many Americans would probably feel more comfortable controlling their own funds, and may believe that they can produce *much* higher returns on their balance. But current expectations on the potential rates of return on individual accounts may be unrealistic.

- **Pre-Funding Retirement.** Individual accounts would move the nation's public retirement system away from a pay-as-you-go approach and toward a pre-funded approach. The advantages of a pre-funded approach are that it raises national saving now and insulates the system from future demographic fluctuations.

- **Tangibility.** Individual accounts would provide citizens with a tangible, visible asset that accumulates over time. On the other hand, many young workers perceive that they are unlikely to receive Social Security benefits. Many Americans currently believe that "Social Security won't be there" during retirement, and that the government lacks credibility in making good on its promises. For this reason, some analysts believe that substituting $1's worth of individual accounts — with their greater tangibility — may *more* than offset in the popular mind a loss of $1 worth of Social Security benefits.

- **Reduced Welfare Costs.** If account balances are invested wisely and left untouched until retirement, the higher returns associated with pre-funding could increase retirement incomes for many low-wage workers, possibly reducing future welfare costs.

- **Tax Cuts.** If individual accounts are funded through the surplus, they could be presented as a "tax cut" for individuals. Even if the accounts are not funded through the surplus, contributions are likely to seem less like a "tax" than the current Social Security payroll tax.

- **Magnification Effect.** Establishing individual accounts could sensitize millions of Americans to the need to save for retirement. Thus, individual accounts could have a "magnification" effect, if, for example, government contributions into those accounts elicit additional private contributions. Establishing individual accounts could also advance the financial education of financially unsophisticated Americans.

Others of your advisers are concerned that individual accounts could operate as *substitutes* for the existing system rather than as substitutes, and thus as the means by which some of the favorable aspects of the status quo are eroded.

Among the disadvantages of individual accounts are the following considerations:

- **The Slippery Slope.** The major objection to individual accounts has been that they could 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 often argue that individuals will compare the higher promised rate of return on individual accounts to the 2 percent or so promised real rate of return on Social Security contributions, and exert pressure for an increasingly large share of their overall contributions to be channeled into individual accounts.

- **Progressivity.** Bob Ball and others are also concerned that a system with individual accounts would not be as progressive as the current system. In the context of using the unified surplus to fund such accounts, it may be possible to alleviate this concern by insisting, for example, that the surplus be distributed in the form of a flat contribution from the government to each eligible person. Such a structure would be even *more* progressive than the existing Social Security system.

- **Risk for Non-Retirement Budget After Budget Moves Back into Deficit.** If the government uses the surplus to fund individual accounts with the surplus in the near-term, it could face pressure to continue such funding even after the budget moves back into deficit. Such continued funding would either exacerbate the deficit or squeeze other budget areas, including pressures to cut Social Security to fund individual accounts.

- **Retention and Increased Welfare Costs.** Once account balances begin to grow, demands to access the money through withdrawals or loans, for any number of good reasons would be irresistible. Allowing such access would reduce the promised retirement income -- in some cases, that drop may be dramatic. To the extent that accounts will be compromised by premature withdrawals, many low-wage workers might be need additional public assistance. (Under current law, the present value of expected benefits is not accessible.)

- **Administrative Costs.** Individual accounts would be more costly to manage than the current Social Security system, and those administrative costs would reduce the net benefits of setting up the accounts. In Chile, for example, administrative costs have proven to be unexpectedly large — although there is continuing debate over the relevance of this example for the United States.

- **National Saving.** Because they are more tangible, individual accounts may cause individuals to save less in other accounts or cause employers to reduce existing pension coverage. In addition, because they may be perceived as the "property" of individuals, individual accounts seem likely to generate demands for financing of non-retirement emergencies. If such demands are accommodated, they could lead to additional declines in national saving.

- **Risk for Individuals.** Under a system of individual accounts, the individual would face investment risk that is not faced under a defined benefit program such as Social Security. Some individuals will surely prove to be unsophisticated investors, and could experience extremely poor returns on their portfolios. This could create pressure for the government to compensate investors holding failed or underperforming investments. In effect, unless strong safeguards are put in place, individual accounts could become a huge new contingent liability of the government. Chile has used a system of both floors and ceilings on returns, to protect investors and discourage excessive risk-taking.

INDIVIDUAL ACCOUNTS VS. INVESTING THE TRUST FUND IN PRIVATE SECURITIES

As many of your advisers have noted, the higher returns from individual accounts could also be achieved by allowing the Trust Fund to invest in private securities. Taking the more centralized route would, as noted above, avoid the possibility of undermining support for the current defined-benefit program. On the other hand, individual accounts avoid the difficulties inherent in the government's holding private securities, including the pressure to express social or political choices through such means as targeted investments, voting proxies, or intervening on market downturns. They also offer the opportunity to use a tax cut to fund retirement income.

TAB F:
POSSIBLE ELEMENTS OF A COMPLETE PLAN

For your convenience, this tab reproduces a table from an earlier memorandum, showing possible building blocks of an overall plan for the reform of Social Security. These building blocks have not been subjected to any formal review within the Administration. The purpose of the tab is to convey a more complete sense of the range of actions that could be taken to bring the Social Security system into actuarial balance.

The table below presents the impact of each building block on the actuarial imbalance of the Social Security Trust Fund, as well as the impact on the retirement benefits of a hypothetical 65-year old retiree in 2015 with an average earnings history, and a similar retiree in 2040.

The impact on the 75-year actuarial balance is the traditional yardstick for measuring the "size" of proposed reforms to the system. Many of your economic advisers, however, prefer alternative or additional metrics — such as ensuring perpetual (not just 75-year) balance in the system; putting greater 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.

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. Impact on benefits is measured in annual terms.

TAB G:
THE "DOUBLE COUNTING" PROBLEM

This memorandum explains and analyzes the "double counting" problem that is an aspect of proposals that would "transfer" part or all of the unified surpluses to the Social Security Trust Fund.

I. BACKGROUND

The unified Federal budget measures total Federal receipts and total Federal expenditures, including Social Security payroll taxes and expenditures, for each fiscal year. From a bookkeeping point of view, the unified budget is divided between the "General Fund" and other types of funds. One of these other funds is the Social Security Trust Fund.

Unlike the "General Fund," the Trust Fund keeps track of its "balance" over time. Thus, for example, if receipts exceed expenditures in a given year, the balance increases. The Social Security Trust Fund balance is held almost entirely in the form of non-marketable Treasury securities. In effect, the Trust Fund lends the General Fund its balances and receives interest-bearing securities in return.

In any year, funds may be transferred from the General Fund to the Social Security Trust Fund, or vice versa. Under current law, a number of different transfers must take place each year from the General Fund to the Social Security Trust Fund. These funds are treated like any other receipt of the Trust Fund and they augment the balances in the Trust Fund. Because the General Fund and the Trust Fund are both part of the unified budget, these intragovernmental transfers have no effect on the unified deficit or surplus.

If Social Security were permitted to purchase private securities — such as equities — rather than purchase non-marketable Treasury securities, funds would move outside the Government. Under current budgetary scoring rules, the purchase of these private securities would be scored as an outlay, and could reduce or eliminate any unified budget surplus. Under the same rules, when these securities were sold at a later date, the proceeds would be scored as receipts.

II. "TRANSFER" PROPOSALS AND THEIR EFFECT ON THE UNIFIED BUDGET

Proposals have been made to transfer an amount of money each year — equal to the unified budget surplus for that year — from the General Fund into the Social Security Trust Fund. If the unified budget were in deficit, no amount would be transferred.

The transfer of these amounts — like any other transfer from the General Fund to the Trust Fund — would augment the balance in the Trust Fund. So long as the balance continued to be invested in Treasury securities, however, the transfer would be "intragovernmental" and would have no effect on the unified surplus or deficit. In particular, any surplus in the unified budget would still remain after the transfer, and could be used for new tax cuts or new spending. The new proposal is therefore, sometimes combined with an additional proposal.

The additional proposal would require the Trust Fund to purchase private sector securities in the amount of these new transfers into the Trust Fund. As noted above, under current budgetary rules, the purchase of private securities would be scored as an outlay, and hence could be used to reduce the unified surplus. Moreover, to the extent that the long-run rate of return on private securities such as private equities exceeds the rate of return on Treasury debt, the actuarial imbalance in the Trust Fund would be reduced by more than would occur if the transferred monies were invested in Treasury securities.

III. THE "DOUBLE-COUNTING" PROBLEM AND OTHER OPTICAL PROBLEMS CREATED BY THE NEW PROPOSAL

A number of optical problems are created by the new proposal. First, the new proposal is based on a transfer of funds from the General Fund to the Social Security Trust Fund. Optically, all such transfers seem arbitrary in nature because they have no effect on the unified deficit or surplus. Critics will ask why we do not just transfer some larger amount of money to the Trust Fund and eliminate its long-run financing problems completely.

Requiring that the new transfers be invested in private securities would mitigate, but not eliminate this optical problem. The purchase of private securities could be used to reduce or eliminate surpluses. However, this effect arises from the investment in equities, not from the initial transfer of monies from the General Fund to the Trust Fund. The first step in the process is still a transfer and the transfer will be criticized as arbitrary.

The optical problem is exacerbated by another important factor. The unified surpluses early in the next decade are projected to occur solely because the Social Security system is in surplus. As noted above, the Social Security surpluses are already converted automatically into additional balances for the Social Security Trust Fund. To the extent that the unified surplus is due to the Social Security surplus and that an amount equal to the unified surplus is transferred to the Trust Fund under the new proposal, it will appear that the same amount has been credited TWICE to Social Security's balances. This is referred to as the "double-counting" problem or the "logic problem." This problem persists at least through 2007 under OMB's Mid-Session projections.

In actuality, however, the unified surplus in 2002 is not really "caused" by the Social Security surplus. From a budgetary perspective, it is no more accurate to attribute the unified surplus to Social Security's surplus than it to attribute it to surpluses in that year in other Trust Funds or special funds. Nonetheless, critics will make that charge.

Another aspect of the "double-counting problem" is that it could lend force to the argument that we should remove Social Security altogether when measuring the Federal budget balance. Removing Social Security from the definition of balance would eliminate any appearance of "double-counting." Moreover, under this alternative definition, the budget would not be in balance until 2007 under current projections, and significant pressure could develop to make even deeper spending cuts in the non-Social Security portion of the budget in order to balance it.

One method for dealing with the double counting problem, would involve permitting or requiring the Trust Fund to invest some of its balances in private securities such as equities. The amount that would be invested each year would be equal to the unified budget surplus in that year. However, no money would be transferred from the General Fund to the Trust Fund.

Because the investment in private securities would be scored as an outlay under current budget rules, the unified surplus could be eliminated under this proposal. To the extent that private securities earn a higher long-run rate of return than Treasury debt, the Trust Fund's balances would be augmented. As there is no transfer of unified surpluses to the Trust Fund under this proposal, there is no "double-counting" or "logic" problem.

A virtue of this proposal is that it would clarify that the Federal government is already taking concrete action — much as any private corporation would be required to do under Federal pension regulation — to prefund its retirement obligations. On the other hand, the proposal might seem weaker than the first proposal because the unified surpluses are not being transferred. While it is true that the only reason that the unified surpluses disappear under either proposal is a budget scoring convention, the first proposal allows focus on the transfer as the "use" of the surplus. Without this focus, the alternative proposal might not be sufficiently persuasive to preclude proposals that would use the surpluses for new tax cuts or new spending.

This alternative would also augment the Trust Fund balances by substantially less than the proposals described earlier. For some, this would be a drawback. For those who are concerned that augmenting Social Security's balances would put added pressure on the rest of the budget — by reducing the size of "real reforms" needed in Social Security — it would be an advantage.

TAB H:
TALKING POINTS IN SUPPORT OF SOCIAL SECURITY BEING A GOOD DEAL

(With Related Background Information)

I. BACKGROUND

- The schedule of benefits and taxes for Social Security under current law will provide slightly more than a 2 percent *real* rate of return for two-earner couples with average wages in each cohort retiring after 2010.

- If the current schedule of benefits and taxes were maintained, the Trust Fund would be exhausted in 2029.

- However, under the Advisory Council Plan proposed by Robert Ball to correct these financial imbalances, this rate of return would drop only slightly. A key element of the Ball plan allows the Trust Fund to phase in investment in private equities until 40 percent of the Fund is invested in these securities.

- If private equity investments were not used, the benefit cuts and tax increases necessary to restore financial balance would reduce the real rate of return by about half a percentage point for these couples. The reduction in the rate of return would be as much as about 1 percentage point for many singles and other couples.

- If all workers redirected their contributions and invested them wisely in equities, over the long-term, they could earn a much higher real rate of return e.g. 6 percent (if past history from 1959 to 1996 holds).

- If such redirection occurred, tax rates would have to rise by huge amounts immediately in order to pay the benefits of current retirees, because the current system is not advance funded.

II. TALKING POINTS

- The schedule of benefits and taxes for Social Security under current law will provide slightly more than a 2 percent *real* rate of return for two-earner couples with average wages in each cohort retiring after 2010.

- This is similar to the long-run rate of return on Treasury securities, which are backed by the full faith and credit of the U.S. Government and which are seen as riskless.

