1997-SE-002005

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

February 24, 1997

MEMORANDUM FOR **SECRETARY RUBIN**

FROM: David A. Lipton DL
Assistant Secretary (International Affairs)

SUBJECT: Memorandum for the President on Chile

President Frei of Chile is making a state visit this week beginning Wednesday. In anticipation of this event, we have prepared the attached memorandum from you to the President providing information on two themes of likely interest -- Chile's economic performance, the best in Latin America, and its experience with pension reform.

RECOMMENDATION. That you sign the attached memorandum for the President.

AGREE_______________ DISAGREE________________ OTHER______________

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

MEMORANDUM FOR THE PRESIDENT

FROM: **ROBERT E. RUBIN**

SUBJECT: **CHILE**

In anticipation of President Frei's visit to Washington this week, I wanted to share some thoughts on Chile's enviable economic record and pension system.

Economic Performance. Chile is often described as an East Asian country in Latin America. While the comparison can be overdrawn, Chile is by far the leading economic performer in the region. Its economic success -- and the policies driving it -- can provide important lessons for the rest of the region.

Chile's economic reform program began after the military seized power in 1973. The reforms focussed on unleashing market forces, including deregulation of financial markets, liberalization of trade and some financial transactions, elimination of subsidies and price controls, and a far-reaching privatization program. Perhaps most remarkably, the government has run a surplus every year since 1989.

The results have been impressive: since 1986, real GDP has grown an average of about 7% per annum, while inflation has fallen from over 27% in 1990 to less than 7% last year. Even in 1995, while the rest of the region was struggling in the aftermath of the Mexican crisis, Chile's economy grew by 8.5%. Chile's high savings rates -- along with strong capital inflows -- have helped permit a high level of domestic investment, as well as significant Chilean investment abroad.

Pension System. One of the most interesting reforms was the 1981 restructuring of Chile's pension system, which is often cited as a possible model for reforming Social Security. Under the reform, a government-run system was replaced by one in which contributions are defined, but all participants have individual retirement accounts managed by private companies. The government guarantees a minimum pension for poorer participants and a minimum return on accumulated funds, and also provides some guarantees against bankruptcy of a fund.

Assets of the pension funds now total over 40% of GDP and have been a major force in modernizing Chile's capital market and in providing long-term financing for investment. This growth owes much to the funds' high rates of return, which exceeded 15% per annum in the first 15 years of operation (although they suffered a 5% loss last year).

The reform has increased private savings and may have helped raise total national savings (which rose from less than 10% of GDP in 1986 to almost 29% in 1996), although this is a source of controversy. The funds' administrative costs -- about eight times those of our Social Security system -- have also been criticized, although they have declined and could decline further.

1997-SE-002942

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

March 12, 1997

Vice President Albert Gore, Jr.
Office of the Vice President
Old Executive Office Building
Washington, D.C. 20501

Dear Mr. Vice President:

I spoke with Ward Hussey, as you suggested. As it turns out it's a very small world. Ward and my wife have worked closely together in the past.

My conversation with Ward was very timely and tremendously helpful. Ward's views on structural problems in Russian tax administration coincide with what our people are saying - which gives me added confidence in our views. I will push these views with the Russians and will report to you when I get back.

Sincerely,

Lawrence Summers

Barretta - 3/13
will you
make sure
this gets
in the AM
WH pickup
Thanks - NC

NCC faxed to
WH 3/12/97

NCC cc to JBN
MF
3/12/97

Please Log
and File Prepared
by L. Summers

****
*** ACTIVITY REPORT ***
****

TRANSMISSION OK

TX/RX NO.	5337
CONNECTION TEL	94567044
CONNECTION ID	OVP
START TIME	03/12 20:18
USAGE TIME	00'56
PAGES	2
RESULT	OK

FACSIMILE COVER SHEET

Deputy Secretary of the Treasury
Washington, D.C. 20220

DATE: March 12, 1997 NUMBER OF PAGES TO FOLLOW: 1

TO: Vice President Albert Gore, Jr.

FAX: 456-7044

PHONE: 456-2326

FROM: Lawrence Summers

SENDER' FAX NUMBER: 202/622-0081

SENDER'S CONFIRMATION NUMBER: 202/622-1780

1997-SE-004318

→ Check language
→ Establish Nat'l Comm

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 17, 1997

INFORMATION

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY RUBIN

FROM: Joshua Gotbaum
Assistant Secretary (Economic Policy)

SUBJECT: **Medicare and Social Security Trustees Reports**

Attached please find draft materials for the annual Trustees Reports. Deputy Secretary Summers has already received these materials. We are now in the final stages of preparing these reports. A trustees meeting is scheduled for April 24th and (Thurs) we would like to send them to the printer this weekend. Specifically provided are:

Conclusions

1. The Old-Age, Survivors Insurance and Disability Insurance Trust Fund Report (conclusion only) Tab A; OAS + DI = 2029

2. The Federal Supplementary Medical Insurance Report (conclusion only) Tab B; and, SMI = Good

3. Hospital Insurance Trust Fund Report (conclusion only) Tab C. HI = 2001

We and other members of your staff are reviewing them, as are the other Trustees. Additional comments are due by c.o.b. Friday, April 18.

