THE WHITE HOUSE

WASHINGTON

April 24, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

RE: NEC WEEKLY REPORT

cc: ERSKINE BOWLES

1998 World Competitiveness Report -- America: The World's Most Competitive Economy Again: On Monday (4/19), the Institute for International Management Development (IMD) released their 1998 World Competitiveness Report. For the fifth year in a row, the United States was ranked the most competitive economy in the world. The IMD cited our strong economy, massive domestic investments, labor market flexibility, and deregulation as the reasons for our #1 ranking. In 1992, they ranked the United States #5 -- behind Japan, Germany, Denmark, and Switzerland. This report used to be prepared jointly by IMD and the World Economic Forum. However, they split in 1995 and decided to publish rival surveys, with IMD maintaining the same methodology and the World Economic Forum developing an alternative survey. You should know that while IMD ranked the America #1 in 1997, the World Economic Forum placed the U.S. at #3, behind Singapore and Hong Kong. The World Economic Forum has not yet published their 1998 competitiveness report.

IRS Hearings: The Senate Finance Committee will begin another round of hearings next week, beginning on Tuesday. The hearings will focus on the Criminal Investigations Division of the IRS and are going to be more sensational than the previous hearings. The Senate Democrats have been completely excluded from the process and are angry. Senator Daschle has criticized the Republicans in advance of the hearings. We believe that Moynihan wrote a letter to Roth that was sent on Friday--we don't expect it to be leaked until Sunday. On Wednesday, Rahm, Paul, and I met with Secretary Rubin to discuss our strategy. The IRS and Treasury have been actively recruiting a major law enforcement figure to head up an investigation into the criminal division. Treasury and the IRS are trying to finalize the arrangement by early next week. Commissioner Rossotti has asked Chairman Roth that he be allowed to testify at the outset of the hearings. Roth is apparently going to reject the request and Rossotti is likely to testify at the end on Friday. He will give strong testimony, expressing no tolerance for the types of abuses raised. Either at that time or before, the IRS will likely announce Administrative actions in response. Treasury is also working on possible relevant amendments that could be added to the IRS reform bill when it moves to the Senate floor.

Unemployment Insurance Reform: On Thursday (4/22), the Department of Labor transmitted to the Hill the reforms to the Unemployment Insurance (UI) system included in your FY99 budget. The legislation was subsequently introduced by a bipartisan group of Congressmen: Levin (D-MI), English (R-PA), and Rangel (D-NY). Our proposals strengthen the UI safety net in three ways: (1) it provides incentives to States to implement administrative systems that will make the program more accessible to low-wage workers, increasing the proportion of unemployed workers receiving UI; (2) it revises the program's unemployment triggers to make extended benefits more readily available during recessions, helping to avoid situations like the one that arose during the last recession when the Federal government had to allocate $28.5 billion to provide extended benefits to unemployed workers: and (3) it provides incentives to States to voluntarily improve the solvency of their unemployment trust funds and thereby their ability to pay benefits if unemployment increases. These proposals are a first step toward more comprehensive reform. An interagency NEC working group will continue to meet to develop more extensive reform proposals.

Social Security: Three developments on Social Security are worth noting this week. First, the Ways and Means Committee approved the Archer commission bill by voice vote on Wednesday (4/22). In addition to creating a formal National Dialogue on Social Security (led by two Facilitators and a Dialogue Council, with representation from a long list of interest groups and think tanks), the bill creates a commission charged with designing a single package of long-term Social Security reforms. While we do not object to the National Dialogue component we have three serious concerns about the commission. First, we are worried that the commission (through leaks and perhaps periodic reports) could politicize the Social Security Reform efforts before the November elections. Second, the commission's reporting date (Feb 1999) is after the date we had hope to start negotiations thus delaying reform. Third, it is not clear at this point precisely what mechanism will be the best one to get reform done-- and legislating a commission could restrict our flexibility. You should also know that Speaker Gingrich has asserted publicly that Erskine had said that we would sign the bill in its current form. This is not true. What Erskine told Speaker Gingrich was that we are willing to listen to their idea and work them to see if there is an acceptable compromise. I have been in contact with the bi-partisan Leaders staff to explore possibilities.

Second, Senator Gramm held a press conference on Wednesday to release his reform proposal, which involves a 3 percent individual account starting January 1, 2000. Gramm claims to finance his proposal by using the projected surplus, reducing Social Security benefits by $1 for every 72 cents withdrawn from an individual account, and earmarking for Social Security the additional corporate income taxes he assumes will result from higher national saving under the plan. Gramm has not yet subjected his proposal to scrutiny by the Social Security actuaries, however, his estimates are likely to prove inaccurate--particularly because of his unrealistic assumption of dynamic scoring to preserve existing benefits.

Social Security Trustees Report: The 1998 Social Security Trustees report will be released next Tuesday (4/28). Outside experts are expecting a slight improvement relative to the 1997 report (which showed a 75-year actuarial imbalance of 2.23 percent of taxable payroll, and forecasted that the Trust Fund would be depleted by 2029).

Medicare Trustees' Report: Although there will be no information released on the status of the Trust Fund prior to the official release on 4/28, it seems clear that results from a recent analysis will hold: that the BBA reduced the 75-year actuarial deficit of Medicare by about one half. It is unclear whether the precise year of Trust Fund exhaustion will remain at 2010. You should have a chance on Tuesday to comment on the Social security and Medicare numbers.

AARP to Release Positive Analysis of the Medicare Buy-In: Next Thursday (4/30), the AARP will hold a press conference to release an actuarial analysis of the Medicare buy-in. We understand that the analysis confirms both our Actuaries' and CBO's estimates of the premiums and suggests what the premiums would be if age eligibility were raised to 67. The American Academy of Actuaries may release a report in May with similar findings. Attention is also being directed toward the buy-in through a series of public forums. Chris Jennings spoke at one of these forums this week, and another is scheduled for late May. Moynihan is considering holding hearings.

H-1B: Last week Sally Katzen and Elena Kagan met with House members and their staff to further discuss pending H1-B legislation. We anticipate that the House version of legislation to increase the number of temporary (H-1B) visas for foreign "specialty" workers will contain strong reforms to the H-1B visa program (as we have advocated for several years) and a training component (to insure that U.S. workers can obtain the skills needed by employers.) We expect Reps. Smith and Watt will introduce such a bill sometime next week. Also, we can expect that this issue will move quickly in both the House and the Senate because the current cap (of 65,000) on the number of H-1B visas is expected to be reached by mid-June.

G. I. Bill: If all goes well the Senate version of the G. I. Bill, the Workforce Investment Partnership Act, will reach the floor next week. We clearly support passage of the bill, but there is an amendment to the current Senate bill by Sen. Ashcroft that threatens the Administration legacy on School-to-work that the Administration strongly opposes. I spoke with Senator Kennedy myself several times to discuss strategy and we decided not to fight the amendment now in order to move the bill through the Senate, because Sen. Kennedy has gotten verbal commitments from Sens. DeWine and Jeffords to work with us in Conference to address our objections to the Ashcroft Amendment. Larry Stein also recommends this strategy.

Bankruptcy: As you know, the startling increase in consumer bankruptcy filings (1.3 million in 1997, an almost 400% increase since 1980) is giving momentum to an effort to make significant changes to the Bankruptcy Code; however, dramatically different diagnoses of the problem have produced varied approaches. Credit card companies argue that consumers are abusing the bankruptcy system and so advocate a new "needs-based" approach to bankruptcy, which would force some of those who can afford to repay a share of their debts to do so. These proposals are sharply criticized by consumer groups who blame the increase in bankruptcies on excessive credit extension. They offer competing proposals that would not allow collection of certain debts in bankruptcy if the credit were imprudently extended. The lack of definitive information and analysis cautions against a radical departure from the historic structure of the Bankruptcy Code, but some changes may be warranted. The NEC is running a process to develop a package that appropriately balances consumer and creditor interests and a strategy to address legislation moving on Capitol Hill.

Apparel Industry Partnership: Much to everyone's surprise, the AIP survived another meeting this week without defections. Secretary Herman and I pressed both sides to make reasonable compromises. Modest progress was made on external monitoring requirements and the Association's authority to address companies doing business in a country whose laws or practices make it impossible to be in compliance with the Code (e.g., China, where freedom of association and freely chosen unions are not recognized). Cooperative public behavior notwithstanding, we have reason to believe that we still face the possibility I warned of last week: UNITE (the key apparel industry labor union) departing, the other unions and NGOs unable to remain without UNITE, and the companies proceeding alone. We should have a report from the Labor/NGO caucus early next week. We will coordinate closely with DoL and Karen Tramontano and make recommendations to you on how to proceed.

Child Labor: The NEC convened a meeting (4/24) of DoL, State, Treasury/Customs, AID, USTR, NSC, OMB, and White House officials to get reports on child labor activities throughout the government and better coordinate activities to advance your child labor agenda. A working group will meet biweekly to produce a detailed Child Labor Action Plan and calendar. Topics include: advancing your FY 99 budget initiative; the U.S. role in promoting the ILO Convention on Child Labor; the Customs Service's child labor enforcement efforts; a strategy to respond to Rep. Chris Smith's legislation proposing international sanctions for child labor; better use of opportunities to highlight your child labor message; and better advance planning and coordination in connection with overseas trips.

Future of Manufacturing Extension Partnership: NEC staff this week chaired a Commerce-EOP meeting on the future of the Manufacturing Extension Partnership, which will be one of your legacies in technology policy. We have succeeded in achieving our start-up goals for MEP: a demand-driven network of 70 locally managed centers (up from 7 in 1992) in all 50 states that reach about 30,000 small manufacturers a year, half of them repeat customers. It is now time to stretch the goals and scope of MEP by optimizing this remarkable network and improving the effectiveness of program services. (For example, the current focus on helping firms manufacture commodities more efficiently needs to shift toward helping them develop higher value products.) To help us think about this more systematically, we agreed to ask the National Academy to organize a workshop on the future of the MEP.

User Fees for FAA: On Monday (4/20), Secretary Slater and Administrator Garvey announced legislation to make the FAA operate more like a business. Specifically, FAA air traffic control services would be centralized in a Performance-Based Organization and services for commercial (not general) aviation would be funded by cost-based user fees. These proposals largely mirror the recommendations of the National Civil Aviation Review Commission (chaired by Norm Mineta), with which OMB and NEC worked closely. NCARC's support for user fees followed from a similar recommendation by last year's "Gore Commission" on Aviation Safety and Security. As NEC director, Laura Tyson served on the Gore Commission; the NEC was the major champion for user fees, overcoming initial opposition from a majority of other commission members who preferred to continue the existing ticket tax.

Student Loan Interest Rates: Representative Armey and others are pushing for a "fix" to be included with the supplemental appropriations bill. Because it is the only truly time-sensitive driver on the HEA reauthorization, moving the interest rate provision to the supplemental unfortunately reduces the likelihood of Congress sending you a Higher Education reauthorization bill. But we may not be able to stop this from happening, so we will likely be involved in negotiations over the weekend. As you remember, the current interest rate proposal in Congress adopts the rate we recommended for students, but has taxpayers footing the bill for additional subsidies to banks. We have objected. *It is possible that we will have to sign on to a compromise that will involve a higher rate for students* than we proposed (for example, a 60 basis point reduction from today's rates rather than 80 basis points).

America Reads: On Thursday (4/23) Sen. Coverdell himself proposed to add the language of the House-passed Reading Excellence Act as one of the many amendments proposed to the Coverdell Education IRA legislation (As you know, the Goodling response to America Reads has some problems, but it is acceptable). At our recommendation, the Democrats accepted it on a voice vote. There was a good colloquy between Sen. Kennedy and Sen. Coverdell in which they agreed that it is important for a reading bill to pass soon (we need one by July 1 to use the $210 million advance appropriation). Sen. Kennedy urged that this happen separately, through the normal process that would allow amendments.

Technology Training for Teachers: The NEC and the Department of Education met with over 100 people from around the country on technology training for teachers -- K-12 teachers, industry executives, faculty at teacher colleges, and state technology coordinators. The purpose of the meeting was to (1) share best practices; (2) get input on the best uses of the Administration's $75 million grant program; and (3) build private sector support for doing more to ensure that teachers can use technology effectively in the classroom. Assuming that we can get a critical mass of support from the private sector -- we would like to have an event on this issue.