- Some individuals may argue that if they were allowed to withdraw their contributions and invest them in equities, they could earn a much higher real rate of return e.g. 6 percent. This argument ignores some key issues:

- Social Security provides substantial disability and survivor coverage for all beneficiaries. Workers may not be able to get coverage in the private sector that is as good, as permanent, or as comprehensive as that provided by Social Security. In some cases, especially as workers grow older, they may not be able to get such coverage at all.

- Social Security provides for annuities that are fully indexed for inflation. Retirees may not be able to get such annuities in the private sector.

- If workers were allowed to withdraw their contributions from Social Security now, they would face a huge tax increase in order to pay for the benefits of current retirees.

- Social Security provides some redistribution from high-wage workers to lower-wage workers. A system of individual accounts very likely would accomplish less redistribution.

- Under Social Security, workers are protected regardless of sudden changes in the economy. Individual accounts would be subject to the vicissitudes of volatility in the markets that might occur close to retirement age.

- Some individuals would invest unwisely. And as noted above, all would be subject to the volatility of the markets close to retirement age. Pre-retirement access to accounts could be irresistible and could greatly reduced the promised level of retirement income for many, especially low-wage workers. To ensure a minimum safety net in retirement, general revenues — financed by higher taxes on everyone — would be required.

- Individual accounts would have higher administrative costs than Social Security.

THE WHITE HOUSE

WASHINGTON

THE PRESIDENT HAS SEEN
1-5-98

January 2, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

The attached proposal reflects conversations between the Chief of Staff's office, your economic team, and key political advisers. Erskine asked that we submit this to you (through Sylvia) for guidance on whether we should implement it as written or whether you had suggested changes. You could relay your comments or questions either to Sylvia, who has been participating in the discussions, or directly to Gene.

THE PRESIDENT HAS SEEN
1-5-98

Actions for our Social Security message over the weekend
January 2, 1998

As you know, we engaged with the Republican leadership as early as our CPI discussions on the issue of a possible Social Security commission or process. Erskine has also discussed that possibility at other times with the Republican leadership. The issue before us is whether or not we should take some message actions over the weekend to ensure that our message and our leadership are not pre-empted by others' rushing out ahead of us with process proposals. On the substance of Social Security reform, we will be meeting with you next week to finalize our strategy for emphasizing that the surplus should be reserved in some way for Social Security.

A recommended proposal for this weekend is the following:

1. A story in the *Washington Post* on Sunday morning, giving some indication of our intention to take a leadership role on Social Security and to propose some form of national dialogue.

2. Bob Rubin and Frank Raines confirm the story during their appearances on the Sunday shows (Raines is appearing on *Meet the Press*, and Rubin is appearing on *Face the Nation*).

3. Welcome any process proposals put forward on Monday as ideas that could be considered within the President's plans for a bipartisan national dialogue, but stress our principles on the importance of preserving and protecting Social Security as the progressive and universal structure that has served the nation so well over the past six decades.

Message for Sunday paper and shows

1. The President is strongly committed to trying to pass long-term Social Security reform and feels that it must be done within the next two years.

2. The President and his team are actively considering a wide variety of substantive options for Social Security reform. While it would be unlikely that the President would announce a complete proposal prior to engaging in further bipartisan dialogue, he has not ruled out making a partial statement on the substance of Social Security reform in the next several weeks. [This element is designed to signal that you are not limiting your role in 1998 to process -- leaving room for the surplus statement -- without raising expectations too high.]

3. Regardless of any substantive proposal he may or may not make, the President plans to call for a major and broad national dialogue on Social Security and retirement needs. The dialogue could include a series of national fora or a bipartisan commission. The primary focus of the effort would be reforming Social Security while protecting the basic universal and progressive structure that has dramatically reduced poverty among elderly Americans. The President also plans to confer with the Republican and Democratic

leadership regarding the best process for producing a bipartisan legislative proposal.

The President's staff has already been in discussions with several major groups, which are also interested in a strong national dialogue:

- The bipartisan Congressional working group on Social Security co-chaired by Congressmen Jim Kolbe and Charles Stenholm;
- The AARP, which has asked the President to raise the profile of the conferences it plans to hold in each of the 435 congressional districts; and
- The Concord Coalition, which has asked the President to support its planned regional fora on Social Security reform.

4. In addition to this effort to produce substantial Social Security reform, the President is committed to promoting retirement security more broadly:

- The Administration plans additional, specific pension proposals as part of the State of the Union address;
- The Administration is planning to take steps to highlight the National Summit on Retirement Savings, which must be held at the White House by July 15, 1998, as mandated by the Savings Are Vital to Everyone's Retirement (SAVER) Act of 1997. The Summit, which will be presided over by leaders from both the executive and congressional branches and will include up to 200 additional participants, is intended to increase public awareness of the value of personal savings for retirement, and to facilitate the development of a broad-based, public education program to enhance personal retirement security.

Personal saving and pensions are important complements to Social Security, which is the principal leg of the retirement stool.

THE WHITE HOUSE

WASHINGTON

January 5, 1998

MEETING WITH ECONOMIC ADVISORS

DATE: January 6, 1999
TIME: 5:10-6:10pm
LOCATION: Cabinet Room
FROM: Gene Sperling

I. PURPOSE

The purpose of this meeting is to continue to discuss different options for how to handle Social Security in the State of the Union. In particular, we need to move toward decisions about whether you would like to put out a proposal in the State of the Union and if so, how specific you would like to be in the proposal.

II. BACKGROUND

In previous meetings, we have discussed a range of Social Security reform plans. In the aftermath of the White House Social Security Conference, members of Congress are beginning to engage on the issue. We now need to focus on different options for moving the reform process forward in the New Year. At the meeting, we will present a few options in order to help you think through the advantages and disadvantages of different approaches.

III. PARTICIPANTS

<u>YOU</u>
John Podesta
Jack Lew
Sylvia Mathews
Maria Echaveste
Steve Ricchette
Gene Sperling
Janet Yellen
David Bier
Larry Stein
Larry Summers
Paul Begala
Bruce Reed
Elena Kagan
Karen Tramontano

Sally Katzen
Michael Waldman
Doug Sosnik

IV. SEQUENCE OF EVENTS

YOU will meet with your advisors in the Cabinet Room.

V. PRESS COVERAGE

NONE

VI. REMARKS

NONE

VII. ATTACHMENTS

NONE

Agenda for Special Issues Meeting
January 5, 1998

A. Three approaches to Social Security and the unified surplus

1. 100 percent of the projected surpluses should be devoted to Social Security.

An alternative would be that none of the projected surpluses should be spent until Social Security has been adequately addressed

Pros:

- Clean message -- we need to meet the retirement challenge of the 21st century.
- Provides the strongest stance against dissipating any of the surpluses in low-priority spending or tax initiatives.

Cons

- May not be sustainable -- could position us as not just opposing tax cuts and tax reform, but also against using a small percentage of the surpluses for high-priority investments in science or children's initiatives.
- Could make it difficult to join compromise coalition with some Democrats or ultimately with Republican leadership.

2. Announce that 75 percent of surpluses should go to Social Security, while asking for national dialogue on how the other 25 percent would be allocated among the following four priority areas: Social Security; children and education; science and R&D; tax reform and tax cuts.

Pros

- Setting aside the bulk of the projected surpluses for Social Security reform will be seen as a strong sign of leadership, while more sustainable because it avoids putting us in the position of having to oppose all proposals for tax reform or popular investments.
- Keeps open possibility of devoting entire surplus to Social Security (since Social Security is also a potential use for the remaining 25 percent).
- The proposal still blocks use of surplus for major regressive tax reform proposals: the funding from at most a quarter of the surpluses is not sufficient to prevent major options from regressivity or raising the deficit.

Cons

- Splitting the surplus -- even if the bulk goes to Social Security -- muddies the message that the entire surplus should be devoted to retirement needs, and opens the door to other less attractive formulaic approaches.

- Could make it difficult to oppose more modest Republican tax proposals, paid for with 25 percent of the surplus or less.

3. 100 percent of a *conservative* estimate of the surplus should be devoted to Social Security.

Instead of explicitly splitting the projected surpluses, declare that a *conservative* estimate of the surpluses should go to Social Security. Then in constructing the conservative baseline, leave room for other domestic needs -- thus implicitly splitting the surplus. (For example, if NDD grows at nominal GDP, instead of inflation, the budget would include roughly an additional $70 billion in 2010.)

Pros

- Allows us to retain a relatively clean message ("we should devote a conservative estimate of the surplus to Social Security"), while still funding non-retirement priorities.

- May protect us against any charges that our NDD assumptions are unrealistic -- that they would either not be met or would squeeze the role of government if they were.

Cons

- May wind up in the worst of all worlds, with the Republicans charging that we favor more government spending, as opposed to a reserve that we could explicitly say goes for popular, high-priority areas.

B. Issues for any of the three approaches

1. Equity investments:

A. Vague support/leave open

B. Specific support at outset

C. Specific support at later date

2. Individual accounts:

A. Make clear opposition

B. Don't rule out, pending entire package

C. Explicit support, or more willingness to consider

D. In Option 2 above, limit to the 25 percent piece -- combine with national dialogue over how to spend that money

3. Presentation of approach and whether the surplus is eliminated:

Issue of whether to leave the surplus on the books

4. How many years of the surplus should be dedicated?

C. Process for 1998

1. National dialogue

A. Experts commission

B. Congressional commission

C. Regional fora, each administered in bipartisan fashion

2. "Real deal" process

A. Normal legislative process, following POTUS proposal

B. Negotiating process, as in the balanced budget agreement

C. Fast-track legislative process, following commission report

D. Special session of Congress, or commitment to specific period of time

SOCIAL SECURITY MEETING
January 13, 1998

ISSUES AND DECISIONS

- Final agreement on "Social Security first" strategy
- Budget presentation
- Process for 1998 and 1999
- Principles for reform

SOCIAL SECURITY FIRST STRATEGY

Based on NEC meetings and our previous meetings with you, we believe that we are evolving toward a "Social Security first" strategy. Under this strategy, 100 percent of the surpluses would be reserved pending Social Security reform. But to be clear: The strategy does not commit 100 percent of the surpluses to Social Security; instead, it reserves 100 percent of the surpluses until it is shown that the funds are *not* needed for Social Security reform. The logic is that reserving the surpluses in this way will provide a strong incentive for passing Social Security reform.

Issues

Flexibility

The main question is whether, or to what degree, this proposal limits our flexibility to make specific announcements in 1998 on Social Security before a full reform is passed. Possible announcements could include:

- Extending the life of the Trust Fund. We may not be able to attach any specific numbers showing the impact of the surplus on "Social Security reform," because it would not be clear whether we were actually going to contribute any of the surpluses to Social Security in the end.

  -- We could, however, speak about hypotheticals: "If those surpluses were donated to the Trust Fund in the form of equities, they would extend the life of the Trust Fund to XXXX."

- Specific portion of the surplus to the Trust Fund. To facilitate specific estimates of the impact on the Social Security system, we may want to say later that at least some portion or some percentage of projected surpluses should go into the Social Security Trust Fund.

-- Would this be seen as consistent with the "reserved pending Social Security reform" pledge?

- Equity investments of the Trust Fund. Already, a major issue emerging in the debate over reform is the rate of return to Social Security. To address this issue, we may want to support investing some of the Trust Fund in equities. But under current accounting rules, any purchase of equities for the Trust Fund would score as an expenditure.

    -- Would equity investments, even if they absorbed some of the surplus, be consistent with the "reserved pending Social Security reform"? Some will argue that since it takes the surplus off the books without providing a full solution to Social Security, equity investment would be inconsistent with our statement. But others would argue that as long as it's for Social Security, it's consistent.

- Individual accounts proposal. The surplus can finance the accounts, at least temporarily, without having to raise additional taxes.

    -- Individual accounts would absorb the surplus, and some would say they were therefore inconsistent with our statement. But others would argue that they were part of the Social Security reform.

Other non-retirment priorities

- We will also not be able to support legislation for tax cuts, education spending, or science and R&D. But in addition to paid-for proposals, we could perhaps clarify how we would use the surplus once Social Security reform is accomplished.

    -- We could perhaps come out with proposals such as: "Once Social Security reform is passed, we plan to devote x% of the surpluses to a Children's Fund."

BUDGET PRESENTATION

Your advisers have agreed that the tables in the budget will not show surpluses. Rather, each table will include a line "Reserved pending Social Security reform" that will absorb the surplus. [Example from OMB]

PROCESS

It may be best to think about the Social Security reform process in three stages: first, the

1998 State of the Union; second, action we can take during 1998 prior to the election; and third, action we can take in 1999.

- First Stage: 1998 State of the Union and FY 1999 Budget.
- Second Stage: 1998 — Setting the Stage.
- Third Stage: 1999 — Finishing The Job.

Stage 2 (1998)

- **Regional forums.** You would ask Bob Dole, Warren Rudman, George Mitchell, and Lloyd Bentsen to hold a series of 6 regional forums administered in a bipartisan fashion. The forums would include representatives from Generation X, the baby boomers, and the current elderly -- as well as from a variety of racial and labor market backgrounds.

  -- The four people listed above (Dole, Rudman, Mitchell, and Bentsen) would provide a strong bipartisan flavor to the forums. But some of your advisers are worried that the four do not reflect enough diversity (in terms of gender, race, and age).

- **White House Conference.** You would also announce that following the completion of the regional forums, you would convene a two-day White House conference on Social Security as the first step in a bipartisan process to get reform passed. You would work together with the Congressional leadership to ensure that the conference was an effective first step in moving the legislative agenda forward. The conference would thus be the segue between Stages 2 and 3.

- **Social Security Commission during Stage 2 (1998).** You could also call for a commission on Social Security reform to report in December 1998 or January 1999 (before the Medicare commission reports in March 1999). The advantages of a Social Security commission are that it provides a more specific process for 1998 and more cover to those running in the fall 1998 elections (to avoid having to make "no new taxes or benefit cut" pledges). And since it seems to be favored by some of the leading Republicans, it could enjoy bipartisan support. The costs are "commission-itis" -- the Gramlich commission just reported, and many other commissions exist on a variety of topics (e.g., Medicare). And a commission could run away from us (e.g., as occurred with the IRS commission), or have trouble reaching a majority opinion. Issues that would have to be resolved if we support a commission include membership (whether the Administration and Hill would have official members, for example), reporting (whether a final report would be submitted to you), and staffing resources.

Stage 3 (1999)

As part of your initial (Stage 1) announcement, you may also want to define what will occur in Stage 3. The concern with such a commitment is that it limits our flexibility in 1999, which we could live to regret. The benefit is that it shows a specific commitment to getting reform done. Possible "real deal" steps include:

- **Administration proposal.** You could commit that following the end of Stage 2, the Administration would put forward our own proposal. That proposal could then be fed into a normal legislative process, or a special process intended solely for Social Security reform.

- **Begin negotiating process in January 1999.** You could announce during the State of the Union that following the regional forums, you will ask the Congressional leadership to begin negotiations on Social Security in January 1999.

- **Top priority for legislative action in 1999.** Alternatively, you could ask that the Congress consider Social Security reform as its top priority, or its first legislative focus, in the 106th Congress. The advantage of this approach is that it provides much specificity to Stage 3. But many of your advisers are extremely considered that it would unduly limit our flexibility in 1999, and that we could wind up much regretting having made such a specific commitment.

Economic Team Recommendation

Your economic advisers recommend that you announce the following process in the State of the Union:

- **National dialogue during 1998:** 6 bipartisan regional fora to be held in 1998

- **White House conference in December:** A 2-day White House conference -- including the Hill -- held in December 1998 to wrap up the regional fora process, and segue into the negotiating process

- **Negotiations in January 1999:** A statement that "Following the White House conference, I will ask the Congressional leadership to begin negotiations in January 1999 over Social Security.

Other possible packages include:

Package 1
- 6 regional fora
- Commission to report back in December 1998
- White House conference in December 1998
- Commitment to beginning negotiations in January 1999

Package 2
- 6 regional fora
- White House conference in December 1998
- Administration proposal in December 1998

Package 3
- 6 regional fora
- White House conference in December 1998
- Top legislative priority in 1999

PRINCIPLES FOR REFORM

- Provide guaranteed retirement security

- Strengthen and update the system for the 21st century

- Maintain the universality and fairness of the current system

- Preserve the progress we have made on the budget deficit

THE PRESIDENT HAS SEEN
1-19-99

'99 JAN 16 PM12:30

THE WHITE HOUSE

WASHINGTON

January 15, 1998

Copied
Sperling
Podesta

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: NEC WEEKLY REPORT

cc: JOHN PODESTA

Bananas: NEC staff continues to work with USTR and others to press the EU to implement a banana import regime that meets WTO requirements. As you know, the Administration promised Congressional leaders (in a letter from Erskine Bowles) to retaliate if the EU did not bring itself into WTO compliance in a timely manner. We are proceeding on several tracks. USTR plans to request new WTO consultations with the EU this week. At the same time, our retaliation list is now public and has been designed to hit hardest and put pressure on those member states (including Britain) that have been least helpful. We are emphasizing to the EU and these member states that we want very much to avoid retaliation by reaching a GATT-consistent negotiated resolution but that we will be forced to act if such a deal is not reached soon. To date, the EU continues to resist reform. The WTO will consider our retaliation request on January 25. But it is quite likely that the retaliation amount we propose will be arbitrated, which would delay the retaliation date until early March.

Steel: Following the release of the Steel Report to Congress, Ambassador Barshefsky, Secretary Daley, Lael Brainard, Sue Esserman, Undersecretary Aaron, and myself briefed industry, steelworkers, state representatives, Congressional staff, and some members on your plan to address the rise in steel imports. Furthermore, the Vice President and I met with steelworker leader George Becker. John Podesta and I also met with a group of steel CEOs to continue our discussions. In these meetings, we explained our strategy for our continued focus on those countries most responsible for the surge. Steelworkers, CEOs, and state representatives all felt strongly that only a *global* solution would be effective, as they believe steel exports will simply increase from sources other than Russia, Japan, and Korea. The CEOs continue to press us to self initiate a Section 201. Becker continues to urge immediate imposition of global quotas without regard to WTO consistency. The most positive response came from Representative Murtha, who reacted very favorably to the Japan/Russia strategy. He wants to be helpful to us, but also feels the need to respond to the general panic in the Steel Caucus. We will work with him and others on ways in which Congress can play a constructive role, including possible initiation of a 201 case by Senate Finance or House Ways and Means. Ambassador Barshefsky, Secretary Daley and I are scheduled to brief the House Steel Caucus next Wednesday (1/20).

You should be aware that very preliminary non-public Customs information shows a significant decrease in Russian and Japanese hot-rolled steel imports in December. Our bilateral strategy, and the November critical circumstances determination by Commerce in the antidumping cases, appears to be yielding results. Unfortunately, November import statistics, due to be released on January 21, will still show record highs. Commerce is working to announce both December and November trade figures on January 21, consistent with your commitment in the report to release steel trade data three weeks earlier than in the past. Important!

Brazil: As you know, Brazilian Central Bank President Gustavo Franco resigned earlier this week causing Brazil's currency to devalue and their stock market to decline. On Friday morning the Brazilians decided it did not make sense for them to spend more of their resevere defending an unsustainable exchange rate and allowed the currency to float. They also indicated that they would present new rules on Monday when the markets open again; the possibilities are as such: continued float, wide bands or a new peg (the least likely). We will also be pressing them for new signs of resolve on fiscal policy. You should know that Brazilian Finance Minister Malan and Central Bank Governor Lopes traveled to Washington, D.C. Friday night and will meet with senior Treasury officials --Secretary Rubin and Deputy Secretary Summers -- and IMF officials -- Camdessus and Fischer -- on Sunday. The NEC and Treasury are monitoring the situation closely and will be sure to keep you apprised of any further developments following their discussions with the Brazilians.

Medicare Commission requests: Congressman Dingell has requested a meeting with Larry Stein, Chris Jennings, and myself to discuss the Medicare Commission. He is extremely concerned about Senator Breaux's handling of the Commission and advocacy for a premium support program. He fears that the proposal could significantly harm lower or lower middle-income Medicare beneficiaries in terms of higher premiums and cost-sharing. He will ask that we help ensure that Democrats, including our appointees, don't sign off on a flawed proposal -- and to make sure that it includes prescription ~~drugs. At the same time,~~ Senator Breaux is requesting and receiving technical assistance from the Administration. He is both looking for independent cost estimates (since CBO will not do them) and for guidance on how to make premium support and other Medicare reforms more efficient. We are trying to be as responsive to their requests as possible, but are explicitly only providing technical assistance. There is a growing public perception that the Administration appointees are the "swing votes" on the Commission, and we don't want our technical assistance to be interpreted as a sign off on the policies.

THE WHITE HOUSE

WASHINGTON

February 8, 1998

TALK ON SOCIAL SECURITY TO STUDENTS AND PUBLIC AT GEORGETOWN UNIVERSITY

DATE:	February 9, 1998
LOCATION:	Gaston Hall, Georgetown University
TIME:	Briefing (9:15 a.m. -10:00 a.m.)
	Event (10:15 a.m. - 11:30 a.m.)
FROM:	Gene Sperling
	Maria Echaveste

I. PURPOSE

To kick off a national discussion on Social Security, lay out the problems confronting us on entitlements, and underline the principles that must guide our efforts on reform.

II. BACKGROUND

At Gaston Hall at Georgetown University, you will reiterate your call in the State of the Union for the American people to join you in a discussion on Social Security that is aimed at forming a consensus on how we proceed. You will announce that, in April, you will participate in the first of a series of non-partisan forums around the country and encourage lawmakers of both parties to participate. Those conferences will culminate in a White House Conference on Social Security in December after which you will convene the leaders of Congress to craft bipartisan legislation to strengthen the Social Security system.

You will be introduced by Mannone (Ma-non) Butler, a third-year student at Georgetown Law School's evening program. She is paying for law school by working at the Georgetown University Office of Residence Life, where she supervises the RAs. Mammone was born and raised in Washington, D.C. and attended public schools here. Her mother, Veronica Butler, lives in D.C. with her grandmother, Frances Hume (who may not be well enough to attend, but Mammone will reference her in speak.) She graduated from Georgetown in 1995 with a degree in Finance and worked for one year for Project Pact, part of Attorney General Reno's Violence Prevention programs. She is a 25-year-old African American.

III. PARTICIPANTS

Pre-Brief

Gene Sperling
Maria Echaveste
Ken Apfel, Commissioner, Social Security Administration
Paul Begala
Ann Lewis
Peter Orszag
Laura Graham

Event

POTUS
VPOTUS
Father Leo O'Donovan, S.J.
Mannone Butler, Student, Georgetown Law School
Ken Apfel, Commissioner, Social Security Administration
Senator Bob Kerrey
John Rother, AARP
Tim Penny, Concord Coalition
Several hundred audience members, mostly students, and representatives from senior groups, youth groups, and groups concerned with entitlement reform. (List attached)

IV. PRESS PLAN

Open Press

V. SEQUENCE OF EVENTS

Father O'Donovan, President of Georgetown University introduces VPOTUS

The Vice President speaks and introduces a student, whose grandparent will be in the audience.

The student will talk about her generation's fears about Social Security and will introduce you.

You will speak and use the charts (attached) to spell out the challenge confronting us. You will have a hand-held microphone to allow you to move toward the charts.

You will depart.

VI. REMARKS

To be provided by speech writers.

PRESIDENT CLINTON'S COMMITMENT TO STRENGTHENING SOCIAL SECURITY FOR THE 21ST CENTURY

February 9, 1998

THE SOCIAL SECURITY SYSTEM. Since its inception in 1935, the Social Security system has proven to be an outstanding success in providing security and dignity for retired and disabled workers, as well as their families and survivors. The elderly poverty rate has fallen from more than 35 percent in 1959 to just 10.8 percent in 1996. Social Security benefits keep roughly 15 million Americans out of poverty. Those benefits represent more than 75 percent of income for elderly households in the bottom 40 percent of the income distribution, and are particularly important to the economic security of elderly widows.

THE LONG-RUN CHALLENGE. The Social Security system is expected to face increasing strains, because the retirement of the baby boomers means that the number of retirees is expected to grow much faster than the number of workers. There are currently just over 3 workers who contribute for every Social Security beneficiary. By 2030, it is expected that there will be only 2 workers for every Social Security beneficiary. According to the intermediate projection of the Social Security Trustees Report, the retirement of the baby boomers is expected to cause the Social Security Trust Fund to start falling by 2019, and to be depleted by 2029 -- at which time income to the system would only be sufficient to pay about 75 percent of current law benefits.

PRESIDENT CLINTON'S APPROACH TO SOCIAL SECURITY REFORM. President Clinton is strongly committed to strengthening Social Security over the next two years. His plan includes:

(1) Putting Our Fiscal House in Order. Before we could begin to address the long-run problems in Social Security, we first had to solve our immediate fiscal problem. Under President Clinton's leadership, we have now done that. The budget deficit has fallen from $290 billion in 1992 to $22 billion last year, and President Clinton's FY 1999 budget will produce balance by next year.

(2) Surpluses Reserved Pending Social Security Reform. As the President emphasized in his State of the Union address, the projected budget surpluses should be reserved pending Social Security reform. Until we address the critical challenge of strengthening the Social Security system and ensuring retirement and disability security for America's workers, as well as their families and survivors, we should not use the projected surpluses for anything else.

(3) Nonpartisan Regional Conferences in 1998. The President believes that we must use 1998 to engage in a national discussion about Social Security reform. He urges all Americans to participate in the debate. The President or Vice President will attend several nonpartisan and balanced regional conferences, and will also host a conference on private retirement savings in July. The President and Vice President also encourage other groups to organize conferences. The upcoming year-long effort should allow all Americans to express their views, and hear the views of others.

(4) White House Conference. At the end of the year, the President will host a bipartisan White House Conference on Social Security as a culmination of the various conferences, forums, and discussions held throughout the year. The purpose of the White House conference is to bring together the lessons learned from the national dialogue.

(5) Bipartisan Negotiations in January 1999. Following the White House conference at the end of the year, the President and his team will begin negotiations in January 1999 with bipartisan Congressional leaders and members over Social Security reform. The President is firmly committed to strengthening the Social Security system.

...CKGROUND ON CHARTS USED IN PRESIDENT CLINTON'S PRESENTATION ON SOCIAL SECURITY

February 9, 1998

1: Elderly Poverty Rate

The Social Security system has helped to bring about a dramatic reduction in elderly poverty. As the chart shows, the elderly poverty rate has fallen from more than 35 percent in 1959 to just 10.8 percent in 1996. In both 1995 and 1996, the elderly poverty rate was below 11 percent -- lower than any other year on record.

Social Security benefits keep roughly 15 million Americans out of poverty.