Homeownership Rate for First Quarter of 1998: On Tuesday (4/20), the Census Bureau reported that the homeownership rate for the first quarter of 1998 rose to 65.9 percent, from 65.7 percent in the fourth quarter. This is below the all-time quarterly high of 66.0 percent in the third quarter of 1997. However, comparisons between quarters is difficult since the numbers are <u>not</u> seasonally adjusted. You should know that the first quarter number is the highest first quarter homeownership rate on record and over the past year, the average homeownership rate is also the highest on record. The homeownership rate for every group -- including central cities, African Americans, Hispanics, female-headed households, those with low incomes, and married couples under age 35 -- rose in the first quarter. And, through the first quarter of 1998, we still remain ahead of schedule in reaching your goal of 8 million new homeowners by the end of the year 2000.

Japanese Government Stimulus Package: On Friday (4/24), the Japanese Government announced the details of its 16 trillion yen stimulus package. It contains 11.3 trillion yen in "real water" stimulus, at the high end of what Treasury publicly called for several months ago when economic conditions were less negative. Hashimoto went further than his preliminary announcement two weeks ago by boosting public works spending from 6 trillion yen to 7.7 trillion, and extending its deficit reduction target date from 2003 to 2005. As expected, the package contains an additional 4 trillion yen in temporary tax cuts but no permanent tax cuts. Treasury believes the package, if implemented quickly and effectively, will significantly reduce the risk of a deeper recession, and may foster some growth in the short term. Market reaction has been slightly positive, but not effusive. Following an NEC Principals conference call on Friday morning, Secretary Rubin issued a statement welcoming the substantial and positive policy measures announced, and expressing his hope the government will put them into place quickly and effectively. He also noted the need for Japan to move forward with further measures to strengthen its banking system and open and deregulate its economy, to help establish a sound basis for longer term domestic demand led growth that will contribute to a recovery in Asia.

U.S.-EU Trade Initiative: On Monday (4/20), the NEC Deputies held a meeting this week to review progress toward a U.S.-EU trade initiative, with the hope it would be announced at the May U.S.-EU Summit. The EU General Affairs Council will meet on Monday, April 27 to see if an EU mandate can be reached, despite French opposition. Private indications are the they will achieve a political consensus on the outlines of a proposal, but the French will not permit a formal mandate to be granted. This might nevertheless permit agreement at the Summit to pursue a generally described agenda. However, differences between the U.S. and the EU remain in key areas, such as agriculture and audio-visual services, and EU capacity to move forward is not yet assured. We will keep you informed.

Sanctions: On Wednesday (4/22), the NEC Deputies met this week to reach agreement on the Administration's position toward Hamilton-Lugar legislation establishing better Congressional and Administration processes in sanction making policy. Our proposed position is positive toward the spirit of the legislation (to improve decision making and make sure all relevant factors are considered), but we would express concerns about some of the limitations on executive discretion contained in the bill. A proposed draft is being circulated in the OMB process. The Deputies also considered a lawsuit likely to be brought by the business community by the end of April against a Massachusetts statute imposing economic sanctions on companies doing business with Burma. The USG may be asked by the court to intervene. Options are being refined for further Deputies and Principals consideration.

Africa Trade Bill: Senator Lott has informed us he will not move the Africa trade bill in the Senate unless we agree to permit the CBI trade bill to be attached to it. Sandy and I co-chaired a meeting on Friday, in which we agreed to signal to Lott we would agree to its inclusion. This will raise additional labor opposition, but the Africa bill is not likely to move at all otherwise. Lott has also suggested he wants to add fast track to the bill. We intend to try to dissuade Lott from this course, after consultations with Daschle first. Stein and others will follow up.

THE WHITE HOUSE

WASHINGTON

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

DATE: April 28, 1998
TIME: 1:00 p.m. - 1:45 p.m.
LOCATION: Oval Office, Rose Garden
FROM: Gene Sperling

I. PURPOSE:

To review the status of the Social Security and Medicare programs and to highlight the need for entitlement reform.

II. BACKGROUND:

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

We do not receive any advance notice of the conclusions in these reports until they are made public tomorrow. The Trustees who represent your Administration will then brief you on the conclusions of the report before you speak and highlight the need for action on Social Security and Medicare reform and particularly the need for reserving the surplus until we have a long term Social Security fix.

III. PARTICIPANTS:

Pre-Brief

- The President
- Secretary Rubin
- Secretary Shalala
- Secretary Herman
- Deputy Secretary Larry Summers
- Ken Apfel
- Gene Sperling
- Frank Raines
- Jack Lew
- Chris Jennings
- Erskine Bowles
- Ron Klain

Event

- Same as above

IV. SEQUENCE OF EVENTS:

- You will be briefed in the Oval Office by the Trustees on their annual report.

- You will proceed to the Rose Garden where you will make brief remarks to the press corps and depart.

V. PRESS COVERAGE:

Open

VI. REMARKS:

Prepared by speech writing.

June 18, 1998

MEMORANDUM FOR: THE VICE PRESIDENT

FROM: GENE SPERLING
JEFFREY LIEBMAN

SUBJECT: Background on Social Security for July 1 conference

The purpose of this binder is to provide background information on Retirement Trends and Social Security reform before the July 1 conference in Providence 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 Providence event.

The binder contains three sections:

1) General background on the event and on Social Security
2) The seven key issues we propose to discuss in tomorrow's briefing
3) Additional talking points on Social Security and retirement issues.

The President's 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. Prior to that speech, most discussions about the surplus concerned tax cuts or spending initiatives. But the administration has dramatically changed that agenda, and now everyone is trying to fit their proposals into the Save Social Security First framework. By calling for open discussion and bipartisanship, the President has potentially lifted the debate on Social Security above its former status as the third rail of politics. But the threat of that third rail is still with us, which brings us to a key point: our ultimate objective is to get reform done. While some may pressure you for your specific views or for you to reveal the administration's "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, the recent plan unveiled by Congressmen Kolbe and Stenholm and Senators Gregg and Breaux has received a respectful hearing, but has also generated sharp debate (e.g., criticism for raising the retirement age). In that context, we strongly recommend that your general stance at the July 1 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.

THE WHITE HOUSE

WASHINGTON

MEETING ON CONGRESSIONAL AND THINK-TANK SOCIAL SECURITY REFORM APPROACHES

Cabinet Room
July 14, 1998
12:30 PM

AGENDA

I. FOUR ILLUSTRATIVE CONGRESSIONAL AND THINK-TANK APPROACHES:

- #1 Invest Trust Fund in Equities
- #2 Add-On Individual Accounts
- #3 Carve-Out Individual Accounts
- #4 No Stock Market Involvement

APPROACH #1: INVEST TRUST FUND IN EQUITIES

PLAN DESCRIPTION

- Transfer half of projected unified budget surplus to Social Security trust fund for the next 10 years, and invest up to 25 percent of the trust fund in equities.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38.)
- Make additional adjustments to traditional social security program to restore solvency.

KEY ATTRACTIONS OF THIS APPROACH

- Can accomplish reform with minimal changes to existing Social Security benefits. Indeed, if one were willing to invest *half* of the trust fund in equities, reform could be accomplished with almost no benefit cuts.
- Higher rate of return is accomplished with low administrative costs and shared market risk.

KEY DISADVANTAGE OF THIS APPROACH

- Government would be major player in private markets.

IMPACT ON TRUST FUND SOLVENCY:

	Impact on 75-year Actuarial Balance
Common Set of Reforms: Cover state and local workers, raise maximum taxable earnings limit; and change computation base from 35 to 38.	+0.97
Transfer ½ Surplus to Trust Fund Over Next 10 Years and Invest in Equities Up To 25 Percent of the Trust Fund Assets	+1.01
Remaining Actuarial Shortfall (75-year balance under present law is -2.19)	-0.21

POSSIBLE IMPACT ON BENEFIT LEVELS:

	Impact on current law benefits
Common Set of Reforms: Cover state and local workers, raise maximum taxable earnings limit; and change computation base from 35 to 38.	-3.0 percent
Across-the-Board Benefit Cuts Implied by Remaining Shortfall	-2.0 percent
Total Cut in Benefits Compared to Current Law	**-5.0 percent**

KEY ISSUES

KEY ISSUE #1: ADMINISTRATIVE COSTS

- Administrative costs can have large impact on retirement income. For example:

Annual Transaction Costs (basis points per year)	Percentage Reduction in Value of Individual's Retirement Income
10	2.4
50	11.5
100	21.5

- Investing the trust fund in equities will be associated with virtually no administrative costs: estimates suggest that they would be *only one-half of one basis point*.

- Costs of individual accounts depend on how they are administered, customer service quality, and burdens on employers. The following examples apply to mature Individual Accounts, instead of start-ups:

Estimated Administrative and Investment-Management Costs for Individual Accounts
(bps = basis points)

Administering Body	Passive Mutual Fund	Active Mutual Fund
Government-Based (e.g., TSP)	8-16 bps	58-66 bps
Employer-Based (2,000 workers)	36-44 bps	109-117 bps
Employer-Based (25 workers)	76-86 bps	138-148 bps
Individual-Based (e.g., IRA)	81-91 bps	143-153 bps

- The level of administrative costs for Individual Accounts will also depend on how quickly a worker's contributions are credited to his/her account. It will be important to design a plan that is perceived to provide the best trade-off between good service and administrative costs.

2

KEY ISSUE #2: GOVERNMENT OWNERSHIP OF PRIVATE EQUITIES

- Under optimistic budget forecasts, transfering half of the surpluses to the trust fund and investing 50 percent of trust fund in equities can solve the entire problem, moving the actuarial balance from -2.19 percent of payroll to +0.18 percent of payroll.

- However, if 50 percent of the trust fund were invested in equities, the trust fund would be a very large share of the U.S. stock market.

Year	Trust Fund Holdings As A Percent of The Stock Market
2010	5-12%
2030	15-30%
2050	15-30%

- If only 25 percent of the trust fund were invested in equities, the trust fund would hold about 7-15 percent of the U.S. stock market in 2030.

- Even ownership of a smaller fraction of the market, though, could raise issues such as "the government is the largest single shareholder of 200 of the 500 largest companies."

- Additional implications of investing the trust fund in equities include:

  1. Political pressure on investment decisions. Political considerations could influence the manner in which the Trust Fund is invested.

  2. Corporate governance issues. The government will have to decide whether and how to exercise its right as a shareholder to choose corporations' managers and influence business decisions.

  3. Constraints on economic policymaking. Investing a large share of the Trust Fund in equities could constrain economic policies that affect stock prices.

  4. Similar issues are present with individual accounts. Some of the issues listed here could also arise under a system of individual accounts if the system were centrally administered and investors were limited to a small number of investment vehicles.

Key Issue # 3: Risk

- Market risk only applies to portion of benefits in Individual Accounts or invested in equities. Under most plans, current payroll tax receipts pay most of current benefits.

- Both investing trust fund in equities and individual accounts expose a portion of retirement benefits to stock market risk.

- This risk is not trivial. In real terms, the Dow Jones did not rebound to its 1968-peak until 1987. On three occasions during the past 70 years, the S&P 500 index has declined over two years by more than 35 percent; Japan's Nikkei has fallen by 60 percent since 1989. To get a handle on the risk that equity investment could introduce, we simulated the impact of three scenarios:

    - *"Best guess:"* 40 percent of the trust fund is invested in equities.

    - *"Nikkei-Followed By Slow Growth:"* Stocks fall by 60 percent over the next 8 years, then grow about two percentage points slower than historical trend.

    - *"Cold-feet:"* Stock prices decline, then the Trust Fund shifts from stocks to bonds.

Effect of Alternative Investment Scenarios on
Trust Fund Long-Run Actuarial Balance
(percent of taxable payroll)

Best Guess	Nikkei	Cold-Feet
1.13	0.20	-0.25

- There are a number of reasons to think, though, that the risk is smaller in the case of investing the trust fund in equities than individual accounts. For example, investing the trust fund shares risk across individuals in a cohort *and* across cohorts. And the danger of individuals making unsound investment decisions is eliminated with the trust fund making the investments..