Without Social Security benefits, the elderly poverty rate today would be almost 50 percent.

Social Security benefits are particularly important for the low-income elderly. They represent more than 75 percent of money income for elderly households in the bottom 40 percent of the income distribution.

Chart 2: Worker-beneficiary ratio

- The Social Security system faces a long-run challenge because people are having fewer children and living longer. As the Baby Boom generation retires, the elderly population is expected to double by 2030 -- from 35 million to roughly 70 million. The total population, meanwhile, is expected to increase by only a quarter.

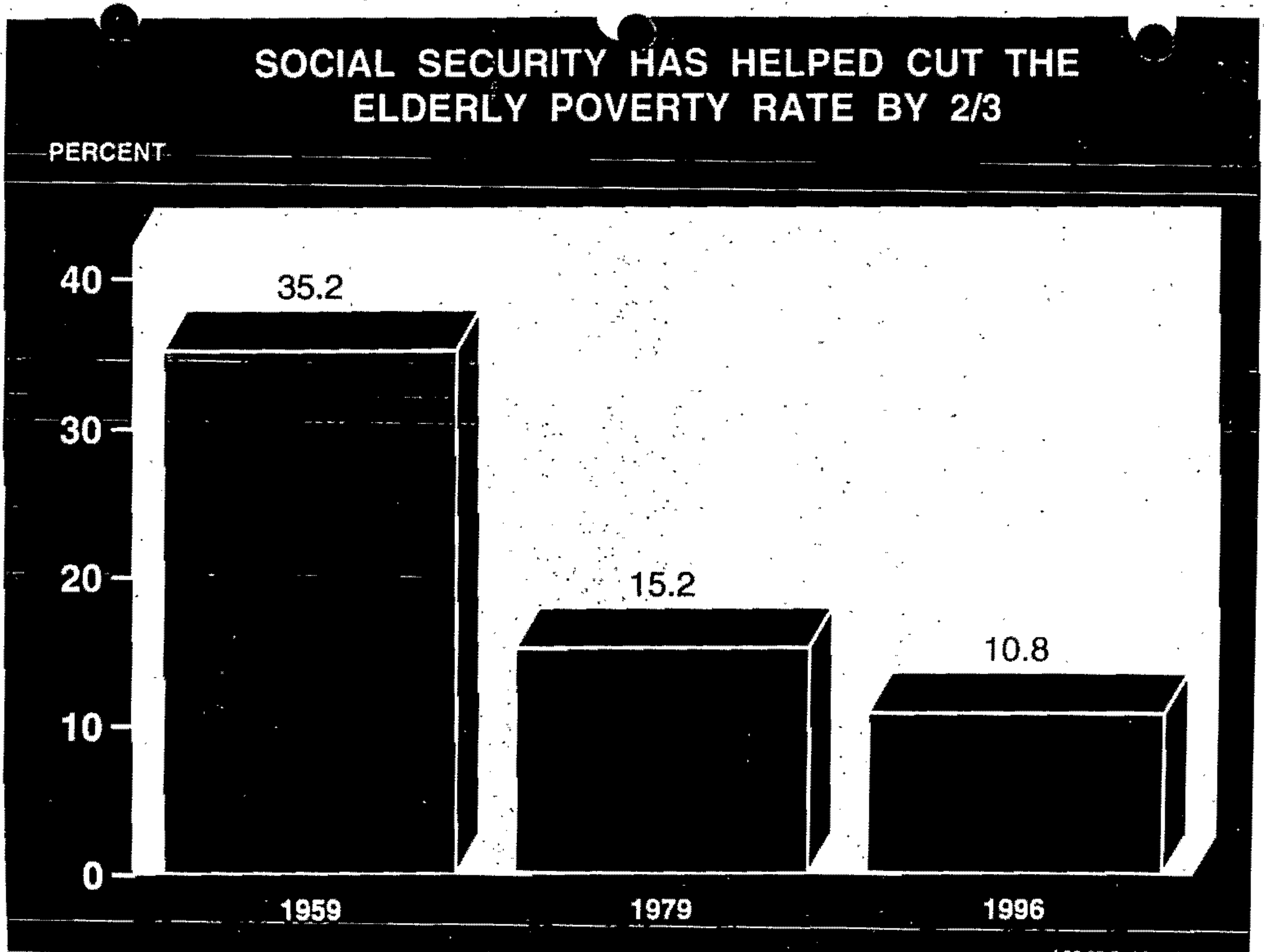
- When the Social Security system first started in the mid-1930's, there were many workers contributing to the system for each beneficiary drawing benefits. Even as late as 1960, there were 5.1 workers for each beneficiary. By 1975, the ratio had fallen to 3.3 -- where it has remained until today.

- As the Baby Boom retires, the number of retirees is expected to grow much faster than the number of workers: By 2030, it is expected that there will be only 2 workers for every Social Security beneficiary (see chart).

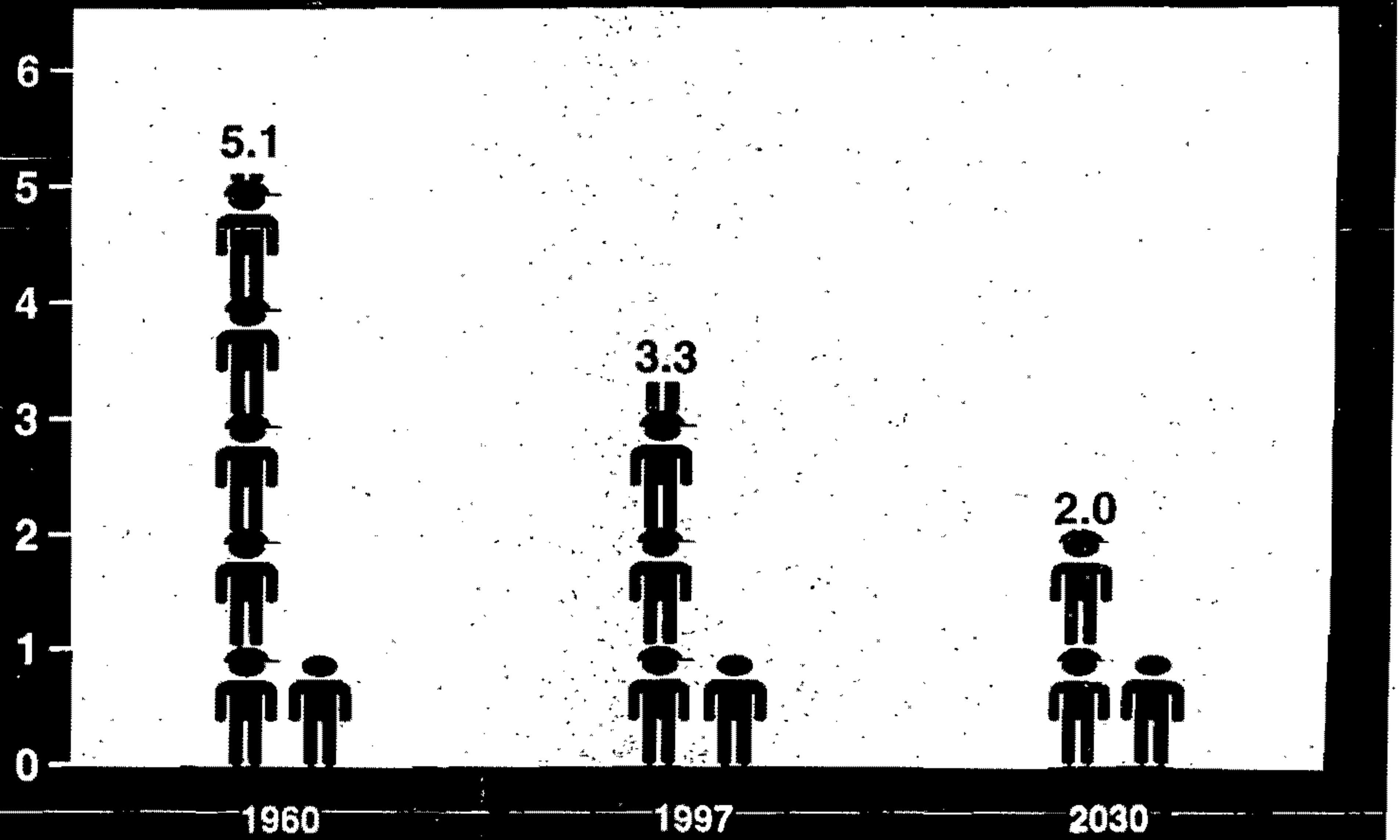
Chart 3: Social Security Trust Fund

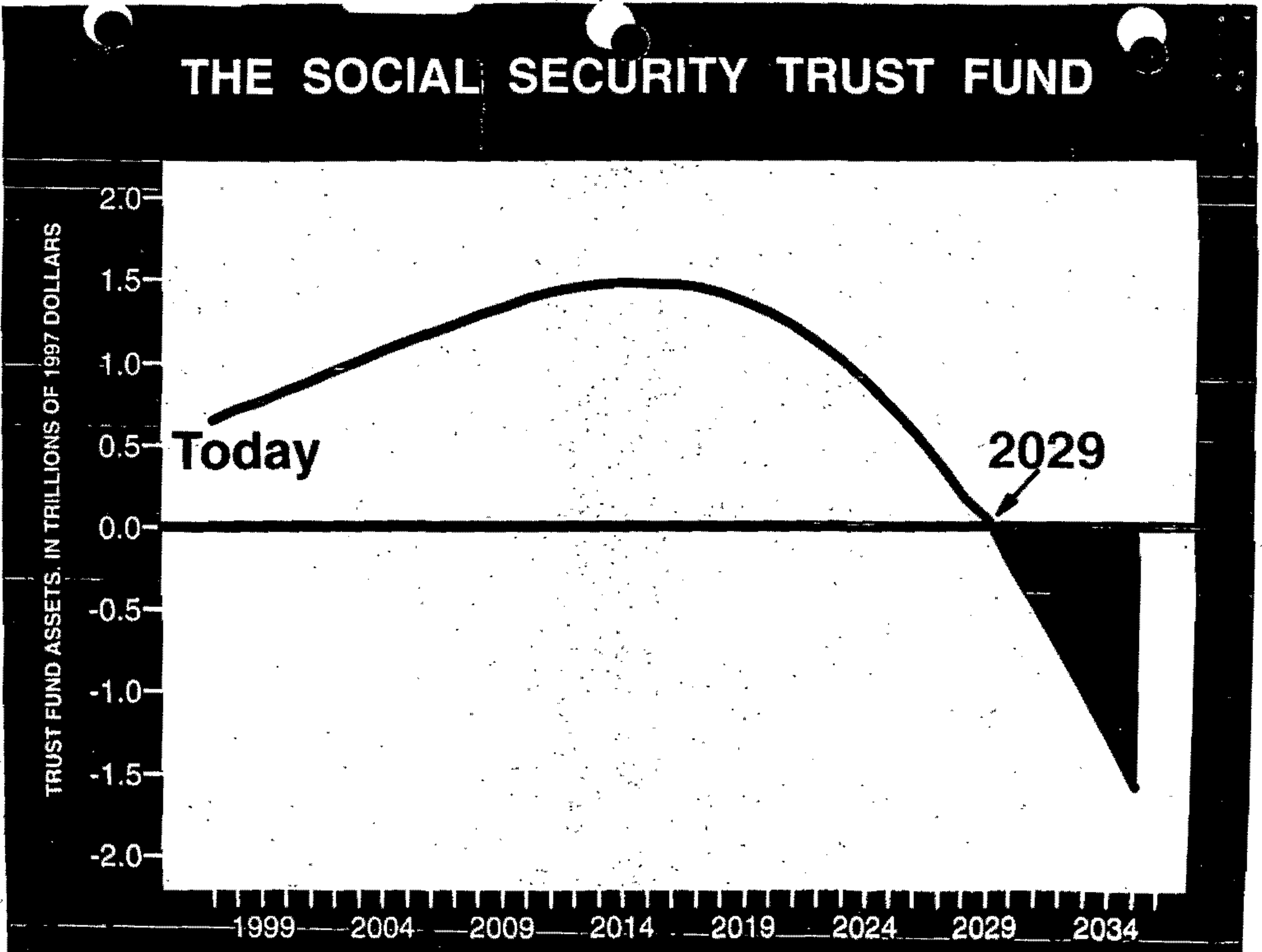
- The Social Security Trust Fund currently stands at about $650 billion. While the baby boomers remain contributing workers in the system, the Trust Fund is expected to continue increasing. For example, it will increase this year by about $100 billion.

- By 2019, as the baby boomers are retiring, income to the system will be insufficient to match all current law benefits, and the Trust Fund is expected to start falling in nominal dollars. By 2029, the Trust Fund is expected to be depleted (see chart). At that point, income to the system would be enough to pay about 75 percent of current law benefits.