4

KEY ISSUE #4: FORMULA FOR USING BUDGET SURPLUSES

- If the budget surplus is committed to the Social Security trust fund through any formula (e.g., half of all projected surpluses, etc.), as opposed to a certified amount, it creates two additional issues:

  I. The Social Security actuaries may not score transfer of surpluses.

  II. All future spending initiatives or tax cuts can be described as a "cut in Social Security."

APPROACH #2: ADD-ON INDIVIDUAL ACCOUNTS

PLAN DESCRIPTION

- Fund $500 per worker Individual Accounts (indexed to wages) out of general revenues.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38.)
- Make additional adjustments to traditional social security program to restore solvency.

KEY ATTRACTION OF THIS APPROACH

- Can use surplus to fund progressive individual accounts while preserving most of the traditional Social Security benefit.

KEY DISADVANTAGES OF THIS APPROACH

- Individual accounts would expose individuals to market risk, and administrative costs could eat up some of the higher returns.
- Individual accounts would need to be funded after surpluses run out.

IMPACT ON TRUST FUND SOLVENCY:

	Impact on 75-year Actuarial Balance
Common Set of Reforms: Cover state and local workers, raise maximum taxable earnings limit, and change computation base from 35 to 38.	+0.97
Remaining Actuarial Shortfall (75-year balance under present law is -2.19)	-1.21

Possible Impact on Benefit Levels

	Possible Impact on Current Law Benefits (2030)		
	Low earner ($12,000)	**Average earner ($27,000)**	**High earner ($43,000)**
Common Set of Reforms	-3.0 percent	-3.0 percent	-3.0 percent
Across-the-Board Cuts Implied by Remaining Shortfall	-11.7 percent	-11.7 percent	-11.7 percent
Annuity Provided by Individual Account (2030)	+30.8 percent	+18.7 percent	+14.1 percent
Total	**+16.1 percent**	**+4.0 percent**	**-0.6 percent**

- The annuity provided by Individual Accounts assumes the stock market grows at its historic rate, an optimistic level for administrative costs (only 10 basis points); and reflects single workers only who do gain more from Individual Accounts than married couples.

- Because add-on Individual Accounts funded through a flat contribution are so progressive, the additional Social Security reforms could include across-the-board changes and a lower-income worker would still be better off.

Key Issues

Key Issue #1: Progessivity

- Flat contributions lead to higher benefit levels (as a fraction of current law benefits) for lower-income workers. On the other hand, percent of payroll individual accounts plans do the most for high-income workers.

	Social Security benefit plus annuity from $500/worker individual account (as percentage of current law benefit)	**Social Security benefit plus annuity from 2 percent individual account** (as percentage of current law benefit)
Low Earner	116.1	101.5
Average Earner	104.0	106.9
High Earner	99.4	111.5

KEY ISSUE #2: LONG-RUN BUDGET VIABILITY

- Add-on Individual Accounts cannot be funded out of the surplus forever. For example, $500 per worker can be afforded -- as part of a comprehensive reform -- until between 2012 and 2057 depending on which surplus forecast is used (and assuming that surpluses not spent on Individual Accounts after 2008 are used to pay off debt). During the next decade, an add-on Individual Account with contributions of $500 per worker would require 37 percent of the surplus. Over the next 35 years, the funding of these Individual Accounts would represent 0.7 percent of GDP.

- Two percent of payroll Individual Accounts can be funded between 2011 and 2051 depending on which surplus forecast is used. During the next decade, they require 42 percent of the surplus.

- Because these Individual Accounts are dependent on projected surpluses, they create the following future budget scenarios: (1) the perputual commitment to $500 per worker per year will create future fiscal deficits and put pressure to unduly cut back government programs in the outyears -- which may hurt support for this proposal today; (2) may need to seek trigger or other mechanism to ensure that Individual Account funds do not lead to future budget deficits; and (3) could put pressure to use remaining surplus in early years for debt reduction.

- Individual Accounts could also create a "slippery slope" toward privatization if stock market performance was particularly impressive in the near future.

- Contribution to Individual Account does not have to be $500 per worker per year. Lowering the contribution -- to say, $250 -- would mitigate some of these factors.

KEY ISSUE #3: PRESERVATION OF TRADITIONAL SOCIAL SECURITY BENEFIT

- Protects the 12.4 percent payroll tax for the traditional Social Security system. This approach to individual accounts has the most potential to attract defenders of the traditional system.

- Because the approach brings additional revenue into the system, it reduces the need for overall benefit cuts -- when both the retirement income from individual accounts and traditional benefit are taken into account -- and will appeal to people who favor pre-funding of Social Security's obligations.

- These Individual Accounts could be described as a tax cut.

- Because the benefits from an Individual Account are uncertain, some will argue that the income from the Individual Account should not be counted -- which would show significant benefit cuts.

KEY ISSUE #4: RISK

- Risks of stock market variation and bad investment choices would fall on individuals on the portion of benefits coming from Individual Accounts. Additional "appearance risk" results when people expect the final account value will match its highest level over its lifetime.

- However, the risk in Individual Accounts depends to a certain extent on how they are designed. For example, a "safe investment option" could be provided through inflation-protected Treasury bonds. A minimum benefit or other guarantee could minimize the downside risk of the overall system.

- One possible goal for reform would be to try to design a package in which the traditional benefit plus the individual account totaled as much as current law benefits, if the individual invested in the safe investment option. This would be the default option; those workers who wanted to take on more risk to seek a higher return would be allowed to do so.

APPROACH #3: EXISTING CONGRESSIONAL CARVE-OUT INDIVIDUAL ACCOUNTS

PLAN DESCRIPTION

- Use two percent of existing 12.4 percent OASDI payroll tax to fund Individual Accounts.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38.)
- Make additional adjustments to traditional Social Security program to restore solvency.

KEY ATTRACTION OF THIS APPROACH

- Individual Accounts can be sustained forever without depending on surpluses, and without additional sources of revenue.

KEY DISADVANTAGE OF THIS APPROACH

- Creates a transition problem by diverting revenue to Individual Accounts that had previously been allocated to funding traditional Social Securty benefits.
- Potentially undercuts social insurance and redistribution features of traditional system.

IMPACT ON TRUST FUND SOLVENCY:

	Impact on 75-year Actuarial Balance
Common Set of Reforms: Cover state and local workers, raise maximum taxable earnings limit, and change computation base from 35 to 38.	+0.97
Carve-Out of 2 Percent of FICA Tax Rate for Workers Under 55	-1.88
Remaining Actuarial Shortfall (75-year balance under present law is -2.19)	-3.09

POSSIBLE IMPACT ON BENEFIT LEVELS

	POSSIBLE IMPACT ON CURRENT LAW BENEFITS (2030 AND 2050)		
	Low earner ($12,000)	**Average earner ($27,000)**	**High earner ($43,000)**
Common Set of Reforms	-3.0 percent	-3.0 percent	-3.0 percent
Across-the-Board Cuts Implied by Remaining Shortfall	-30.0 percent	-30.0 percent	-30.0 percent
Annuity Provided by Individual Account (2030)	+16.2 percent	+21.6 percent	+26.2 percent
Total (2030)	-16.8 percent	-11.4 percent	-6.8 percent
Annuity Provided by Individual Account (2050)	+30.0 percent	+40.4 percent	+49.0 percent
Total (2050)	-3.0 percent	+7.4 percent	16.0 percent

- The annuity provided by Individual Accounts assumes the stock market grows at its historic rate, an optimistic level for administrative costs (only 10 basis points); and reflects single workers only who do gain more from Individual Accounts than married couples.

- Because Individual Accounts are a percentage of payroll, the additional reforms to Social Security most likely would need to be progressive.

KEY ISSUES

KEY ISSUE #1: THE TRANSITION PROBLEM

- When two percent is carved out for Individual Accounts, that revenue can no longer pay for benefits for current retirees. This approach would take $700-$900 billion from the traditional Social Security system over the next 10 years.

- This dilemma -- the "transition problem" -- in moving from a pay-as-you-go system to a funded system is that if the contributions of current workers go into Individual Accounts for their retirements, how do we pay for the retirement of current retirees?

- The unified budget surplus could be transferred to the trust fund and used to pay for benefits under the traditional Social Security system during the transition period. Under the most optimistic long-run budget projections, transfering the *entire* surplus to the trust fund would cover the entire 2.19 percent shortfall <u>plus</u> half of the lost revenue from the carve-out.

- In 40 years, when workers will have contributed to Individual Accounts for their entire working lives, traditional Social Security benefits can be reduced and still leave total retirement income above current law benefits.

- In the short run, though, benefits need to be cut to make up for the lost revenue and for 2.19 actuarial imbalance, but the Individual Account will not be large enough to offset these cuts.

- An important challenge in designing reform plans is to time the benefit cuts and the build up of Individual Accounts so that the total benefits of retirees over the transition do not fall too much.

KEY ISSUE #2: POLITICAL VIABILITY

- A number of the reform plans proposed by moderate Members of Congress take the approach of carve-out Individual Accounts.

- Can be described as a promising new social compact: workers get a payroll tax cut so long as they save it in their Individual Accounts.

- Can use surplus to partially mitigate transition costs.

KEY ISSUE #3: LONG-TERM STRUCTURE OF PROGRAM

- For the average retiree in 2030, the income from an add-on Individual Accounts would account for 18 percent of their retirement income. For a similar retiree, a carve-out Individual Account would be 24 percent of their retirement income. These numbers are even greater for beneficiaries eligible for Social Security in 2050: the add-on Individual Account would be 29 percent and the carve-out would be 38 percent.

- Individual Accounts could be accompanied by a guaranteed benefit or a guaranteed return which would both reduce individual risk (but at a price).

APPROACH #4: NO STOCK MARKET INVOLVEMENT

PLAN DESCRIPTION

- Transfer half of projected unified budget surplus to social security trust fund for the next 10 years. Maintain the current policy of investing the trust fund entirely in special-issue government securities.

- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38.)

- Make other adjustments to traditional social security program to restore solvency.

KEY ATTRACTION OF THIS APPROACH
• Social Security is the safest aspect of the "three legs" of retirement income and this policy protects individuals from the risks of the market.

KEY DISADVANTAGES OF THIS APPROACH
• Will need to rely heavily on traditional benefit cuts and revenue options since the plan does not achieve a higher rate of return by investing in private securities.

IMPACT ON TRUST FUND SOLVENCY:

	Impact on 75-year Actuarial Balance
Common Set of Reforms: Cover state and local workers, raise maximum taxable earnings limit, and change computation base from 35 to 38.	+0.97
Transfer ½ Surplus to Trust Fund Over Next 10 Years and Invest in Special-Purpose Bonds	+0.36
Remaining Actuarial Shortfall (75-year balance under present law is -2.19)	**-0.85**

Impact on Benefit Levels

	Impact on current law benefits
Common Set of Reforms: Cover state and local workers, raise maximum taxable earnings limit; and change computation base from 35 to 38.	-3.0 percent
Across-the-Board Benefit Cuts Implied by Remaining Shortfall	-8.2 percent
Total Cut in Benefits Compared to Current Law	**-11.2 percent**

Key Issues

Key Issue #1: Double Counting

- Some have argued that transfering the surplus to the Social Security trust fund involves "double counting," since the trust fund was already credited with the excess of Social Security income over outgo, and the unified budget surplus is largely the result of Social Security surpluses.

- If in the absence of transferring the surpluses to the trust fund, the surpluses would have been spent or used for tax cuts, then transferring them to the Social Security trust fund reduces the amount of debt issued to the public and boosts national savings. Thus, it is not simply double counting.

- Under the assumption that the surpluses would otherwise be used to pay off national debt, the double counting argument has some merit.

THE WHITE HOUSE
WASHINGTON

MEETING ON CONGRESSIONAL AND THINK-TANK SOCIAL SECURITY REFORM APPROACHES

Cabinet Room
July 22, 1998
5:30 PM

AGENDA

I. RISK

II. INTEGRATIVE APPROACH

III. ADMINISTRATIVE COSTS

IV. CORPORATE GOVERNANCE

I. RISK

KEY POINT #1: THE CASE FOR EQUITIES

- Stocks have out-performed bonds over nearly all long periods of time in the US during the past century.
  - The "equity premium" is the difference between the average annual rate of return earned by stocks and the rate earned by bonds. The table below shows this difference in returns between the S&P 500 and the bonds held by the Social Security trust fund for various time periods.
- During the 20th century in the US, even large stock market declines have been more than made up for in subsequent rebounds.
  - A portfolio of a worker who lived through the 1929 crash -- when the S&P 500 lost 85 percent of its value between September 1929 and June 1932 -- would have fully recovered by the end of 1936.

Equity Premium
S&P 500 over Social Security Trust Fund Bonds
(percent per year)

		End Year					
		1949	**1959**	**1969**	**1979**	**1989**	**1996**
Start Year	1939	6.91	11.63	9.16	6.69	6.65	6.51
	1949		16.56	10.30	6.61	6.58	6.42
	1959			4.37	1.96	3.45	*3.84*
	1969				-0.39	3.00	3.64
	1979					6.50	6.09
	1989						5.52

KEY POINT #2: CAUTIONS ABOUT EQUITIES

- <u>Markets fall.</u> While 20th century US markets have always rebounded strongly from large market declines, this need not be the case in the future.

  -- On three occasions during the past 70 years, the S&P 500 index has declined over two years by more than 35 percent (in nominal terms).
  -- Japan's Nikkei index has fallen by 60 percent since 1989.
  -- The S&P 500 (even including reinvested dividends) did not regain its 1968 value in real terms until 1983.

- <u>Perceptions may be colored by recent stock market history.</u> The tremendous recent stock market performance has likely increased support for investing Social Security funds in equities. If the stock market were performing badly, as it did in the 1970s, it is unlikely that people would be as eager to invest Social Security funds in the market. Indeed, in 1979, *Business Week* ran a cover story entitled "The Death of Equities."

- <u>Stocks may not retain their historic advantage relative to bonds.</u> Simple economic models have trouble explaining why the 20th century rate of return on stocks has been so much higher than the return on bonds. Many economists think that the added risk from stocks is not sufficient to justify such a large "equity premium." Given that it is not well understood why stocks have out-performed bonds in the past, some economists are concerned about whether this gap will persist into the future.

- <u>Shorter market exposure at beginning of new system.</u> In the transition to a new individual account system, older workers would participate in the system for only a few years before they reached retirement. These workers would not have a full 40 years of market exposure. If a downturn occurred during their few years of contributions, the older workers could end up doing worse than in safer investments.

- <u>Lack of individual or political patience after downturn.</u> In a system of Individual Accounts, individuals might shift out of equities after a market decline, missing the recovery. If the trust fund were invested in equities, there might not be sufficient political patience to stay with an equity-based system after a large market downturn. If equity investments were abandoned after the first large downturn, such a system could provide the worst of both systems, the low returns of bonds plus the risk of equities.

- <u>Perceptions of pre-retirement market declines.</u> Individuals might feel that they had fared poorly even if they had done better over their lifetime being invested in equities than in government bonds. For example, if the market fell substantially just before a worker retired and annuitized his/her account, he/she might feel that it was unfair that workers who had retired one year earlier received higher retirement incomes. Similarly, if a worker annuitized his/her account balance at a point when the stock market is below a previous peak, the worker might feel like he/she lost even though he/she did better over his/her lifetime.

- <u>Naïve investor risk.</u> Some individuals might lack the investment know-how to make wise investment decisions. This risk could be largely eliminated by constraining the investment options available to individuals.

2

Key Point #3: Risk Under Different Reform Proposals

- **Risk in the current Social Security system.** The current system does not have market risk. However, it has other forms of risk:

  -- Political risk that tax or benefit rules will change. For example, Social Security taxes and benefits have changed numerous times in the past 60 years.

  -- Demographic risk that forecasts of mortality and fertility trends will turn out to be incorrect. For example, if projected fertility rates dropped by 0.3 children per woman, the actuarial imbalance would worsen by about 0.4 percent of payroll.

  -- Economic risk that productivity growth will be higher or lower than currently forecast. For example, if productivity growth fell by 0.5 percentage points, the actuarial imbalance would worsen by about 0.55 percent of payroll.

- **In reforms, only a portion of benefits would be exposed to market risk.** Even in 2070, payroll tax revenue will be sufficient to provide two-thirds of current-law Social Security benefits. If the full payroll tax continues to be dedicated to providing the traditional benefit, then at most one-third of the total Social Security benefit would be at risk.

  -- If only a limited portion of the trust fund -- for example, 25 percent -- were invested in equities, less than 15 percent of benefits would be dependent on stock market performance.

  -- Individual accounts funded with contributions equal to $500 per capita or 2 percent of payroll would typically provide less than 37 percent of total Social Security benefits including IA account proceeds (assuming the accounts were invested half in bonds and half in stocks). Thus, over 60 percent of benefits would be free of market risk.

- **By investing through the Social Security trust fund, some risks are reduced.** With the trust fund partially invested in equities, there would be no need to tie annual benefits to year to year trust fund performance. Thus, market risk could be spread both across workers and across generations. In addition, since individual workers would not be making investment decisions, there would be no "naïve investor" risk.

Key Point #4: Some Downside Scenarios

- The table below explores how Individual Account accumulations would vary with investment strategy under a number of scenarios in which the stock market falls sharply and fails to recover.
- The scenarios take a worker with average earnings who is 22 in 1998 and follow him/her until retirement.
- The scenarios assume that the typical annual bond yield is 6.4% (2.8% real), and that the typical annual stock yield is 10.5% (6.76% real). Thus, the equity premium is 3.86.

		Individual Account Assets at Age 65	Ratio of Assets at Age 65 to All Bonds Steady Yield Scenario
Maintain Portfolio All Bonds			
0	Steady Yield	$218,000	1.00
Maintain Portfolio Half Stocks, Half Bonds			
1	Steady Yield	$356,900	1.63
2	Stocks fall by 60% at age 24	$343,800	1.57
3	Stocks fall by 60% at age 44	$274,300	1.25
4	Stocks fall by 60% at age 64	$241,300	1.10
5	Stocks fall by 60% at age 24 then market flat for 9 years	$308,400	1.41
6	Stocks fall by 60% at age 44 then market flat for 9 years	$200,400	0.92
Maintain Portfolio All Stocks			
7	Steady Yield	$605,600	2.77
8	Stocks fall by 60% at age 24	$547,800	2.51
9	Stocks fall by 60% at age 44	$300,600	1.37
10	Stocks fall by 60% at age 64	$219,700	1.00
11	Stocks fall by 60% at age 24 then market flat for 9 years	$440,000	2.01
12	Stocks fall by 60% at age 44 then market flat for 9 years	$169,200	0.77
Maintain Portfolio All Stock With Only 2% Equity Premium After Decline			
13	Stocks fall by 60% at age 24	$337,300	1.54
14	Stocks fall by 60% at age 44	$223,900	1.02
15	Stocks fall by 60% at age 64	$219,700	1.00
16	Stocks fall by 60% at age 24 then market flat for 9 years	$290,000	1.33
17	Stocks fall by 60% at age 44 then market flat for 9 years	$142,800	0.65

KEY POINT #5: VARIATION IN RETIREMENT INCOME FROM MARKET EXPOSURE

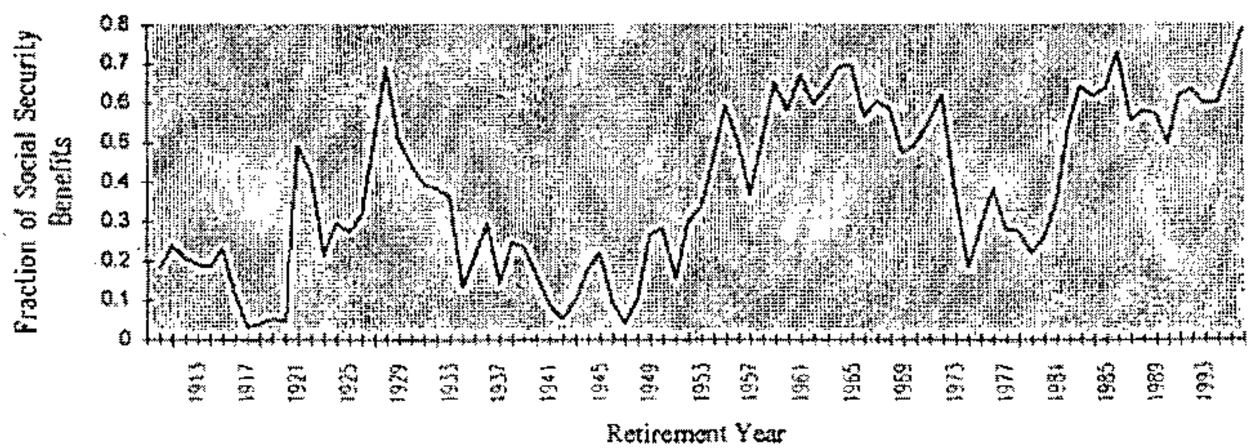
- **Outcomes from market investments depend on when individual retires.** Studies suggest that individuals would have widely different outcomes from market investments solely because of the market performance in the particular years in which they lived. For example, average workers retiring in 1972 would have received a retirement annuity equal to more than 60 percent of their current-law Social Security benefits. However, individuals retiring two years later, in 1974, would have received an annuity that was only 20 percent of their current law benefits.

- **In past century, Individual Accounts could have provided between 5 and 80 percent of an average worker's current law Social Security benefits.** If average workers had had a 2 percent Individual Account and retired a different times in the past century, their retirement annuities would have varied greatly: from 5 percent to 80 percent of their current law Social Security benefits.

- **In most years, Individual Accounts could have provided a large enough annuity to ensure that current benefits were maintained.** One constructive way to view this result is that under the illustrative plans we discussed last week, the traditional Social Security program would continue to provide an additional 66 to 85 percent of current-law benefits (depending on whether the Individual Accounts were implemented as carve-outs or add-ons). Thus, to maintain current benefits, the annuity from the Individual Account would have to be at least 15 to 34 percent of current benefits, depending on whether it were an add-on or carve-out Individual Account.

- **There are a number of limitations to this analysis.** The chart assumes that the entire individual account was invested in the S&P 500, and was annuitized at the Aaa corporate bond rate in the year that the worker turned 65. If a portion of the accounts were invested in bonds, or if annuitization happened in stages, the variation in experiences would be reduced.

Fraction of Social Security benefits replaced by 2% Individual Accounts



Key Point #6: Wealth Creation

Supporters of Individual Accounts make strong arguments about how such accounts help to create wealth and give lower-income workers a stake in the economy. Advocates base their argument on four ideas:

1. <u>Access to Higher Rates of Return.</u> Because nearly half of all Americans have little or no financial assets, Individual Accounts would give lower-income workers access to the higher rates of return offered by the stock market, and allow them to build wealth for their retirement.

2. <u>Allows Individuals To Use Access Income However They Want</u>. Many Individual Account proposals would require retirees who have accumulated a large nest-egg to annuitize enough of the account to provide a basic retirement income, while allowing the retiree to take the remaining money in a lump-sum to be spent as they wish. In other words, retirees would have to set aside a minimum amount of money, but the rest could be used for whatever they desire.

3. <u>Individual Accounts Could Be Bequeathable</u>. Some people die before they reach age 65, and Individual Accounts could be bequeathable, thus making it possible for individuals who do not pass along any wealth to their heirs to do so. However, if a portion of individual accounts were bequeathable, the income available for consumption during retirement years would be reduced.

   -- Most reform proposal retain the existing structure for survivor benefits for young people. However, cuts to the Social Security benefit formula -- as part of comprehensive reform -- would reduce survivor benefits.

   -- Permitting bequests is particularly appealing to low-income and minority populations which have lower life-expectancy, and therefore, on average, would not receive their Individual Account annuity for as many years. For example, life expectancy at age 65 is 1.8 years shorter for blacks than for whites. (In the traditional Social Security system, the progressivity of benefit formulas offsets the shorter life expectancy.)

4. <u>May Change Perception of Saving</u>. The experience of owning an Individual Account may lead people who do not save currently to begin saving on their own. By directly showing people the power of compound interest and the benefits of savings, we may alter people's spending habits.