SOCIAL SECURITY HAS HELPED CUT THE ELDERLY POVERTY RATE BY 2/3
PERCENT
40
30
20
10
0
35.2
15.2
10.8
1959
1979
1996
ref.98-02-5.eldpovt

NUMBER OF WORKERS PER SOCIAL SECURITY BENEFICIARY





THE SOCIAL SECURITY TRUST FUND
TRUST FUND ASSETS, IN TRILLIONS OF 1997 DOLLARS
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
Today
2029
1999
2004
2009
2014
2019
2024
2029
2034

SOCIAL SECURITY EVENT
Georgetown University
February 9, 1998

Julie Andrews	Salomon Smith Barney
Michael Andrews	Salomon Smith Barney
Bob Bixby	Concord Coalition
Robert Blancato	Matz, Shea, and Blancato
Jim Brett	The New England Council
Debora Briceland-Betts	Older Women's League
Lolita Rockwell Buran	Lockhead Martin
Nancy Duff Campbell	National Women's Law Center
Sharon Canner	National Association of Manufacturers
Carolyn Carlson	EDS-Electronic Data Systems
Susan Cimburek	American Assoc. Of Colleges for Teacher Education
Derek Cressman	USPIRG
Debbie Chalfie	AARP - Women's Initiative
Craig Cheslog	FIRST
Maria Cordone	International Association of Machinist Retirees
Marian Conrad	National Education Association Retirees
Carolyn Colvin	SSA
Todd Crenshaw	National Education Association Retirees
Hilda Crespo	ASPIRA
Susan Daniels	SSA
Nancy Danielson	National Farmers Union
Judge David Davidson	Union of American Hebrew Congregations
Terri Dickerson	American Women in Radio and Television
Jim Dickson	National Organization on Disability
Lucia DiVenere	National Association of Home Care
Joan Donohug	Pension Rights Center
Terry Edmonds	SSA
Steve Elkins	National Association of Manufacturers
Karen Ferguson	Pension Rights Center
Cuauhtemoc Figueroa	League of United Latin American Citizens (LULAC)
Martha Ford	The Arc
Lela Foreman	Communications Workers
Maxine Foreman	AARP - Women's Initiative
Arthur Fried	SSA
Phil Gambino	SSA
Kuyomars Golparvar	Student Body President George Washington Univ.
James Golden	SSA
Stephen Goss	SSA
Jane Gould	SSA Nominee
Sarita Gupta	United States Student Association
Heidi Hartman	Institute for Women's Policy Research

Janis Hazel	Rhythm and Blues Foundation
Richard Hensley	SSA
Cindy Hounsell	WISER
Brian Keane	Third Millennium
Timothy Kelley	SSA
David Kemps	US Chamber of Commerce
Evelyn Knolle	National Committee on Pay Equity
Carla Luggiero	American Hospital Association
Don Mack	SEIU Retirees
Robert McAlpine	National Urban League
Mark Meridy	B'nai B'rith International
Jackie Morgan	SSA
Jonathan Njus	National Council of La Raza
Bob Nickerson	SSA
Becky Ogle	Justice for All
John O'Hanlon	The Washington Group
Rep. Tim Penny	Concord Coalition
Lisa Peoples	SSA
Paula Price	Concord Coalition
Elizabeth Proffitt	Earnst & Young
Steve Regenstreif	AFSCME Retirees
Hans Reimer	2030 Center
Pat Reuss	NOW Legal Defense Fund
Max Richtman	National Committee for Preserving Social Security
Lisa Rickard	Ryder Trucks
Jamie Ridge	Concord Coalition
Elena Rios	Naional Hispanic Medical Association
Patricia Rizzo	Gray Panthers
Kristin Robinson	National Women's Law Center
Mike Rodgers	American Assoc. of Homes and Services for the Aging
John Rother	AARP
Ana Salazar	Mexican American Naional Women's Association
Stacy Savage	WISER
Jenny Schrager	National Committee on Pay Equity
Dan Schulder	National Council of Senior Citizens
Yvonne Scruggs	Black Leadership Forum
Neil Sharma	Student Body President American University
Hilary Shelton	NAACP
Xiomara Sosa	COSSMHO
Marta Sotomayor	National Hispanic Council on Aging
Shelley Spencer	Airgate Wireless
Casey Taminovich	Earnst & Young
Jennie Torres	National Puerto Rican Coalition
David Voight	US Chamber of Commerce
Victoria Wagman	National Council on the Aging

Joan Waiwright	SSA
Roberta Weiner	Older Women's League
Rosalie Whelan	SEIU Retirees
Cassandra Wilkins	SSA
Roy Wyse	United Auto Workers Union
Patt Wyse	United Auto Workers Union

Congress of the United States

Washington, DC 20515

Copies to: Frank Raines, Jack Lew, Stein, Podesta, Sperling, Klain, SMAT, Rahm, Paul

March 5, 1998

Gene for draft response

The Honorable William J. Clinton
The White House
1600 Pennsylvania Avenue
Washington, DC 20500

Dear Mr. President,

In your State of the Union address, you vowed that your administration would "save Social Security first" by putting "100% of the surplus … every penny of any surplus" toward preserving the Social Security system. Yet according to a budget analysis issued yesterday by the Congressional Budget Office (CBO), your budget falls tragically short of that commitment.

Under current law, with no changes, the CBO estimates that we will have total surpluses of $143 billion over the next five years. To meet your promise to put "every penny" of the surplus into Social Security, you must put at least $143 billion – that full amount -- toward debt retirement or other programs designed to strengthen Social Security.

Unfortunately, according to CBO estimates released yesterday, the budget you sent to Congress this year will produce only $100 billion in surpluses over the next five years -- shortchanging Social Security by more than $43 billion over your stated commitment.

Rather than "every penny," your current proposal would put "whatever is left" after tens of billions of dollars have been allocated to your new social spending programs. That is wrong. It is no different than spending all but one dollar of the surplus each year and claiming you are fulfilling your pledge by putting that single dollar toward Social Security.

To truly fulfill your promise to the American people, Mr. President, we urge you to resubmit a budget to Congress that puts at least $143 billion toward debt retirement or Social Security. If you do not, we have no choice but to believe your call to "save Social Security first" was nothing but a hollow election-year rhetorical ploy.

In addition, the CBO estimates that your massive new spending programs will throw the budget completely out-of-balance in the year 2000 – returning us to the days of red ink and deficits. We ask you to ensure that your new budget actually maintains fiscal discipline by locking in a long-term balanced budget – this year, next year, in 2000, and beyond. Talking about fiscal discipline is very different than actually providing it.

Sincerely,

Newt Gingrich | John Kasich | Jennifer Dunn

Newt Gingrich
John Kasich
Jennifer Dunn

THE WHITE HOUSE

WASHINGTON

April 5, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: Background on Social Security for April 7 conference

The purpose of this binder is to provide background information on Social Security reform before the April 7 conference in Kansas City that is being hosted by the AARP and Concord Coalition. The conference is an important step in the year-long process of elevating the Social Security debate, in preparation for the White House conference in December and the beginning of bipartisan negotiations in January 1999. We will be meeting with you tomorrow to prepare for the Kansas City event, and this memorandum provides additional background.

<u>Your Save Social Security First statement in the State of the Union has transformed the fiscal landscape and made Social Security reform the nation's premier policy debate</u>. Prior to that speech, most discussions about the surplus concerned tax cuts or spending initiatives. But you dramatically changed that agenda, and now everyone is trying to fit their proposals into your Save Social Security First framework. Second, by calling for open discussion and bipartisanship, you have potentially lifted the debate on Social Security above its former status as the third rail of politics. Even the mere convening of a bipartisan conference on Social Security during an election year is a remarkable accomplishment. But the threat of that third rail is still with us, which brings us to the third point: our ultimate objective is to get reform done. While some may pressure you for your specific views or your "plan," most informed observers agree that keeping the discussion open and bipartisan at this point offers the best chance for accomplishing reform in 1999.

By being open-minded, not commenting on specific proposals, and encouraging participation in the debate, we have thus far succeeded in keeping the debate substantive and not too politicized. Ideas are now forthcoming, and are being vigorously examined on their merits. For example, Senator Moynihan's recently unveiled plan has received a respectful hearing, but has also generated sharp debate (e.g., strong criticism from Henry Aaron at Brookings). New ideas -- such as using the surplus to fund progressive (equal per capita) contributions into individual accounts for all workers -- are being examined for the first time. In that context, we <u>strongly</u> recommend that your general stance at the April 7 conference be one of promoting bipartisan discussion and listening to ideas, rather than committing in any way to specific proposals or positions.

The purpose of this binder is to identify the key questions that could come up during the conference, and provide the key points that could serve as your anchor for answering them -- however the specific questions are phrased.

TABLE OF CONTENTS

BACKGROUND ON SOCIAL SECURITY

- The elderly poverty rate has fallen from more than 35 percent in 1959 to 10.8 percent in 1996. Even today, with our strong economy, the elderly poverty rate without Social Security would be 48 percent. Social Security benefits lift roughly 15 million elderly Americans out of poverty (and another 1 million non-elderly Americans out of poverty).

- Social Security is very important to women -- for single, divorced, or widowed elderly women, the poverty rate would be 60 percent without Social Security (relative to 20 percent with Social Security).

- Social Security benefits represent the majority of income for two-thirds of elderly beneficiaries, and are the *only* source of income for 18 percent of its elderly beneficiaries.

- Unlike almost any private retirement benefit, Social Security provides a benefit that is both guaranteed for life after retirement <u>and</u> indexed to inflation.

- Social Security is more than just a retirement program. It also provides disability insurance (in case an individual becomes disabled and can't work) and survivors' insurance. Each is equivalent, for the average young family with two children, to an insurance policy of about $300,000 ($600,000 in total). Nearly one-third of Social Security's 44 million beneficiaries are either disabled or survivors (or their dependents).

- 3.8 million children receive benefits: 1.9 million as survivors of deceased parents; 1.4 million as children of disabled workers; and 0.4 million as children of retired workers.

PRINCIPLES FOR SOCIAL SECURITY REFORM

You have already approved the use of general principles to guide Social Security reform, but have not specifically enumerated them in public. Your speech at the Kansas City conference offers an appropriate opportunity to do so. The principles are:

- **<u>Strengthen and protect Social Security for the 21st century</u>**. This principle provides our overall goal in reforming Social Security.

- **<u>Maintain universality and fairness</u>**. This principle is designed to ensure progressivity, and preclude an opt-out option (which would unduly benefit upper-income Americans).

- **<u>Provide a benefit people can count on</u>**. This principle precludes radical privatization, which would undermine Social Security as a foundation of retirement income security.

- **<u>Preserve financial security for low-income and disabled beneficiaries</u>**. This principle highlights disability and survivors' insurance, as well as protection for low-income widows and other beneficiaries -- which are often overlooked in reform discussions.

- **<u>Sustain fiscal discipline</u>**. This principle is intended to ensure that the surpluses are not drained before addressing Social Security reform, and that we maintain our fiscal discipline in order to prepare for the retirement of the baby boomers.

BACKGROUND ON SOCIAL SECURITY TRUST FUNDS

The Concord Coalition and others may argue that the Social Security Trust Funds are not real, that they will bankrupt the budget beginning in 2012, and that we are "raiding" the Trust Funds now. The 2012 question is also addressed on the next page (Long-Term Financing Projections).

TALKING POINTS

Are the Trust Funds real?

- **Trust Funds' Bonds Backed by Full Faith and Credit of U.S.** The special-purpose bonds held by the Trust Funds have the same legal standing as regular Treasury bonds, which are the benchmark of quality and reliability in the capital markets today.

- **Trust Funds Lock In A Legal Commitment *Now* to Finance Social Security Later.** The Trust Funds are real because they represent a legal commitment *now* to finance Social Security later. Under the law, if Social Security requires funds and the Trust Funds have assets in them, the Treasury must make the funds available -- and thus Congress would have to change the law *not* to make good on the Trust Funds' bonds. So the bonds represent a real commitment.

The budget is not really balanced/you're raiding the Trust Fund to pay for other things

- **Unified Balance is Traditional Measure Used to Evaluate Budget.** The unified balance is the traditional metric used to evaluate the budget, and there are good reasons for that.

- **Unified Budget Affects the Macroeconomy.** The unified budget lets us know how much the Federal Government is borrowing from the private sector -- which affects the capital markets and business investment. That's why Alan Greenspan and the Federal Reserve are most concerned with the unified budget.

- **Projections of Unified Budget Let Us Know If We're Going To Run into Trouble.** Projections of the unified budget allow us to see whether we are living within our means or not. We have reduced the deficit from $290 billion in 1992 to roughly balance now and for the first time in 30 years, we expect a small surplus next year -- if not before. And over the foreseeable future, including well into the 21st century, we are projecting substantial surpluses -- even while making good on all our Social Security obligations and *not* raising taxes.

- **The Social Security Surplus is NOT Being Raided.** We are providing bonds to the Social Security Trust Funds to reflect the surplus that Social Security is currently running. Later, those bonds will be have to paid back. Right now, our projections show that we can comfortably pay back the bonds -- without raising taxes -- through 2029. But the goal of Social Security reform is to put the system on a stronger financial footing, and ensure that we can afford to pay for Social Security benefits well beyond 2029 without squeezing other parts of the budget.

LONG-TERM FINANCING PROJECTIONS

The Social Security system is expected to face increasing strains as the nation's nearly 80 million baby boomers retire, as life expectancies continue to increase, and as the fertility rate declines. There are currently 3.3 workers who contribute to the system for every Social Security beneficiary. By 2030, there will be only 2 workers for every Social Security beneficiary.

According to the intermediate projections of the Trustees:

- By 2012, payroll contributions (plus income taxes on benefits) will not be sufficient to pay for benefits due under current law. In order to meet its benefit obligations, the system will have to begin spending some of the interest it earns on the assets in the Trust Fund.

- By 2019, taxes plus interest earnings will not be sufficient to pay for benefits, and the Trust Funds will begin declining, gradually at first, and then more rapidly.