KEY POINT #7: TRANSITION COSTS AND MISLEADING RATES OF RETURN ARGUMENTS

THE CHARGE:

- Some claim they could do better investing on their own. Many critics of Social Security point to the rate of return that workers will earn in the future on their contributions into the system, and argue that they could do better on their own investing in individual accounts.
  - According to the Social Security actuaries, a single male with average earnings retiring in 2030 will receive a real return of only about 1-1/2 percent per year.
  - By contrast, over the period 1926-1996, stocks earned a real rate of return equal to about 7 percent per year.
- By using the surplus to prefund retirement benefits and invest in equities, it is possible to increase rates of return in the future.

THE TRANSITION ISSUE:

- The story is different if we are talking about funding individual accounts with revenue currently allocated to paying benefits under the current system. In this case, simply calculating rates of return for the individual accounts ignores the need to provide benefits for current and future retirees who have paid into the current Social Security system. Ninety percent of contributions into the Social Security system are used immediately to pay benefits to today's retirees and other beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirement, we will need to come up with some other way to pay retirement benefits for people who are entitled to Social Security benefits. Rates of return that ignore this cost are misleading when compared to Social Security rates of return that include this cost.

IS THE RATE OF RETURN THE CORRECT WAY TO JUDGE SOCIAL SECURITY?

- Some suggest that focusing too much on rate of return does not acknowledge that Social Security plays a distinct role as a universal low risk leg in the retirement structure that you can always count on.

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

KEY POINT #8: OPTIONAL INVESTMENTS IN INDIVIDUAL ACCOUNTS

Some reform proposals include a voluntary individual account option. These options are of two types:

TYPE I: Individual Account proposals that allow additional contributions

TYPE II: Non-Individual account proposals that would allow for a Voluntary individual account

ISSUES:

- A main benefit of these proposals is that for the half of all American workers who do not have pension plans this could be a major step toward increasing employment-related retirement savings.
- Some employers who currently resist the administrative burden of setting up retirement programs might match employee contributions, thereby augmenting the impact of the worker's savings.
- However, it is possible that some employers who currently provide a pension to their employees might cancel these plans knowing that their employees have this new retirement savings option.
- In addition, since most employees currently have the option of contributing to an IRA, the new accounts might not be seen as providing much additional impetus for saving.
- Indeed, the plans could be criticized for giving upper-income Americans another opportunity for tax-preferred saving. This risk could be minimized by providing a cap on total contributions to IRAs, 401ks, and the new Individual Accounts.

II. INTEGRATING INDIVIDUAL ACCOUNTS WITH THE TRADITIONAL SOCIAL SECURITY BENEFIT

BASIC IDEA:

- Integrate an individual account with a defined benefit system so as to ensure a basic benefit package.

- For example, plans can be designed to ensure that the combined income from the individual account and the traditional Social Security benefit exceed a basic benefit package.

- This approach shifts some of the risk of individual accounts from individuals to the federal budget.

- The simplest approach would be to provide a flat minimum benefit along with a large individual account.

EXAMPLE #1:

- <u>Provide a Safe Investment Option.</u> The individual account plan could include a safe investment option such as an inflation-indexed Treasury bond. Workers who liked the old system and did not want to take on market risk would still be able to do so. The plan could be designed to ensure that the combined individual account and Social Security income for a worker who invested in the safe option was always above some benefit goal. Workers who chose to take on more risk could come out ahead or behind the benefit goal.

EXAMPLE #2:

- <u>Clawback the individual account.</u> A portion of individual account accumulations could be used to pay for benefits under the traditional defined-benefit Social Security system. Since workers would continue to get their full benefit from the traditional system, their total income would be higher even though part of their individual account was "clawed-back."

  <u>Clawback the traditional benefit</u>. An alternative way to describe this approach is that the traditional Social Security benefit is reduced by some fraction (50 percent for example) of each dollar of income provided by the individual accounts. The advantage of this second way of describing the accounts is that it does not sound as much like a tax on the individual accounts. The disadvantage is that it reduces the portion of retirement benefits provided by the traditional Social Security program, and could lead to diminished political support for the traditional benefit.

Illustrative Example of Integrative Approach

Plan Description

- Fund individual accounts equaling 2 percent of earnings using general revenue.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit; and increase number of years in computation base from 35 to 38).
- Claw-back 50 percent of income realized from individual account accumulations, and use to fund traditional Social Security benefits.
- Make additional adjustments to traditional Social Security program to restore solvency.

Key Attraction of This Approach

- Individual Accounts are provided allowing for a higher return while simultaneously ensuring workers of a substantial risk-free Social Security benefit.

Key Disadvantages of This Approach

- Under an add-on, individual accounts need to be funded in perpetuity even though projected budget surpluses (under this plan) run out in 2023.
- The clawback could be perceived as a tax and might not be politically sustainable.
- If most of people's benefit was perceived as coming from the individual account, public support for the traditional Social Security program could fall, especially among high income workers.

Impact on Trust Fund Solvency:

	Impact on 75-year actuarial balance
Common Set of Reforms: Cover state and local workers, raise maximum taxable earnings limit; and change computation base from 35 to 38.	+0.97
Revenue from Taxing Individual Account Accumulations.	+0.91
Remaining Actuarial Shortfall (75-year balance under present law is -2.19)	-0.31

	IMPACT ON CURRENT LAW BENEFITS		
	Low earner ($12,000)	**Average earner ($27,000)**	**High earner ($43,000)**
Common Set of Reforms	-3.0 percent	-3.0 percent	-3.0 percent
Across-the-Board Cuts Implied by Remaining Shortfall	-3.1 percent	-3.1 percent	-3.1 percent
Expected Annuity Provided by Individual Account (2030)	+8.1 percent	+10.8 percent	+13.1 percent
Total	**2.0 percent**	**4.7 percent**	**7.0 percent**

- The annuity provided by Individual Accounts assumes the stock market grows at its historic rate; an optimistic level for administrative costs (only 10 basis points); and reflects single workers only, who gain more from Individual Accounts than married couples.

III. ADMINISTRATIVE COSTS

KEY POINT #1: INTERNATIONAL EVIDENCE ON ADMINISTRATIVE COSTS IN INDIVIDUAL ACCOUNT PLANS

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

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

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

- Costs in the early years of the UK individual account system have been high as well. In the UK, workers can opt out of the earnings-related defined benefit system, and instead contribute to an individual retirement account. A recent paper by Professor Peter Diamond reports that the charges for these individual accounts are large, complicated, and often not visible to the workers. He calculates that the total administrative costs in the typical UK account reduce retirement income by more than 24 percent.

- The international evidence suggests that it is important to focus on ways to keep costs down. The lesson from these two examples is not that individual account systems are necessarily expensive, but rather that it is important to design systems in a way that provides the desired services at a reasonable cost.

KEY POINT #2: ADMINISTRATIVE COSTS DEPEND ON SERVICES PROVIDED

- **Administrative costs can have a large impact on retirement income.**

Annual Administrative Costs (basis points per year)	Percentage Reduction in Value of Individual's Retirement Income
10	2.4
50	11.5
100	21.5

- **Current US system has very low costs.** The current Social Security system has maintained an extremely low level of administrative costs. Less than 1 cent of every dollar paid into the system by workers and employers goes to administrative costs. To achieve this low an administrative cost, an individual account plan would have to have annual administrative costs of less than 5 basis points.

- **Investing trust fund in equities would be extremely inexpensive.** Estimates suggest that costs could be only one-half of one basis point.

- **Under individual accounts, costs could vary widely depending on the services provided and on the way in which the accounts are administered.**

Estimated Administrative and
Investment-Management Costs for Individual Accounts
(bps = basis points)

Administering Body	Passive Mutual Fund	Active Mutual Fund
Government-Based (e.g., TSP)	8-16 bps	58-66 bps
Employer-Based (2,000 workers)	36-44 bps	109-117 bps
Employer-Based (25 workers)	76-86 bps	138-148 bps
Individual-Based (e.g., IRA)	81-91 bps	143-153 bps

- **Costs in the early years would be even higher.** Account balances would be small at the beginning, driving up cost ratios.

- **The costs of actively managed funds are significantly higher than are the costs of index funds.** A 1998 Department of Labor study found average expense ratios for actively managed retail large equity funds of 147 basis points, while average expense ratios for index funds were only 59 basis points.

- **Technological advances might reduce the costs substantially in the future.** If fund allocations could be handled by an automatic telephone procedure or over the Internet, individuals could be permitted to reallocate their portfolios frequently at a relatively low cost.

(1

KEY POINT #3: THE TSP MODEL

- <u>The Federal Thrift Savings Plan has been a model for many individual account proposals.</u> Its costs are low -- roughly 10 basis points per year, excluding employer costs of reporting individual earnings to the TSP.

  -- Costs are low in part because TSP offers only 3 investment options -- a stock index fund, a corporate bond fund, and a Treasury security fund -- and all three funds are passively managed. In addition, the participating "employers" (Federal departments and agencies) are large. Finally, the total pool of funds is large, and TSP runs a competitive process in issuing contracts to private fund managers to run the funds.

- <u>A national government-run system would face much larger challenges.</u> The TSP covers 2.6 million participants, all of whom work for one employer (the Federal government). A universal personal account system would eventually involve 180 million individual participants, who work for 6.5 million different employers.

  -- Last year over 55 million individuals called the SSA's 800 number. Many additional calls would need to be handled if individual accounts were set up. In recent testimony, Frank Cavanaugh, former Executive Director of the TSP, estimated that a Social Security reform plan modeled after the TSP "would require at least 10,000 highly trained Federal employees to man the telephone and answer employee questions."

- <u>Corporate governance issues could arise in a TSP-style plan.</u> Because the government would be contracting with a small number of private-sector managers to invest the aggregate holdings of the accounts, corporate governance issues could arise that are similar to those that would arise if Social Security were invested in equities.

KEY POINT #4: HOW WOULD SERVICES BE PERCEIVED?

- <u>How would services be perceived?</u> In a very inexpensive system, the services provided would likely be perceived as inferior to those provided under workers' other investment accounts such as 401ks and IRAs. For example, workers might have their contributions deposited into their accounts only infrequently, be given limited opportunity to reallocate their portfolios, and receive less frequent statements of account balances.

  -- Some analysts fear that people would be disappointed when they realize that under some forms of a TSP approach, deposits would not be made to individual accounts until October of the following year (the date at which SSA and IRS essentially finish reconciling the previous year's earnings). In 401k plans, contributions are made much more frequently.

  -- Others feel that the individual account will seem like a new tax cut and that people will be pleased to receive it. If a new policy is announced that every year $500 or 2 percent of earnings will be deposited into your account 90 days after you file your taxes, it will seem like a good deal.

- <u>Keeping costs low conflicts with features that give individual accounts their popularity.</u> Proponents of individual accounts hold up savings account booklets and suggest that people could have frequent reports on account balances, wide investment choices, and the ability to reallocate their portfolios whenever they want. These features would raise costs.

- <u>Political pressure for added services could drive up costs.</u> There might be political pressure to introduce additional services, such as emergency loans against the accounts. The additional services would drive up costs.

IV. CORPORATE GOVERNANCE

KEY POINT #1: POTENTIAL PROBLEMS

- Some experts have proposed that as much as 50 percent of the Social Security trust fund be invested in equities. Under this scenario, the trust fund would be a very large share of the U.S. stock market. In fact, it could rise to as high as 15-30 percent of total equity holdings in 2030.

- Even smaller fractions could raise issues such as "the government is the largest single shareholder of 200 of the 500 largest companies."

- Additional possible implications of investing the trust fund in equities include:

  1. Political pressure on investment decisions. Political considerations could influence the manner in which the Trust Fund is invested.

  2. Corporate governance issues. The government will have to decide whether and how to exercise its right as a shareholder to choose corporations' managers and influence business decisions.

  3. Constraints on economic policy-making. Investing a large share of the Trust Fund in equities could constrain economic policies that affect stock prices.

  4. Similar issues are present with individual accounts. Some of the issues listed here could also arise under a system of individual accounts if the system were centrally administered and investors were limited to a small number of investment vehicles.

KEY POINT #2: POTENTIAL SOLUTIONS

A number of strategies have been suggested for limiting the risk of these adverse outcomes. Several of these strategies are interrelated.

- *An independent investment board.* Like the members of the Federal Reserve Board, the members of a Social Security Investment Board could be appointed to long overlapping terms, and could be subject to removal only "for cause." The Board could be empowered to determine its own budget and submit it directly to the Congress.

- *Qualifications.* Members of the board could be required to be from the private sector, and have substantial expertise in the investment industry, pension industry, or similar background. (Such qualifications are currently required of the TSP Board members.) Nominees could be rated as "well qualified," "qualified," or "not qualified" by some outside group in a procedure modeled on the rating of judicial candidates by the ABA.

- *Strict fiduciary duty.* The Board could be charged with acting in the sole interests of the beneficiaries of the Trust Fund, and no other interests, however meritorious.

- *Limited investment choices.* The experience of the state pension funds suggests that scope for non-economic investing is especially great when the available range of investment vehicles is broad. For example, some state funds are authorized to invest in local infrastructure, in-state equity funds, Ginnie Mae and Fannie Mae pools, residential mortgages, and small-business loans. By contrast, the Thrift Investment Board is authorized to invest in only five broad funds, and thus far has avoided any difficulty with issues related to corporate governance.

- *Proxy voting strategies.* Some have suggested that government-owned shares simply not be voted, or be voted in proportion to the votes of non-governmental shareholders. This approach would have the downside of effectively destroying one of the important sources of value in share ownership, namely the power to vote, and facilitating the ability of managers to be unresponsive to shareholders. In addition, minority shareholders could be turned into majority shareholders. One alternative strategy for dealing with this issue would be to require that the shares be voted by the private-sector firms serving as portfolio managers; these firms would be under fiduciary responsibility to act in the best interests of the beneficiaries of the plan. Another options would be to limit the share of any one company that the government could hold.

- *Culture of non-interference.* Since Congress could pass a law altering any of the safeguards, it will be important that a culture of non-interference develop around the independent board, similar to the culture surrounding the Fed.

KEY POINT #3: THE NEW CANADIAN SYSTEM

The Canada Pension Plan (CPP) is expected to begin investing in private securities in early 1999. Draft investment regulations have been proposed, and final regulations are expected to be issued later this summer.

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

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

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

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

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

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

MEMORANDUM TO: GENE SPERLING

FROM: PETER ORSZAG
JEFF LIEBMAN

SUBJECT: White House Conference on Social Security

DATE: September 13, 1998

Following your instructions, we have started to think through how to structure and prepare for the December conference on Social Security. In particular, we are trying to flesh out the "teach-in" approach, in which the conference serves us an educational backdrop to the beginning of bipartisan negotiations in January. The general concept would be to have an opening plenary session, including a welcome and an overview of the reform challenge, followed by a series of six workshops in which classes of 30 or so people rotate through presentations and discussions with outside experts on specific reform options. The session would then wrap up with a concluding panel on how to put the pieces together into a comprehensive plan (as well as concluding remarks by the hosts).

This memorandum:

- Presents several questions that affect our thinking about, and planning for, the conference;

- Provides an overview of how the conference could be structured;

- Proposes a draft agenda for the conference, including specific sessions, topics, presenters, and background materials (as well as a draft schedule for the conference and a complete list of proposed and possible presenters)

I. QUESTIONS REGARDING THE "TEACH-IN" APPROACH

We have several crucial questions that affect how the conference would be structured:

Participation

1. Congressional participation: Is the session intended to educate Congressional staffers, to educate Congressmen themselves, or to serve as the beginning of high-level negotiations? Our working hypothesis is that the session is primarily intended to educate staffers, although some Congressmen may participate in the workshops.

2. Administration participation: What level of POTUS and other senior Administration involvement should we assume? Our working hypothesis is that the POTUS will open and close the session, but not participate in the intervening workshops.

3. Press participation: Will all the sessions be open to the press? We recommend that the plenary sessions be open-press, and that a few carefully selected reporters be allowed to observe the workshops on an off-the-record basis.

4. Other participation: In addition to Administration representatives, Congressional representatives, the outside experts, and the press, will there be any other participants? Possibilities include representatives from interest groups (e.g., AFL-CIO, Chamber of Commerce); lobbyists; the hosts of the regional conferences; other outside luminaries (e.g., Pinera, Ball); and other experts who are not necessarily presenting anything. Our initial suggestion is to strictly limit such participants. In particular, if interest groups are permitted, we will have to think very carefully about the invitation list to ensure both fairness and feasibility.

Logistics

5. Length: Our working hypothesis is a two-day conference. A one-day conference would make it extremely difficult to explore the complex substantive issues in anything beyond the most superficial manner. A three-day conference may be too long to maintain the attention and interest of the participants (as well as the presenters).

6. Dates and location: We understand that the preliminary plan is to host the conference in early December, and that the President's calendar is wide open right now for early December. The sooner we can pick specific dates, the better. In addition, we will need to select a site for the conference. Should we get Jon Kaplan involved on these issues in the near future?

Planning and preparation

7. Congressional participation in planning and preparing: How much Congressional participation will be involved in the planning and preparing stages? We assume that most of the

important issues will be discussed with relevant Congressional members and staff as the planning proceeds.

8. Pre-reading material: Will the outside experts prepare balanced *papers* to be distributed before the conference, or merely balanced presentations to be given during the conference? If the outside experts prepare papers, they could be combined with other extant background material into a binder that participants would receive approximately one week to 10 days before the conference. If we decide to hand out pre-reading material, first drafts should be due at the end of October to allow sufficient time for editing and distribution before the beginning of December. We must therefore move relatively quickly to select the outside experts.

II. OVERVIEW OF CONFERENCE

The conference will be held over two days in early December. It will open with an address by President Clinton and the Congressional Leadership. Then the participants will be briefed in plenary sessions on the structure of the Social Security system and the challenge facing the system. Following the plenary sessions, the participants will be split up into groups of 30 and attend a series of workshops. Those groups will remain together throughout the conference, rotating through the different workshops on specific topics. We believe it is important for the groups to remain together throughout the conference, as a way of bonding and providing continuity.

The workshops will each last 90 minutes, and involve a presentation by two outside experts on the pros and cons of specific reform options, followed by a general discussion of how the option could be best structured. Our current plan is for six workshops, discussed below. (Since the outside experts will play such a crucial role in presenting the pros and cons and facilitating the discussion, we plan to have them give "practice" presentations to the Administration's technical working group three weeks before the conference.)

Following the workshops, the group will gather back together for a plenary session on how to put together a comprehensive plan given all the disparate reform options. The hosts will then close the conference with a final plenary session.

To ensure that participants are properly prepared, we would put together a set of background materials that would be sent out approximately one week to 10 days before the conference. We will need to discuss whether the background materials will ~~include only published~~ papers, or also papers specifically written for this conference. We will also need to discuss how widely the background binder would be distributed.

III. POSSIBLE AGENDA

OPENING (30 minutes)

Leader: President Clinton and Congressional Leadership

Participants: Plenary

Topics: Welcome and objectives

STRUCTURE OF THE SOCIAL SECURITY SYSTEM (45 minutes)

Leader: Ken Apfel

Participants: Plenary

Topics:

1. Participation in system and characteristics of beneficiaries
2. Structure of benefits (retirement, disability, etc.)
3. Eligibility for benefits
4. Benefit computation
5. Benefit reduction and increase (DRC, etc.)
6. COLAs
7. Taxation of benefits
8. Social Security payroll taxes
9. Social Security trust fund

Background materials:

1. 1998 Green Book
2. SSA publications

OVERVIEW OF THE CHALLENGE (45 minutes)

Leaders:
- Option 1: Charles Shultze and Herbert Stein
- Option 2: Laura Tyson and Martin Feldstein or Paul Volcker
- Option 3: Alan Greenspan

Participants: Plenary

Topics:

1. Aging of the population (include a demographic expert?)
2. Natural maturation of pay-as-you-go system
3. Actuarial imbalances and projections
4. Objectives of reform

Background materials:

1. 1998 Trustees report

PANEL SESSIONS (EACH 90 MINUTES)

NOTE: Each group will rotate through the six panel sessions. The first panel will be held before lunch on the first day; the second and third will be held in the afternoon. The fourth and fifth panels will be held on the morning of the second day, and the final panel will be held immediately after lunch on the second day. Note that the order of the specific panels will by necessity vary from group to group; the order below is purely illustrative.

PANEL 1: BUDGETARY AND MACROECONOMIC IMPLICATIONS

Leaders: Robert Reischauer and Jim Poterba

Topics:
1. Current budget projections
2. Impact of Social Security system on budget with no reforms
3. Budgetary benefit of various reforms
4. National saving projections with no reforms
5. National saving implications of Social Security reform (brief overview)

Background materials:

1. *Analytical Perspectives* from the Budget
2. Engen and Gale, "Effects of Social Security Reform on Private and National Saving"
3. Poterba, Venti, and Wise, "How Retirement Programs Increase Savings" (JEP, 1996)
4. CBO, *Long Term Budgetary Pressures and Policy Options* (May 1998)

PANEL 2: RETIREMENT AND HEALTH

Leaders: Jon Gruber and Victor Fuchs

Topics:
1. Trends in life expectancy
2. Trends in health status and ability to work
3. Trends in retirement behavior in US and around the world
4. Description of current and projected rules for NRA and EEA
5. Accelerating increases in the normal retirement age, and increases beyond 67
6. Increases in the earliest eligibility age
7. Implications for private pension systems and disability insurance

Background materials:

1. David Wise, "More Older People Living Longer, Working Less"
2. Gruber's papers on incentives for retirement internationally

PANEL 3: OTHER BENEFIT AND REVENUE OPTIONS

Leader: Option 1: Gene Steuerle and Michael Boskin
Option 2: Bill Gale and Ed Gramlich

Topics:
1. COLAs
2. State and local workers (including impact on current state and local programs)
3. Maximum taxable earnings
4. Income tax exemptions and treatment as private defined benefit plan
5. Primary insurance amount adjustments
6. Computation period extension
7. Impact of reform options on minorities and women

Background materials:
1. Gramlich report (relevant sections)

PANEL 4: ADMINISTERING INVESTMENTS IN PRIVATE SECURITIES -- EITHER THROUGH TRUST FUND OR INDIVIDUAL ACCOUNTS

Leaders: Option 1: Representatives from TIAA-CREF, Fidelity or State Street, TSP, and/or SSA/IRS
Option 2: Peter Diamond and TBD
Option 3: Representatives from other countries (e.g., UK and Australia on private accounts, Canada on Trust Fund investments). Could be combined with option 1 or 2.

Topics:
1. How individual accounts might be set up
   -- Mechanics of reconciliation
2. How investment board for Trust Fund might be set up
3. Administrative costs of individual accounts -- evidence from other countries
4. Administrative costs of individual accounts -- evidence from other U.S. experiences
5. Administrative costs of Trust Fund
6. Corporate governance issues: Trust Fund and individual accounts, including investment rules and investment board

PANEL 5: INVESTING THE TRUST FUND IN EQUITIES

Leaders: Henry Aaron and John Shoven

Topics:

1. Benefits to broadening asset diversification of Trust Fund: actuarial impact and savings impact
2. Benefits to broadening asset diversification of Trust Fund: risk sharing
3. Potential size of Trust Fund holdings relative to market aggregate
4. Investment rules -- indexes, international, etc. (see link to above)
5. Canadian experience
6. Budgetary implications

Background materials:

1. Alicia Munnell's paper
2. Chapters from Aaron and Reischauer's forthcoming book
3. Paper by Theo Angelis

PANEL 6: INDIVIDUAL ACCOUNTS

Leaders: Martin Feldstein and Steve Zeldes

Topics:

1. Funding sources: general budget vs. payroll charge
2. Mandatory vs. voluntary
3. Effects on national saving
4. Rates of return (see link to administrative costs above)

Background materials:

1. Geanakoplos, Mitchell, and Zeldes
2. Feldstein and Samwick

RETURN TO PLENARY SESSION

PUTTING A PLAN TOGETHER (60 minutes)

Leaders: Ed Gramlich, NCRP Congressional staff (e.g., Blahous/Lorenzen), and Steve Goss

Participants: Plenary

Topics:

1. Interaction effects between different reform options – illustrative examples
2. Timing effects and impact on different cohorts
3. How some illustrative plans were actually put together

CLOSING SESSION (30 minutes)