- By 2029, the Trust Fund is expected to be depleted -- at which time income to the system would still be sufficient to pay about 75 percent of current law benefits.

The Concord Coalition is likely to suggest that the Trust Funds will run into trouble starting in 2012, and you may be asked when the critical date is. The talking points below are intended to answer that question.

TALKING POINTS

- **Trust Fund Solvent Through 2029.** The Social Security Trustees currently project that the Trust Fund will be solvent through 2029. And even then, income to the system would still be sufficient to pay about 75 percent of current law benefits.

- **People Often Focus on Different Dates Because of Concern Over The Unified Budget, But Our Projections of Unified Surplus Look Strong.** Some people focus on earlier dates than 2029 because they are concerned that the unified budget will not be able to afford to pay back the bonds that the Trust Fund holds. But we have reduced the deficit from $290 billion in 1992 to roughly balance now and for the first time in 30 years, we expect a small surplus next year -- if not before. And over the foreseeable future, including well into the 21st century, we are projecting substantial surpluses -- even while making good on all our Social Security obligations and *not* raising taxes.

BACKGROUND ON RATES OF RETURN

Gingrich and others are already focusing on the rate of return within Social Security, relative to the rates of return possible on other forms of investment. We need to make clear that the issue is a legitimate one, but note that there are other ways of raising the rate of return (e.g., investing the Trust Funds in equities) and that the Social Security system provides more value than many people realize (e.g., disability and survivors insurance).

TALKING POINTS

- **Rates of Return on Social Security are Positive, Even After Accounting For Inflation, For Almost All Workers.** Rates of return to Social Security are lower than they once were -- but they remain positive, even after accounting for inflation, for almost all workers.

- **Rates of Return Could Be Raised Either Through Individual Accounts, or Through Investing Some of the Trust Funds in the Stock Market.** Both approaches need to be explored carefully in the context of a comprehensive plan, to see whether they meet the principles I have put forward.

- **Finally, Social Security is More Than a Retirement Program.** It provides disability insurance and survivors' insurance -- each is equivalent for the average young family of four to an insurance policy worth about $300,000 ($600,000 in total). And it is low risk: its benefit is always there for you, no matter what happens to stocks, interest rates, or inflation. But most importantly, it reflects our fundamental values and a social compact.

BACKGROUND

The table below presents the real rate of return to Social Security contributions for different types of workers born in different years. Rates of return are:
- Lower for later cohorts;
- Lower for high earners; and
- Lower for single earners than one-earner couples

Real rate of return to Social Security contributions, percent per year

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

BACKGROUND ON MINORITIES AND SOCIAL SECURITY

TALKING POINTS

- **Social Security is Universal.** Social Security is a universal program, which benefits all Americans.

- **Heritage Study is Flawed, and Other Studies Show Different Results.** I understand that the Heritage study's methodology is flawed, and that its results are highly misleading. Other studies, which do not use such misleading methodology, show different results. African Americans and Hispanics do at least as well as other Americans under Social Security.

  -- As just one example, the Heritage study ignores disability insurance, which is a key component of the overall Social Security package and is particularly important to African Americans. In 1995, 18 percent of disabled workers were African-American, even though the group comprises only 12 percent of the U.S. general population.

- **In Addition to Insurance In Case You Become Disabled or Die, Social Security Provides a Positive Real Rate of Return for Virtually All Workers.** Rates of return to Social Security are lower than they once were -- but they remain positive, even after accounting for inflation, for almost all workers.

BACKGROUND

The Heritage Foundation has recently issued several reports suggesting that African Americans have lower rates of return under Social Security than other Americans, and that Hispanic Americans would do better under a system of individual accounts than under Social Security. Despite these claims, rates of return are not lower for minorities than for whites. The methodology used in the Heritage studies is flawed:

- The most important error is that the study underestimates life expectancies, especially for African Americans.

- The study also neglects disability insurance, part of the OASDI benefit package. A study underway in the Office of Research, Evaluation, and Statistics at the SSA suggests that non-whites have fared relatively better under the DI program than whites.

- According to a 1993 Treasury study, the net result of higher mortality rates (which reduce the rate of return), and lower incomes (which raise the rate of return) for African Americans, is that African Americans have earned a slightly higher rate of return (about 0.5 percentage points per year) on Social Security than whites.

- Hispanic Americans do better, on average, than other Americans within Social Security. Hispanic Americans, on average, have *higher* life expectancies and lower incomes than other Americans -- both of which boost their rate of return on Social Security.

REFORM OPTION: RETIREMENT AGE

TALKING POINTS

- **<u>Current Law: Normal Retirement Age 65, But Reduced Benefits Available at 62.</u>** First, we need to understand the current law. The normal retirement age is currently now 65. But you can also retire earlier, as early as 62, with reduced benefits.

- **<u>1983 Reforms Raised Normal Retirement Age to 67 by 2022.</u>** Remember that the 1983 reforms will gradually raise the normal retirement age to 66 by 2005, and 67 by 2022. [The earliest eligibility age will remain 62 under current law.]

- **<u>Some Want to Move Beyond Those Increases</u>.** Many have proposed increasing the retirement age beyond 67, or implementing the increase to 67 more quickly.

<u>PRO:</u>

- **<u>Longer Life Expectancies: Up At Least 10 Years Since Social Security Created</u>.** The motivation for raising the retirement age further is that Americans are living longer -- life expectancy at birth has risen by at least 10 years since Social Security was created. [There are two different ways of calculating life expectancies. By one measure, life expectancy at birth has risen from 62 years in 1935 to 76 years now. By another measure, it has risen from 71 years to 81 years. Either way, the increase has been a "decade or more."]

<u>CON:</u>

- **<u>But Remember Those With Health Problems or Having Trouble Finding Work</u>.** Raising the retirement age could hurt retirees who wish to retire early for health reasons. For example, about 10 percent of workers are in "fair" or "poor" health at ages 60 or 61 -- and they are much more likely to retire at age 62 than other workers.

Additional points

- **<u>60 Percent of Retirees Now Receive Benefits at 62, not 65</u>.** Over the past four decades, the percent of retirees choosing to receive benefits at the earliest eligibility age has risen dramatically. In 1962, only 18 percent of retirees received benefits starting at age 62. That figure has now risen to 60 percent. So we need to think very carefully about how early retirement affects our views about changing the normal retirement age.

BACKGROUND

The normal retirement age (NRA) is the age at which full retirement benefits may first be received. The earliest eligibility age, which is 62, defines the age at which retirement benefits can first be received -- with benefits reduced for each month of early retirement. Similarly, the system provides an actuarial adjustment for delaying benefits until after the NRA. The 1983 reforms included scheduled increases in the normal retirement age:

Birth year	Year reaching 62	Normal retirement age
Before 1938	1999 and before	65
1938-1942	2000-2004	65 + increase of 2 months for per year after 1999
1943-54	2005-2016	66
1955-59	2017-2021	66 + increase of 2 months for per year after 2016
1960+	2022+	67

REFORM OPTION: INVESTING TRUST FUNDS IN EQUITIES

TALKING POINTS

- <u>Important Issue to Be Discussed</u>. Investing the Trust Funds in the stock market is controversial, and will be an important part of our overall debate during the coming year.

- <u>Pros Are:</u>

  <u>1. Higher Returns</u>. Over any reasonably long period of time, the stock market has yielded more than government bonds.

  <u>2. Low Administrative Cost</u>. Having the Trust Fund invest in the stock market offers the possibility of higher returns at very low administrative cost. [Social Security's administrative costs are just 0.8 percent of annual contributions.]

  <u>3. Canadian Example</u>. Canada has recently moved toward investing its Social Security system (the Canada Pension Plan, or CPP) in private securities. Previously, the CPP invested only in provincial and Federal bonds. An investment board has been created, and draft regulations allowing investments in private securities have now been issued.

- <u>Cons Are:</u>

  <u>1. Concerns Over Government Interference in the Stock Market</u>. But investing in the stock market also raises a number of difficult issues. Some are concerned about government interference and politicization of the stock market, and especially about pressures to invest -- or not invest -- in specific firms (e.g., tobacco).

  <u>2. Higher Risk</u>. We have been blessed with a strong stock market. But we need to remember that stock markets fluctuate, and investments in them could therefore entail higher risk. [The S&P 500 index has declined 10 percent or more in *nominal* terms during 8 of past 70 years, and the Nikkei index has declined by more than 50 percent since 1989.]

BACKGROUND

Under the Social Security Act, the Social Security Trust Funds must currently hold assets guaranteed as to principal and interest by the U.S. Government. The Trust Funds therefore hold "special-purpose" Treasury securities, whose yields are tied to the yield on regular Treasury debt. At the end of 1997, the U.S. Social Security Trust Funds amounted to $650 billion.

REFORM OPTION: INDIVIDUAL ACCOUNTS

TALKING POINTS

- **<u>Many Ideas Are on the Table As Part of a Comprehensive Plan. Overall Plan Must Meet Principles</u>.** I have called for the nation to examine the options to save Social Security over the coming year. And as part of an overall plan, many ideas are on the table. Ultimately, what we must consider is whether a comprehensive reform package meets my principles. That's why I don't want to judge any specific element now.

If pressed

- **<u>Opposed to Radical Privatization, but Not Necessarily All Individual Accounts</u>.** I am opposed to radical privatization, which would undermine my goal of providing a benefit that people can count on. At this point, however, I don't want to pass judgment on all forms of individual account proposals. We need to give them a fair hearing, and see whether modest individual accounts could form part of a comprehensive reform that is consistent with my principles.

Additional points

As people study individual accounts, they should fully consider the pros and cons:

<u>PROS</u>

- **<u>Higher Returns</u>.** Individual accounts could allow a higher rate of return than Social Security currently offers.

- **<u>Greater Sense of Control</u>.** Individual accounts also could allow a greater sense of control over your retirement income.

<u>CONS</u>

- **<u>Risk Borne By Individual</u>.** Individual accounts would force individuals to bear more of the risk for their retirement income.

- **<u>Administrative Costs</u>.** Individual accounts would involve higher administrative costs -- for example, compared to the possible alternative of investing the Trust Fund in the stock market. [Social Security's administrative costs are only 0.8% of contributions per year. Individual accounts are likely to be much more expensive -- and could lead to billions of dollars in administrative fees going to Wall Street instead of Social Security recipients.]

- **<u>Transition Costs Could Be Significant</u>.** Some forms of individual accounts involve significant transition costs -- because moving from the current pay-as-you-go system to some forms of individual accounts could force one generation to pay twice (once for their parents, and once for their own individual accounts), or many generations to share those costs.

BACKGROUND

Individual accounts come in many different forms:

- Some would be funded by "carving out" part of the current 12.4 percent OASDI tax;
- Others would be funded by mandatory contributions above the 12.4 percent; and
- Still others would be funded out of the surplus, at least temporarily.

Our ultimate response to individual accounts could depend not only on the rest of the comprehensive package, but also the size of the accounts and on which of these funding mechanisms is chosen. Ken Apfel and others are extremely concerned about any approach that "carves out" part of the 12.4 percent OASDI tax, because that would reduce the funding available to the traditional Social Security system. The second approach, which was adopted by Ned Gramlich, would involve an additional mandatory contribution above the current 12.4 percent and could be seen by some as raising taxes. Finally, funding the accounts out of the projected surpluses is a new idea that the Republicans have discussed publicly and we have examined internally. It could allow the contributions to be extremely progressive -- a flat dollar amount for each worker -- but raises issues such as what to do after the surpluses run out, or if our budget projections turn out to be wrong.

In general, it is worth remembering that moving to a system of individual accounts could involve substantial transition costs -- as high as $9 trillion, for "full" privatization -- depending on how the accounts are set up and financed. Those transition costs reduce the rate of return on individual accounts. Indeed, a recent academic paper concluded that "transition costs mean...that returns under a privatized system would be the same as the current system." The three plans included in the Gramlich commission report highlight this point. The plans involved dramatically different commitments to individual accounts, but produced rates of return which were very similar.

REFORM OPTION: STATE AND LOCAL WORKERS

TALKING POINTS

- <u>**Clearly An Idea That Is On The Table, But Pros and Cons Need to Be Weighed.**</u> This proposal is often put forward as a possible reform. But before we reach any conclusions, we need to study carefully the pros and cons.

<u>**Pros include:**</u>

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

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

<u>**Cons include:**</u>

- <u>**But Impact on Existing State and Local Programs Needs to Be Carefully Examined.**</u> I know that the impact of the proposal would vary greatly across the nation, and that some people -- like the teachers here in Missouri -- are concerned about its effect on existing state and local retirement programs. So we will need to look carefully at this and other proposals over the coming year, to figure out which changes are best to ensure that we strengthen Social Security for the 21st century.

BACKGROUND

Since the Social Security Act of 1935, coverage has expanded from workers in business and industry to include the self-employed, nonprofit groups, agricultural and household workers, the Armed Services, Congress, and all other Federal employees hired after 1983. In 1998, 96 percent of all workers are covered under Social Security -- up from 55 percent in 1939 in 1970.

State and local government employees are the final sizable group of workers not universally covered by Social Security. If such workers are mandatorily covered under a state or local public pension system, they are not mandatorily covered under Social Security. Roughly 30 percent of state and local workers are not covered under Social Security. Many of these workers are in California, Ohio, New York, and Texas. <u>In Missouri</u>, about 23 percent of state and local government employees are not currently covered by Social Security.