Leaders: President Clinton and Congressional Leadership

ILLUSTRATIVE SCHEDULE FOR DAY 1 AND DAY 2

Day 1

Event	Proposed time	Possible schedule
Opening	30 minutes	9:00-9:30
Structure of the Social Security system	45 minutes	9:30-10:15
Overview of the challenge	45 minutes	10:15-11:00
Break	15 minutes	11:00-11:15
Panel session #1	90 minutes	11:15-12:45
LUNCH	60 minutes	12:45-1:45
Panel session #2	90 minutes	1:45-3:15
Break	15 minutes	3:15-3:30
Panel session #3	90 minutes	3:30-5:00

Day 2

Event	Proposed time	Possible schedule
Panel session #4	90 minutes	9:00-10:30
Break	15 minutes	10:30-10:45
Panel session #5	90 minutes	10:45-12:15
LUNCH	60 minutes	12:15-1:15
Panel session #6	90 minutes	1:15-2:45
Break	15 minutes	2:45-3:00
Putting a plan together	60 minutes	3:00-4:00
Conclusion	30 minutes	4:00-4:30

LIST OF POSSIBLE OUTSIDE EXPERTS PROPOSED ABOVE

Henry Aaron
Michael Boskin
Peter Diamond
Martin Feldstein
Victor Fuchs
Bill Gale
Steve Goss
Ed Gramlich
Alan Greenspan
Jon Gruber
Jim Poterba
Robert Reischauer
John Shoven
Charles Shultze
Herbert Stein
Gene Steuerle
Laura Tyson
Paul Volcker
Steve Zeldes

Representatives from:

TIAA-CREF
Fidelity or State Street
TSP
SSA/IRS
Other countries
NCRP Congressional staff (e.g., Blahous/Lorenzen)

Other possible outside experts
Alan Blinder
Barry Bosworth
Gary Burtless
David Cutler
Brad deLong
Milton Friedman
Larry Katz
Robert Litan
Greg Mankiw
Alicia Munnell
June O'Neill

THE WHITE HOUSE

WASHINGTON

September 29, 1998

ANNOUNCEMENT OF FIRST BUDGET SURPLUS IN A GENERATION

DATE:	**September 30 , 1998**	
PLACE:	**Rose Garden**	
TIME:	**Pre-Brief**	**10:00 a.m. - 10:30 a.m.**
	Meet &Greet	**10:30 a.m. - 10:35 a.m.**
	Event	**10:35 a.m. - 11:00 a.m.**
From:	**Gene Sperling**	

I. PURPOSE

On the last day of the fiscal year, you will announce that the U.S. government has balanced its books for the first time in 29 years -- and indeed achieved a surplus. You will make the case for sticking with the economic strategy that achieved this success: maintaining fiscal discipline, investing in people, and leading the world economy toward renewed stability and open markets.

II. BACKGROUND

You will speak to invited guests from Congress, the business community, and the cabinet in the Rose Garden about the historic achievement of balancing the budget. You will highlight the benefits of a balanced budget to working Americans and urge Congress to maintain the fiscal discipline that led to this success -- by reserving the new budget surplus until we have strengthened Social Security.

You will be introduced by Ms. Kay McClure, the President and Co-Founder of Walhonde (WALL-hon-da) Tools, Incorporated. While the firm is a small family-owned business, it makes sophisticated precision tools for heavy construction projects, such as pulp-paper factories, nuclear submarines, and petro-chemical and food processing industries. The firm exports to Japan, Norway, Canada, and Mexico and is trying to break into the European market. Walhonde began to export to Japan in about 1994, after Ms. McClure participated in a trade mission there with Senator Rockefeller. Walhonde has felt the impact of the Japanese economic downturn and has recently cut its prices so that it could still compete there.

Since 1993, Walhonde's revenues have expanded by more than a quarter and their profit margin this year will be about 25 percent. They hope to have a million dollar in sales within the next couple of years. They have also increased their workforce from 5 employees -- several part-time -- to 9 employees today (8 full-time and one part-time).

And they are looking to hire one additional worker in the next 3-6 months. Walhonde has experienced first-hand the benefits of today's economy: their line of credit has been expanded dramatically and banks are even coming to the firm seeking to lend money.

Ms. McClure is married to the inventor of Walhonde's product line. She has four children (three of whom work for Walhonde) and nine grandchildren. She was a delegate to the President's 1995 White House Conference on Small Business where she placed special emphasis on international trade issues, taxes, and intellectual property rights.

III. PARTICIPANTS

Pre-Brief
Erskine B. Bowles
Sylvia Mathews
John Podesta
Jake Siewert

Event
POTUS
Erskine Bowles
J. Kay McClure (goes by "Kay"), President of Walhonde Tools, Inc.

IV. PRESS PLAN

Open Press

V. SEQUENCE OF EVENTS

The President, Erskine Bowles and J. Kay McClure are announced to a stage at the east end of the Rose Garden

Erskine Bowles introduces Kay McClure.

Kay McClure introduces **the President.**

The President gives remarks.

The President works a ropeline and departs.

VI. REMARKS

To be provided by Speechwriting

VII. ATTACHMENTS

Background paper on surplus.

PRESIDENT CLINTON:
CLOSING THE BOOK ON AN ERA OF DEFICITS --
THE FIRST BUDGET SURPLUS IN A GENERATION
September 30, 1998

President Clinton Closes The Book On A Generation of Deficits. In 1993, President Clinton put in place a three-part economic strategy to cut the deficit to help reduce interest rates and spur business investment; to invest in education, health care, and technology so that America was prepared to meet the challenges of the 21st century; and to open markets abroad so that American workers would have a fair chance to compete and win across the globe. Today, America's fiscal house is in order. After three decades of budget deficits, today marks the final day of fiscal year 1998 -- the first year the United States government will record a budget surplus since 1969.

- **Instead of $357 Billion <u>Deficit</u>, About $70 Billion <u>Surplus</u> This Year.** When President Clinton took office, the Congressional Budget Office (CBO) projected the <u>deficit</u> to be $357 billion this year; using preliminary information, the Administration expects the <u>surplus</u> to be about $70 billion this year. (The final numbers will be available at the end of October.)

- **About $70 Billion Surplus -- The First in A Generation.** In 1992, the deficit was $290 billion -- the biggest dollar deficit in American history. This year, the Administration expects the surplus to be about $70 billion -- the first in a generation (1969) and the biggest dollar surplus in American history. As a share of GDP, the budget surplus would be almost one percent this year -- the largest since the 1950s.

- **Six Years in A Row of Fiscal Improvement -- The First Time in U.S. History.** Reaching a surplus in 1998 marks the sixth consecutive year of improved fiscal balance -- the longest period in all of American history.

- **Surplus Estimated To Reach $150 Billion By 2002.** President Clinton promised to balance the budget by 2002. The budget is not only balanced this year -- four years ahead of schedule -- but is in surplus, which will grow to $148 billion by 2002, as projected in the Administration's mid-session review. Instead of the $579 billion deficit projected by CBO for 2002, the Administration projected in May 1998 a <u>surplus</u> of $148 billion for 2002 -- a $727 billion swing.

- **While Cutting Federal Spending To Its Lowest in a Quarter Century, President Clinton Has Expanded Critical Investments in the Future, Such As Education and Training.** President Clinton's 1993 Economic Plan included $255 billion in spending cuts over five years -- more than half of the total deficit reduction package. As a result, federal spending as a share of the economy has declined for each of the past 6 years and is now the lowest in 24 years. However, as spending has been cut in lower priority areas, President Clinton has dramatically increased funding in critical areas, such as education and training, children, the environment, health care, and research and development.

- **While Eliminating The Budget Deficit, President Clinton Has Provided Tax Relief for Middle-Income Families.** Because of the tax cuts for working families signed into law by President Clinton, the typical American family of four will face the lowest federal tax burden in over two decades (since 1976). President Clinton proposes to build upon this record to provide additional targeted, paid-for tax relief for child care, education, pensions, affordable housing, and the environment.

We Cannot Turn Back: We Have Fixed The Fiscal Deficit, Now We Need To Fix The Generational Deficit. In the State of the Union, President Clinton said that any projected budget surpluses should be reserved until Social Security is reformed. Today's achievement of the first balanced budget in three decades makes President Clinton's call even more timely. President Clinton will oppose any spending or tax proposal that fails to set aside surpluses until we have strengthened Social Security for the 21st century.

For America's Working Families, The Improved Fiscal Situation Means Lower Mortgage Rates And A Brighter Economic Future. Here's what the improved fiscal situation means to typical families:

- **Lower Deficits Mean a Lower National Debt -- $17,000 Less Debt for a Family of Four.** The national debt is $1.2 trillion lower now than projected by CBO in 1993 -- that's over $17,000 less debt for each family of four in America.

- **Lower Deficits Mean Lower Interest and Mortgage Rates -- Saving Families Thousands.** The government's share of total borrowing in U.S. credit markets has been eliminated, from nearly 60 percent just six years ago -- which, according to the *Wall Street Journal* (5/7), has played a "major role" in keeping down interest and mortgage rates. According to the *New York Times* and *Money* magazine, lower mortgage rates have saved the 10 million families who refinanced their home mortgages $1,000-$2,000 per year, on average. [Source: *New York Times*, 8/3/96; *Money*, 8/96]

- **Lower Mortgage Rates Mean Higher Homeownership.** Lower mortgage rates -- along with higher family incomes, faster job growth, and the President's National Homeownership Strategy -- have helped raise the national homeownership rate to its highest level in American history (66.0 percent). [Source: Bureau of the Census.]

- **Lower Interest Rates Mean Faster Business Investment Growth.** Under President Clinton, real business productive investment growth has averaged 12.8 percent -- the fastest since John F. Kennedy was President. [Source: Bureau of Economic Analysis, Department of Commerce.]

- **Lower Interest Rates Mean More New Small Businesses.** With lower interest rates, more people are investing in starting small businesses. As a result, in each of the last five years, we have had a record number of new small businesses. [Source: Dun & Bradstreet]

- **Faster Business Investment Growth Means Faster Economic Growth and More Jobs.** Faster business investment growth helps expand capacity and has led to faster economic growth and more jobs under President Clinton. Since President Clinton took office, the private sector of the economy has grown 3.9 percent per year -- far stronger than under President Reagan (3.0 percent per year), the economy has added 16.7 million new jobs, and unemployment has fallen to 4.5 percent -- the lowest in 28 years. [Source: Based on data from the Bureau of Economic Analysis, Department of Commerce, and Bureau of Labor Statistics.]

Experts Agree That President Clinton's 1993 Economic Plan Helped Cut the Deficit, Lower Interest Rates, Spur Business Investment, and Strengthen the Economy. The economy and the budget are now working in a virtuous circle -- lower deficits have led to lower interest rates which have led to faster business investment which led to faster growth which led to even lower deficits. Experts agree that President Clinton's 1993 Economic Plan helped create this virtuous circle.

- **Alan Greenspan, Federal Reserve Chairman, 2/20/96:** The deficit reduction in the President's 1993 Economic Plan was "an unquestioned factor in contributing to the improvement in economic activity that occurred thereafter."

- ***Business Week*, 5/19/97:** "Clinton's 1993 budget cuts, which reduced projected red ink by more than $400 billion over five years, sparked a major drop in interest rates that helped boost investment in all the equipment and systems that brought forth the New Age economy of technological innovation and rising productivity."

- ***U.S. News & World Report*, 6/17/96:** "President Clinton's budget deficit program begun in 1993... [led] to lower interest rates, which begat greater investment growth (by double digits since 1993, the highest rate since the Kennedy administration), which begat three-plus years of solid economic growth averaging 2.6 percent annually, 50 percent higher than during the Bush presidency."

- **Paul Volcker, former Federal Reserve Chairman, *Audacity*, Fall 1994:** "The deficit has come down, and I give the Clinton Administration and President Clinton himself a lot of credit for that... and I think we're seeing some benefits."

- ***Fortune*, 10/3/94:** "[The President's] economic plan helped bring interest rates down, spurring the recovery."