Many proposals would <u>expand mandatory Social Security coverage to state and local government workers hired after a certain date</u>. Such proposals would close roughly 0.2 percent of the current 2.23 percent gap. Moving newly hired workers out of the state and local programs that would otherwise cover them could put financial pressure on some state and local programs -- although a gradual phase-in could attenuate any such pressures.

REFORM OPTION: REDUCING COST OF LIVING ADJUSTMENTS

TALKING POINTS

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

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

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

- **Latest COLA was 2.1 Percent.** Recent COLAs have been relatively small because inflation has been low. The latest COLA payable in the January 1998 benefit check was 2.1 percent for OASDI benefits.

BACKGROUND

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

In December 1996, the Boskin Commission concluded that the CPI was overstating increases in the cost of living by 1.1 percentage points per year. Most of your economic advisers believe that the CPI does overstate increases in the cost of living, but that the Boskin figure was too high. And since the Boskin Commission report was issued, the BLS has been working to address many of the biases in the CPI. According to Janet Yellen, recent and planned changes would reduce even the Boskin estimate by about 0.33 percentage point per year -- to about 0.8 percentage point per year. Furthermore, the BLS has indicated some willingness to publish a new index that would correct for upper-level substitution, which would require legislation before it could be used for the COLAs but would reduce the inflation rate by a further 0.15 percentage point. The remaining portion largely reflects the difficulty of accurately measuring quality improvements, and is unlikely to be bridged in a manner that is supported by the BLS. It is the component of the Boskin report that attracted the most criticism within the broader economics community, because its size and perhaps even existence is extremely hard to quantify.

Reducing the COLA by 1 percentage point per year reduces lifetime benefits for the average retiree by roughly 10 percent, and reduces the long-run actuarial imbalance in the Social Security system by 1.4 percent of taxable payroll (out of current gap of 2.23 percent).

REFORM OPTION: TAXES

The next several pages present several different variants of proposals to raise additional revenue for the Social Security system. The proposals range from raising the payroll tax rate, to expanding the earnings base upon which that tax is applied, to taxing benefits.

Our goal should be to

- Downplay need for a payroll tax rate increase;

- Not make comments that take all revenue options of the table (which could be harmful to reform efforts later).

- Not go out of our way to raise issue in way that elicits a destructive "no-tax" pledge from some Republicans.

The best outcome is simply to encourage the principle that people should be open-minded, without raising the tax issue.

The following are a general set of talking points that could be used whenever a tax issue is raised. The subsequent pages provide more detail on various proposals to raise additional revenue.

GENERAL TALKING POINTS ON TAX ISSUES

- **Should Not Have to Increase the Payroll Tax Rate as Part of a Comprehensive Plan.** Most people believe that we should not have to increase the payroll tax rate as part of a comprehensive plan.

- **But Don't Want to Take Things Off the Table -- Give Everything a Fair Hearing.** Nonetheless, as much as possible, we should not take issues off the table.

- **Bipartisan Process for Fair and Workable Solution.** We are confident that through a mutually agreeable bipartisan process, we can come up with a fair and workable solution to strengthening Social Security for the 21st century.

REFORM OPTION: TAXING BENEFITS

TALKING POINTS

- **<u>Should Not Have to Increase the Payroll Tax Rate as Part of a Comprehensive Plan</u>**. Most people believe that we should not have to increase the payroll tax rate as part of a comprehensive plan.

- **<u>But Don't Want to Take Things Off the Table -- Give Everything a Fair Hearing</u>**. Nonetheless, as much as possible, we should not take issues off the table.

- **<u>Bipartisan Process for Fair and Workable Solution</u>**. We are confident that through a mutually agreeable bipartisan process, we can come up with a fair and workable solution to strengthening Social Security for the 21st century.

BACKGROUND

- The partial tax on Social Security benefits does not apply to seniors with income below $25,000 if single or $32,000 if married.

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

  -- For those with income above $34,000 if single and $44,000 if married, up to 85 percent of Social Security benefits are taxable. The additional revenue from taxing benefits at 85 percent rather than 50 percent is credited to the HI Trust Fund, not the Social Security Trust Funds.

- In calendar year 1997, only 25 percent of beneficiaries were subject to taxes on their Social Security benefits.

- One common proposal would <u>extend the tax on Social Security benefits to all persons subject to Federal income tax</u> by phasing out the current income thresholds.

- Even if the thresholds were completed phased out, other provisions in the tax code (e.g., standard deduction and exemptions) would ensure that 30 percent of beneficiaries (those at the lowest income levels) would still not have to pay taxes on their benefits.

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

- Making both changes would reduce the long-run imbalance in the Social Security system by 0.36 percent of payroll -- relative to the current gap of 2.23 percent.

REFORM OPTION: MEANS TESTING

TALKING POINTS

- <u>**Universal Program.**</u> I believe in a universal program -- which is one of my principles. Everyone pays in to the system, and everyone benefits.

- <u>**Progressive.**</u> I also believe the system must be progressive and fair to those who need it most.

- <u>**In 1983, Congress Addressed These Concerns Through the Tax Code -- and We Did The Same Thing in 1993. The 1993 Plan Did Raise the Percent of Benefits Included in Taxable Income for Very High Income Beneficiaries.**</u> In 1993, as part of my economic plan, I did ask the top 13 percent of Social Security beneficiaries to include more of their benefits in taxable income, while protecting the vast majority of beneficiaries from any such increase.

- <u>**Every Idea Deserves a Fair Hearing.**</u> So while I believe in a universal program, I don't know what further steps are needed. I want to look at the whole context -- and see how we can fulfill the principles of both progressivity and universality. I think that every idea deserves a fair hearing. The key is to see whether they make sense as part of a comprehensive plan.

BACKGROUND

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

Subjecting benefits to income tax accomplishes many of the goals of means-testing benefits. For those with income above $34,000 if single and $44,000 if married, OBRA 93 made up to 85 percent of Social Security benefits taxable. The additional revenue from taxing benefits at 85 percent rather than 50 percent is credited to the HI Trust Fund, not the Social Security Trust Funds.

REFORM OPTION: RAISE EARNINGS BASE

TALKING POINTS

- <u>**Should Not Have to Increase the Payroll Tax Rate as Part of a Comprehensive Plan.**</u> Most people believe that we should not have to increase the payroll tax rate as part of a comprehensive plan.

- <u>**But Don't Want to Take Things Off the Table -- Give Everything a Fair Hearing.**</u> Nonetheless, as much as possible, we should not take issues off the table.

- <u>**Bipartisan Process for Fair and Workable Solution.**</u> We are confident that through a mutually agreeable bipartisan process, we can come up with a fair and workable solution to strengthening Social Security for the 21st century.

BACKGROUND

- Under present law, OASDI taxes total 12.4 percent of the first $68,400 in earnings. This limit is indexed to the growth in average wages.

- At present, approximately 6 percent of workers have earnings at or above the cap on taxable earnings. Approximately 15 percent of total earnings are not taxed under Social Security.

- Eliminating the earnings cap (without decreasing the payroll tax rate) would reduce the long-run actuarial imbalance by about 1.55 percent (of the current 2.23 percent gap).

- Eliminating the earnings cap would raise marginal tax rates by 12.4 percent for the 6 percent of workers who currently have earnings at or above the cap.

- Senator Kennedy has proposed eliminating the cap on taxable earnings for Social Security purposes and using the additional revenues to reduce the payroll tax. Because the proposal would reduce the payroll tax, it would not address the long-rang solvency issues facing the Social Security program. Senator Moynihan has proposed an increase in the base so that only 13 percent of total earnings would not be taxed.

REFORM OPTION: ELIMINATE EARNINGS TEST

TALKING POINTS

- **Benefits Are Given Back Later.** First, we need to understand what the earnings test is and what it's not. Under the earnings test, any benefits that are reduced are given back later -- at least on average -- through higher benefits. Nonetheless, many elderly workers perceive the earnings test to be unfair and an impediment to work. This perception may reflect a failure to recognize the adjustments, through which reductions are later recovered.

- **No Limit for Those 70 and Above.** For those aged 70 and above, there is no earnings test.

- **In 1996, We Raised Earnings Limit for Those 65-69.** For those aged 65-69, the earnings limit in 1998 is $14,500. In 1996, working with both Democrats and Republicans in Congress, I approved annual increases in that limit through 2002, when it will reach $30,000.

- **Willing To Examine Whether It Makes Sense to Eliminate.** I am willing to take a look at the earnings test and whether it still makes any sense. We need to see:

  -- Whether eliminating it would help encourage the elderly to make the right choices about whether to work or not,

  -- Whether it would help make the system more understandable and easy to administer, and

  -- Whether we can afford the short-run costs of eliminating it.

BACKGROUND

- Eliminating the earnings limit would have almost no effect on the long-run actuarial balance of the OASDI program. Such a change would have significant short-run effects, however: In the near term, removing the earnings limit for those aged 62 and above would raise Social Security expenditures by roughly $12 billion in 2001.

- For those aged 62-64, the earnings limit under Social Security in 1998 is $9,120. For those aged 65-69, the earnings limit in 1998 is $14,500 (in 1996, you signed into law annual increases in that limit through 2002, when it will reach $30,000). For those aged 70 and above, there is no earnings test.

- If beneficiaries earn more than the exempt amount, their current-year Social Security benefits are reduced. For those aged 62-64, benefits are reduced by $1 for every $2 of earnings over the exempt amount. For those aged 65-69, benefits are reduced by $1 for every $3 of earnings.

REFORM PROPOSAL: MOYNIHAN

TALKING POINTS

- **Year of Debate.** This year should be used to elevate the debate on Social Security.

- **Deserve Credit for Putting Forward a Full Comprehensive Plan.** Regardless of what you think about the specific proposals, Senators Moynihan and Kerrey deserve credit for putting forward a full comprehensive plan to address Social Security reform.

- **Generated Real Debate.** These proposals have already provoked real debate -- with strong views from thoughtful people on both sides. I think what you'll see is that people will put out even more proposals for public discussion and examination as we begin to move toward bipartisan consideration of various proposals.

Additional points

- **Want to Ensure Progressivity.** I do have some concerns that under any plan, those at the bottom end up with a strong benefit. [Henry Aaron has criticized the lack of progressivity in this plan, calling it the "My Lai" of Social Security reform.]

- **COLAs.** There are some elements that are generating heated debate. For example, the plan includes a reduction to the cost-of-living adjustments that Senator Moynihan believes is warranted, but that others do not.

BACKGROUND

Senators Moynihan and Kerrey have put forward a proposal that eliminates the 75-year actuarial imbalance, which includes a very large COLA adjustment, a movement of the system back to purely pay-as-you-go, and *voluntary* individual accounts.

- The plan includes:

-- A COLA reduction of 1 percentage point per year
-- Change in payroll tax to 11.4 percent in 1999-2000, 10.4 percent in 2001-2024, and then increase to 12.7 percent in 2045-2054, 13.0 percent in 2055-2059, and 13.4 percent in 2060+;
-- An increase in the earnings base under which the payroll tax is charged. By 2003, the Moynihan plan would raise earnings limit to $97,500 -- from $82,800 under current law.
-- An increase in the retirement age to 68 by 2017 and 70 by 2065
-- Mandatory coverage of state and local workers hired after 2000, and extension of computation period in calculating benefits from 35 years of earnings to 38 years by 2002.
-- Taxation of benefits like private pensions and immediate elimination of income thresholds.

The net effect of these provisions is to reduce lifetime Social Security benefits by about 30 percent. The plan also provides the *option* of investing up to 2 percent of payroll in a voluntary individual account -- which could make up the lost 30 percent. More specifically, if the individual puts in 1 percent, the employer will be required to match that 1 percent. <u>Our fear is that low-income workers will not contribute to the accounts, and thus will suffer the roughly 30 percent cut in Social Security, with no offsetting retirement income from an individual accounts.</u>

REFORM PROPOSAL: GINGRICH, KASICH, AND ROTH

TALKING POINTS

- **Gratified That They Are Coming Forward With Proposals.** I am gratified that they are coming forward with ideas on Social Security and answering my call to make this a year of debate on Social Security.

- **But Do Not Drain the Surplus Before We Achieve Comprehensive Reform.** I want to stress, however, that the surplus must not be drained before we have a comprehensive reform. The Republican plans for individual accounts are not comprehensive.

Additional point

- **As To Their Specific Idea: Not Yet Decided on Individual Accounts. But If They Are Included, Want Them To Be Progressive.** A major question -- which I am not ready to decide yet -- is whether individual accounts can form part of an overall plan that meets my principles. If they are included in any comprehensive plan, ensuring that they are progressive would be important. I am encouraged that the Republicans are considering how to make such accounts progressive.

BACKGROUND

As we had anticipated when we first discussed the Save Social Security First proposal, the Republicans have responded by proposing that the projected surplus should be used to fund individual accounts. Speaker Gingrich, Representative Kasich, and Senator Roth have all put forward proposals for doing so.

The Kasich plan would use the surplus to fund contributions on an equal per capita basis to all workers, regardless of their earnings (as long as they had minimum annual earnings of roughly $2,800 in 1998, covering 86 percent of workers); Gingrich and Roth have similarly indicated some support for flat per capita contributions. Such a system is even more progressive than traditional Social Security benefits, but is only viable with funding from the surplus (mandatory contributions probably could not be collected on a flat per capita basis, nor could the redistribution involved be possible if the contributions were a given percent of payroll).