Then and Now: A Look Back at When America Had Its Last Budget Surplus

	When We Had Last Budget Surplus (1969)	Today (1998)
Dow Jones Industrial Average	876 (July 1)	8081 (September 29)
Price of a Can of Coca-Cola	15 cents	65 cents
Home Run Leader	Harmon Killebrew hits 49 home runs	Mark McGwire hits 70 home runs
Most Popular TV Show	Rowan & Martin's "Laugh In" (in July)	Seinfeld (past season)
Median Family Income	$9,433	$44,568
Size of U.S. Economy	$982 billion	$8.441 trillion
NBA Champions	Boston Celtics	Chicago Bulls
Anchors of Network News	David Brinkley (NBC), Walter Cronkite (CBS), and Howard Smith and Frank Reynolds (ABC).	Tom Brokaw (NBC), Dan Rather (CBS), and Peter Jennings (ABC).
World Series Champions	New York Mets	?
Best Picture	Midnight Cowboy	Titanic
Leader of Russia	Leonid Brezhnev	Boris Yeltsin
Speaker of the House	John McCormack	Newt Gingrich
Super Bowl Champions	New York Jets	Denver Broncos

BUDGET DEFICITS: 1969-1998

Fiscal Year	Deficit/Surplus (in billions of dollars)	Deficit/Surplus (as % of GDP)
1969	3.2	0.3
1970	-2.8	-0.3
1971	-23.0	-2.1
1972	-23.3	-2.0
1973	-14.9	-1.1
1974	-6.1	-0.4
1975	-53.2	-3.4
1976	-73.7	-4.3
1977	-53.7	-2.7
1978	-59.2	-2.7
1979	-40.7	-1.6
1980	-73.8	-2.7
1981	-79.0	-2.6
1982	-128.0	-4.0
1983	-207.8	-6.1
1984	-185.4	-4.9
1985	-212.3	-5.2
1986	-221.2	-5.1
1987	-149.8	-3.3
1988	-155.2	-3.1
1989	-152.5	-2.8
1990	-221.2	-3.9
1991	-269.4	-4.6
1992	-290.4	-4.7
1993	-255.0	-3.9
1994	-203.1	-3.0
1995	-163.9	-2.3
1996	-107.5	-1.4
1997	-21.9	-0.3
1998	About 70*	Nearly one percent*

* Estimate Based on Preliminary Information

Moving From An Era of Deficits to An Era of Surpluses: Fiscal Situation Has Improved Dramatically Since 1993

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	1993-1998	1993-2003
Projected Deficits in January 1993†	-290	-310	-291	-284	-287	-319	-357	-404	-455	-513	-579	-653	1,848	4,452
Actual and Projected Deficits	-290	-255	-203	-164	-107	-22	About 70*	54**	61**	83**	148**	150**	681	185
Difference	0	55	88	120	180	297	427	458	516	596	727	803	1,167	4,267

† From January 1993 Congressional Budget Office *Economic and Budget Outlook*.

* From Office of Management and Budget, September 30, 1998, based on preliminary information.

** From Office of Management and Budget, Mid-Session Review, May 1998.

THE WHITE HOUSE

WASHINGTON

November 3, 1998

MEETING WITH ECONOMIC TEAM ON SOCIAL SECURITY

DATE: November 4, 1998
TIME: 2:00-3:00 PM
LOCATION: Oval Office
FROM: Gene Sperling

I. PURPOSE

To discuss your strategy on Social Security reform between now and the State of the Union.

II. BACKGROUND

Between now and the State of the Union, you need to make a number of decisions on how best to begin the process to achieve bipartisan Social Security reform. The attached document walks you through a number of strategic issues that we will discuss with you tomorrow. Your advisors believe it is important that you read the attached document *before* you speak with Senator Daschle and Rep. Gephardt tonight and Senator Lott and Rep. Gingrich tomorrow morning.

While Congress is still out of session, it is very important for us to use the next couple of months to our advantage. We also need to discuss how the White House Conference on Social Security, which is scheduled for December 8th and 9th, fits into our overall strategy of achieving reform sometime next year.

We are also finalizing substantive options for you to discuss with your economic advisors either before you leave for Asia or immediately after you return.

III. PARTICIPANTS

The Vice President
John Podesta
Maria Echaveste
Gene Sperling
Secretary Rubin
Larry Stein
Larry Summers
Ken Apfel

Jack Lew
Sylvia Mathews
Ron Klain
Bruce Reed
Doug Sosnik
Paul Begala

IV. SEQUENCE OF EVENTS

1:40-2:00 Briefing by your advisors for pool spray.

2:00 YOU give short remarks for pool. Pool departs and meeting begins.

3:00 Meeting concludes and YOU depart.

V. PRESS COVERAGE

Pool spray at the beginning of the meeting

VI. REMARKS

To be provided by speechwriting.

VII. ATTACHMENTS

- Hand-out for Meeting.

THE WHITE HOUSE

WASHINGTON

SOCIAL SECURITY REFORM MEETING WITH ECONOMIC ADVISORS

Wednesday, November 4, 1998

Cabinet Room; 1:00pm

AGENDA

STRATEGIC QUESTIONS FOR BIPARTISAN SOCIAL SECURITY REFORM

I. **Decisions We Need Soon:**

- What should our tone be?
- Do we want to start bipartisan process now?
  - Should we call leadership to meeting?
  - Should we begin to discuss possible negotiating structures with the Hill?

II. **Decisions We Need To Consider Going Forward:**

- Do we begin to convince Democrats to be open to progressive Individual Accounts, as long as the basic program remains intact (consistent with the President's five principles)?
- What is the President's first substantive action?
  - Additional framework, guidelines, or principles;
  - Specific framework for legislation without legislative details; or
  - Specific plan.
- If we put out specific proposal, do we want to utilize a "center-out" strategy or a "left-in" strategy?

I. Why Social Security Reform?

- Perceived and real insolvency of Social Security system threatens confidence in crown-jewel of progressive government.
- Seeking reform under Democratic President in second term offers ability to reform Social Security in a way that is progressive and universal.
- Failure to achieve reform could lead to budget surplus being dissipated on spending or tax cut proposals, making eventual Social Security reform more painful and less generous.
- Waiting longer can make reforms within more traditional Social Security structure more difficult, could erode confidence in the system, and lead to more radical reform down the road.

II. Substantive Goals of Social Security Reform

- Reform that meets or strengthens five principles President laid out at Kansas City conference:

1. Strengthen and Protect Social Security for the 21st Century.
2. Maintain Universality and Fairness.
3. Provide a Benefit People Can Count on.
4. Preserve Financial Security for Low-Income and Disabled Beneficiaries.
5. Maintain Fiscal Discipline.

Possible Other Goals:

- Maintain or strengthen progressivity of current system.
- Increase national savings (compared to the surplus being spent).
- Achieve higher returns from Social Security system.
- Reduce widow poverty.
- Strengthen system even more for disadvantaged minorities.

III. Strategic Considerations for Social Security Reform

Bipartisan Reform Must Allow Wins for Both Sides:

- Republicans must have either Individual Accounts or surplus-funded tax cuts.

- Democrats must have either traditional Social Security reform without Individual Accounts or reform that secures the basic Social Security system and also achieves Democratic wins, such as increased progressivity, reduction in widow poverty, improvements for disadvantaged minorities, perception of universal pensions, or Individual Accounts seen as voluntary or on-top of normal structure.

Win-Win Compromises:

- Social Security reform with progressive Individual Account structure.

- Social Security reform without Individual Accounts, but large tax cuts.

Tone:

- We face a choice about our tone heading into this process. We could either:

  - Take a harder edge with Democratic rhetoric and hope to bring the Republicans to the table (and have greater leverage to get bipartisan deal with progressive support).

  - We could stay above the fray, acting as the honest broker seeking to craft and bless any acceptable compromise.

IV. Strategic Goals for Completing Reform in Current Environment

- Must convince Democrats to be open to progressive Individual Account structure as long as the basic Social Security program is maintained (consistent with the President's five principles).

  - Must convince Democrats that without reform this year, surplus will be used for tax cuts -- which would make eventual reform more difficult and less generous.

  - Individual Accounts -- if structured with a basic guarantee and structured like the Thrift Savings Plan (TSP) -- will not be open to harshest critiques and could be popular with some Democratic constituencies.

  - Show that being open to Individual Accounts could bring significant wins for Democrats on progressivity, widow poverty, disadvantaged minorities, etc.

- May need to create principled framework for Individual Accounts:
    - Individual Accounts must make system more progressive -- and basic system stays as progressive as currently.
    - Individual Accounts must offer basic guarantee.
    - Individual Accounts must be structured like TSP with limited choices, low fees, and measures to minimize churning, etc.

- Must convince Republicans to minimize size of Individual Accounts and meet President's demands on progressivity.

V. CHALLENGES WE MUST OVERCOME TO ACHIEVE BIPARTISAN REFORM

- Most bipartisan efforts currently involve fiscally conservative Democrats that don't represent mainstream of party. Likewise, a bipartisan agreement among members of the Senate Finance Committee would not get a majority of House Democrats.

- Many Republicans see Individual Accounts as a means to a completely privatized system. Their demands must be moderated to smaller Individual Accounts and allow for Democratic wins on progressivity.

- Democrats must be open to small Individual Accounts as trade-off for gains on progressivity, widow poverty, etc.

- Middle ground for Democrats has not emerged. Democrats are either for trust fund investments in equity which would leave the government with a significant share of the stock market or relatively harsh Individual Accounts with significant cuts in the traditional program (e.g., Kerrey, Moynihan, Breaux, Stenholm). We must help bring Democrats to middle ground.

Possible Members With Whom To Build Coalition:

- *Senate Democrats:* Daschle, Bingaman, Conrad.

- *House Democrats:* Few options, but possibilities include Pomeroy (Gephardt's representative on Social Security reform), Cardin, Rangel, and New Democrats.

- *Senate Republicans:* Gregg, Gramm, Santorum, Domenici, Chafee, Grassley all expressed desires to work with us. Many Republicans are scared of being targeted as "privatizers." The key challenge with Senate Republicans is that, for example, Gramm and Domenici have a broad clawback approach with 3 percent Individual Accounts and they would need to move to the center.

- *House Republicans:* Kolbe has shown moderate leadership; Sanford wants to work with us, but his proposal is still too excessive. It is unclear how much Gingrich and Armey will move to the center for the sake of reform.

VI. Options on Process

Timing:

- Should bipartisan process begin this year (November/December)?

  or

- Should it begin early next year (January/February)?

Initial Substantive Action:

- President's initial substantive action:
  - Does President put out additional framework, guidelines, principles that could lay out map for Individual Accounts or anti-poverty goals that must be accomplished?
  - Does President put out specific framework for legislation in discussion paper without legislative details?
  - Does President put out specific plan? Key timing issues: December Conference, Early January, or State of the Union.

Process Options:

Process Option #1:

- Republicans and Democrats each appoint head of Senate Finance and House Ways and Means plus one leadership choice for both Democrats and Republicans. (Both sides would be able to designate others on key issues to bring more people into the process.) The negotiating sides would likely be: Moynihan, Bingaman, Rangel, and Pomeroy and Roth, Gregg, Archer, and Sanford, plus Administration representatives. That would be 10-12 people at the table. If we go to next level -- by adding majority and minority members of the budget committees -- there would be 18-20 people in the room.
  - <u>Key Challenge</u>: There will be resistance to formal negotiating structure because people do <u>not</u> want to be cut out (e.g., Gramm, Conrad, Domenici, Kolbe, Stenholm, Breaux, Santorum, Grassley).

Process Option #2:

- Senate Finance Committee becomes vehicle for first negotiations happening among its members with White House participation.
  - <u>Key Challenge</u>: A bipartisan agreement among members of the Senate Finance Committee would <u>not</u> get a majority of House Democrats.

Process Option #3:

- o Use model of tobacco strategy: President puts out detailed guidelines (which he could do under any of these options) and vows to work with any group that wants comprehensive Social Security reform.

  - Key Challenge: May lose leadership points for not putting out specific plan. May be only starting point and issue would be when in process to put something forward that is more specific.

Process Option #3a:

- o President puts out detailed guidelines, but not specific plan. Provides framework for negotiations to go forward with Finance Committee and Ways and Means.

Process Option #4:

- o President does serious consultations and puts out specific Social Security reform plan.

  - Pros:

    President would get immediate leadership points for putting out specific plan.

    Would help jump-start Social Security process to have Presidential plan on the table.

  - Cons:

    A centrist proposal -- "center-out" strategy -- by the President could be criticized by base groups for giving up too much at the start, while Republicans may feel they need to move to the right of the President (even if it would otherwise be acceptable).

    A "left-in" strategy may solidify our base's position that we do not need to compromise and may give Republicans the impression that we are not serious about Social Security reform.