As of right now, none of these proposals is a comprehensive reform, since they do not close the long-run imbalance in the Social Security system. Gingrich has argued that we should adopt these accounts now, and worry about the rest of the reform process later. This violates the fundamental principle of Saving Social Security First: No one should spend the surplus until we have put Social Security on a firm financial footing.

REFORM PROPOSAL: COMMISSION

TALKING POINTS

- **I Have Called for Year of Debate and Discussion.** I have called for a year of national debate and discussion on Social Security reform, including a series of non-partisan regional conferences, and culminating in a White House conference in December. Once that process has been completed, in January 1999, I plan to begin bipartisan negotiations with the Congress.

- **Many Organizations are Becoming Involved.** Many organizations are already becoming involved in the effort to elevate the debate on Social Security reform.

  -- For example, the Concord Coalition and the American Association of Retired Persons are jointly sponsoring regional conferences like the one we are having today.

  -- The Pew Charitable Trust is funding a series of conferences in cities and towns across the nation, and many members of Congress are hosting other discussions in their districts.

  -- The Vice President and I, along with members of the Cabinet, look forward to participating in such events throughout the year -- as do many members of Congress.

- **This Open and Inclusive Structure Seems Better Than Legislating a Commission.** Such an open and inclusive structure, without any specific commission, provides the best opportunity for us to elevate the debate this year before beginning bipartisan negotiations next year. We don't need to legislate a commission. We just need to roll up our sleeves, elevate the debate, and get the job done.

- **Complete Work by December.** And regardless of the structure, any activities should be completed by the time of the White House Conference in December -- to ensure that we can begin bipartisan negotiations in early 1999.

BACKGROUND

Archer, Kasich, and Bunning have co-sponsored the "National Dialogue on Social Security Act of 1998," which would:

- Establish a National Dialogue on Social Security to be convened by the President, Speaker, and Senate Majority Leader, and coordinated through two Facilitators (one appointed by the President and the other by the Speaker and Senate Majority Leader).

- Establish a Dialogue Council, including representatives from 18 listed organizations

- Establish a Bipartisan Panel to Design Long-Range Social Security Reform, with 8 members (four appointed by Speaker and Senate Majority Leader, two by the President, and two jointly by Minority Leaders in the House and Senate).

- The Panel would report by February 1, 1999 and terminate by March 31, 1999.

SOCIAL SECURITY ADMINISTRATION

TALKING POINTS

- **SSA Is One of the Best Run Organizations Within Government.** The Social Security Administration (SSA) is one of the best run organizations within government.

- **Very Efficient: Costs are Less than 1 Percent of Benefits.** SSA is noted for its efficient and effective service. SSA's administrative costs are less than 1 percent of benefit payments.

- **Ranks Very High on Customer Surveys.** Surveys of SSA's customers have shown that the agency gets consistently high marks from its customers for prompt, courteous, and accurate service whether they are dealing with one of SSA's local offices or with the 800 Number Service. SSA's 800 number has been rated better than almost any other public or private sector toll-free number service, including such well-known services such as the L.L. Bean catalog. (SSA's 800 number is 800-SSA-1213).

- **Commissioner Apfel Would Be Happy to Look Into Any Problem.** I am sure that the poor service you received is the exception and not the norm. I know that Ken Apfel, Commissioner of Social Security, is committed to providing world-class service to all of SSA's customers because SSA takes pride in its customer service. [Commissioner Apfel will be glad to assist you in resolving your problem.]

BACKGROUND

In fiscal year 1997, the Social Security Administration served over 55 million individuals who called the 800 number, making it one of the largest toll-free service systems in the world. SSA's achievements in this area have been recognized by Dalbar Associates, an independent auditing agency, which rated SSA's toll-free telephone service as one of the best--and better than many in the private sector.

THE WHITE HOUSE

WASHINGTON

April 10, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

RE: NEC WEEKLY REPORT

cc: ERSKINE BOWLES

Social Security: The Kansas City conference on Social Security that you attended on Tuesday (4/7) has been widely hailed as an outstanding success. It was featured prominently on all three network news programs on Tuesday evening, and you received extremely positive comments from the elite media. It may have been the first time in a decade that Social Security was discussed on all three networks on the same night. The *Washington Post*, for example, wrote in an editorial that "The Social Security forum in which the President participated Tuesday -- the first of four that are planned this year -- was a serious, substantive discussion of a subject that has hitherto been supposed to be politically taboo....The President...called attention to the trade-offs that will be required to finance the retirement not just of the baby boomers but the generation to follow. That's good. It's what people need to understand." Warren Rudman asked me to tell you that he thought you had done extremely well at the Conference and that he thinks you are handling things just right. David Broder also called to compliment us on the Conference. Looking forward, the 1998 Social Security Trustees' Report will be released on April 28. We expect the new numbers to be somewhat more optimistic than last year's report (which showed the Trust Fund being depleted in 2029 and a 75-year actuarial imbalance of 2.23 percent of payroll). In addition, we are continuing our ongoing analysis (with Treasury, SSA, OMB, CEA, and other relevant agencies) of various reform options, and will soon begin preparing for the next regional conference.

Fair Housing Act 30th Anniversary: The NEC, working with the DPC and HUD, prepared a Presidential statement, issued on Friday (4/10), commemorating the 30th anniversary of the Fair Housing Act (it was passed on April 10th and signed by LBJ on April 11). The statement also calls for Congress to provide the full $22 million funding increase requested by the Administration, in the FY 99 budget, for HUD's fair housing enforcement efforts. Ten million dollars of the increase would fund a new paired testing initiative in 20 metropolitan areas. Paired testing, in which otherwise identical white and minority testers (for example, same income, type of job, job experience) approach realtors or landlords, is perhaps the best way to detect the subtler housing discrimination prevalent today.

Indonesia IMF: As you know, Indonesia announced an agreement with the IMF on a revised reform program, as expected. It recommits the Indonesian government to structural reforms, introduces tighter controls on money and interest rates and permits added flexibility on food and fuel subsidies in the context of overall budgetary targets. In addition, by releasing the next disbursement in monthly installments rather than as a lump sum payment, the agreement is intended to strengthen accountability on program conditions. The market reacted positively to the added accountability, but is likely to remain wary until details on corporate debt restructuring are finalized later this month.

Higher Education Act: The House may bring up the bill on the floor the week of May 20, which would make your Teacher of the Year speech that Friday too late for a veto message on master teachers. There is concern that even with a veto threat -- and even if Democrats stick together on an amendment to strip the master teachers provision out of the bill -- the overall legislation will likely pass overwhelmingly, undermining our leverage in the Senate and in conference. We are meeting with DPC, OMB, OLA and Education to discuss options. Among other things, we will explore the extent to which this issue should be combined with the interest rate and other issues. ***Interest rate:*** My staff and OMB will be meeting on Tuesday (4/14) with Budget Committee staff to attempt to begin some real negotiations. ***Old Professors:*** The House bill includes a provision that would allow colleges to offer financial incentives for tenured professors to retire early, to make room for younger (and generally lower-paid) professors. The EEOC -- and the AARP -- have opposed this provision as permitting "age-based, arbitrary distinctions in employee benefit plans which would disadvantage older workers" (for example, a college could make an offer to professors that are 55, but not 65, thus encouraging *early* retirement). The colleges argue that the tenure system is unique, and that this will allow them to diversify the faculty. My staff is working with Education, DPC and the EEOC to determine whether there is any reason to reconsider the Administration's position on this issue. ***High Hopes:*** On the positive side, High Hopes is in the bill and we are trying to get more Republican votes to secure its inclusion in the House Floor vote.

Citicorp-Travelers Merger -- The Impact on Financial Modernization: On Monday (4/6), Citicorp and the Travelers Group announced the largest corporate merger ever, joining two firms each valued at $70 billion before the announcement. The new firm, Citigroup, Inc., will serve over 100 million customers in 100 countries with commercial banking, credit cards, insurance, securities brokerage, and investment banking services. Under current law, Citigroup must divest itself of insurance underwriting activities after several years; this announcement therefore, is expected to increase interest in the financial modernization legislation, which would permit integration of insurance underwriting and banking. As you know, the Administration's SAP on the Republican House Leaders' bill stated that the Secretary of the Treasury would recommend a veto if that bill were presented to you, because it would diminish the value of the National Bank charter and the effectiveness of the Community Reinvestment Act. The NEC has an ongoing process to frame the Administration's strategy.

Privacy: The NEC and DPC have started a deputies process to pull together various small groups working on discrete aspects of this issue and identify options for strengthening the privacy of Americans. Americans are concerned that they are losing control over their personal information. As they shop, subscribe to a magazine, visit a Web site, or fill a prescription, they are leaving "electronic footprints." New technologies make it easier to aggregate these transactions into "electronic dossiers." Options being discussed include: strengthening industry self-regulation; supporting legislation that protects privacy in a particular sector (e.g. medical records); and creating a privacy "entity" within the federal government that plays a coordination and advocacy role. This is a complicated issue - since privacy must also be balanced against law enforcement, First Amendment, and commercial considerations.

Child Labor - Santiago: Your upcoming Santiago trip (4/15- 4/19) is another opportunity for you to promote your international child labor agenda, call for contributions from other nations, and energize domestic support for your budget request for $30 million for IPEC. The NEC is working with Labor and AID to prepare an announcement of a $2 million initiative to combat child labor in Central America. The initiative will include $1 million in IPEC funds and $1 million in AID funds. The funds will support a survey and database on child labor in Central America, as well as a series of demonstration projects to explore approaches to removing children from hazardous work (e.g., shellfish harvesting in El Salvador, sugar cane plantations in the Dominican Republic, child prostitution in Costa Rica, and exploitation of girls at bus stations in Nicaragua). Special emphasis will be given to a Guatemalan project aimed at the complete elimination of child labor in two sectors -- fireworks manufacture and stone quarries -- and producing a successful model that can be emulated throughout Central America.

Santiago Trade: There is now widespread support for a strong and comprehensive launch of negotiations toward the Free Trade Area of the Americas (FTAA) at the Santiago Summit of the Americas, including the creation of a consultative group on labor and the environment. Inevitably, the press will be looking to write about the impact of our fast track loss on the hemispheric trade agenda. Against that backdrop, we believe you should be very forward leaning on trade. We have made tremendous progress on the FTAA and secured our highest priorities even without fast track. Going forward, the tremendous opportunities in the hemisphere make the case for fast track more compelling than ever.

Japan: As you know, Prime Minister Hashimoto unveiled plans on Thursday (4/9) for additional temporary income-tax cuts totaling four trillion yen ($30.5 billion) and fresh government spending of six trillion yen. Although the package was slightly larger than expected and represented an important and politically difficult shift for Prime Minister Hashimoto, Treasury believes it will not likely produce a decisive upturn in Japan's economy. If implemented quickly, it should help avoid a more serious decline, but both we and financial markets eagerly await more details on the package. Hashimoto also said he would ask a special advisory committee to consider revising Japan's budget-deficit control law, which he must do to increase spending and reduce taxes. Publicly, we are stating that we welcome the announcement and look forward to seeing more details. We are emphasizing that it is crucial for Japan put in place a strong program. Secretary Rubin also stated Thursday (4/9) that we shared Hashimoto's concern about recent weakness in the yen, and welcomed the intervention by Japanese authorities to support the value of the yen. The U.S. government did not intervene.

U.S. France Civil Aviation Agreement: On Wednesday (4/8), U.S. negotiators concluded a new civil aviation agreement with France that will significantly increase air service between our countries and choice for American business travelers and tourists alike. This is our third largest market in Europe. Until this week, it was also our largest aviation market not governed by a bilateral agreement. The lack of such an agreement since France renounced our prior agreement five years ago has stifled U.S. carrier operations and market growth. The new agreement will eliminate all restrictions on airline operations between the United States and France in five years. It gives U.S. airlines extensive rights during the transition period that will enhance their ability to compete in this market (increased routes, broad ability to codeshare, pricing freedom). American Airlines had expressed concern about the terms on which it would have to move from Orly Airport (which will be restricted to shorter flights) to Charles de Gaulle, but the we worked with U.S. negotiators to obtain a commitment from the French Government that American would receive the best possible conditions in their new location.

DOT Competition Guidelines: As you know, Secretary Slater this week announced proposed guidelines designed to discourage the major air carriers from predatory pricing designed to drive new low-fare carriers out of the majors' hub markets. OMB and NEC staff held up an earlier draft of the guidelines (which, unfortunately, was leaked to the ***Wall Street Journal***), not because of any substantive disagreement but to make it more understandable to non-economists and less vulnerable to attack. The revisions helped: although the majors, predictably, charged DOT with "reregulating" the airline industry, the guidelines attracted a good deal of primarily positive press coverage.

U.S.-EU Trade Initiative: On Wednesday (4/8) the NEC deputies working group met to review interagency thoughts on a U.S. proposal. The working group continued exploratory discussions through out the week with their EU counterparts. The NEC deputies will meet next week to finalize a U.S. proposal, which will then be subject to NEC Principals and your review.

Sanctions: An NEC/NSC working group met this week to: 1) develop an Administration position toward Hamilton-Lugar legislation seeking to improve Congressional and Administration processes toward sanctions decision making; and 2) improve data and analysis in connection with consideration of sanctions on Nigeria. NEC Deputies will meet next week to consider the legislation and a business community challenge to a Massachusetts sanctions law, in which the federal government may be asked to intervene.