Attachments: Tab A: OASDI Report Conclusion
Tab B: SMI Report Conclusion
Tab C: HI Report Conclusion

- Doc [illegible] Ala. Cole

Prepared by Glen Rosselli

Judd [illegible] GC, Leg Affairs
- cleared by REC 4/18/97

EXECUTIVE SECRETARIAT

Overview

I. CONCLUSION

As we have reported for the last several years, the combined OASI and DI Trust Funds are adequately financed over the next 10 years, and for many years thereafter, but the program is not in close actuarial balance over the next 75 years. Thus, the combined funds meet the short-term solvency test under all three sets of assumptions, but not the long-term test.

1. Short-term Status

At the beginning of 1997, the combined assets of the trust funds represented 153 percent of estimated expenditures in 1997. Under both the intermediate and low cost assumptions, the combined funds, as well as the ratio of fund assets at the beginning of a year to annual expenditures, are projected to grow during the next 10 years and for several years thereafter. However, under the high cost assumptions, while the assets of the combined funds continue to grow throughout the next 10 years, the trust fund ratio would be lower at the beginning of 2002, and each year thereafter, than it was at the beginning of the previous year. Both the OASI and DI Trust Funds separately meet the short-term solvency test.

2. Long-term Status

Although the combined trust funds are well financed over the next 10 years, the OASDI program is not in close actuarial balance over the full 75-year projection period and therefore does not meet the long-term solvency test. The estimated actuarial balance is a deficit of 2.23 percent of taxable payroll over the next 75 years, based on the intermediate assumptions. The combined OASI and DI Trust Funds would become exhausted in 2029 without corrective legislation. At that time, annual tax revenues of the combined trust funds would be less than expenditures by 4.26 percent of taxable earnings and would be sufficient to cover only 75 percent of annual expenditures.

The intermediate estimates indicate that the combined trust funds would be sufficient to enable the timely payment of benefits for the next 32 years. Relative to annual expenditures, the combined trust funds would continue to grow during the next 14 years, reaching a peak of about 2.6 times annual expenditures. Considering each fund separately, the OASI Trust Fund would have sufficient funds for the next 34 years, and the DI Trust Fund for the next 18 years, to enable timely payment of benefits. Based on the high cost assumptions, the combined funds would be sufficient to enable the timely payment of benefits only for the next 21 years.

For each of the next 15 years, OASDI income from contributions on earnings and income taxes on benefits is expected to exceed total expenditures. Starting in about 2010, however, OASDI costs, relative to taxable earnings, are expected to begin increasing rapidly as the "baby-boom" generation reaches retirement age. In contrast, the program's income from contributions on taxable earnings and income taxes on benefits will remain a relatively constant percentage of taxable payroll.

Therefore, the OASDI cost rate is estimated to exceed the income rate from 2012 through the end of the projection period, with the shortfall reaching 5.90 percent of taxable earnings by 2071, the last year of the 75-year period. Based on the less favorable conditions assumed for the high cost estimates, the crossover point would be reached in 2001, and the shortfall would grow eventually to be 15.09 percent of taxable earnings by 2071.

Although OASDI annual balances become negative in 2012 in the intermediate case, the availability of interest earnings results in continued trust fund growth until 2019. Because expenditures are estimated to increase faster than assets, however, OASDI assets would decline relative to annual expenditures, from about 2.6 to about 2.1 times annual expenditures, during the same period.

3. Recommendations

In view of the lack of close actuarial balance in the OASDI program over the next 75 years, we again urge that the long-range deficits of both the OASI and DI Trust Funds be addressed in a timely way. Because the DI Trust Fund is expected to be depleted several years earlier than the OASI Trust Fund, and because DI program growth has fluctuated widely in the past, it is essential that the DI program's future experience be monitored closely

It is important to address both the OASI and DI problems soon to allow time for phasing in any necessary changes and for workers to adjust their retirement plans to take account of those changes. The proposals in the recent Advisory Council Report and others being advanced by public officials and private organizations should be carefully evaluated by the government and the public. It is essential that the financial status of the Social Security program be strengthened and maintained.

However, we continue to believe there is ample time to discuss and evaluate alternative solutions with deliberation and care. The size of the long-range deficit is such that long-range balance can be restored within the framework of the present program* Nonetheless, the impact of any required changes will be less disruptive the sooner they are enacted.

Insert
* or with plans that offer more structural change.

F. CONCLUSION

The financing established for the SMI program for calendar year 1997 is estimated to be sufficient to cover program expenditures for that year and to preserve an adequate contingency reserve in the SMI trust fund. Moreover, trust fund income is projected to equal expenditures for all future years—but only because beneficiary premiums and government general revenue contributions are set to meet expected costs each year.

As in past years, we note with great concern that program costs have been growing faster than the GDP and that this trend is expected to continue under present law. Initially, this rapid growth is attributable primarily to assumed continuing rapid growth in the volume and intensity of services provided per beneficiary. Starting in 2010, the retirement of the post-World War II baby boom generation will also have a major influence on the growth in program costs.

Of additional concern is the fact that premium income after 1998 is projected to cover a progressively smaller fraction of SMI expenditures, shifting a greater share of program financing from beneficiaries to the general public

Given the past and projected cost of the program, we urge the Congress to take additional actions designed to control SMI costs in the near term. For the longer term, the Congress should develop legislative proposals to address the large increases in SMI costs associated with the baby boom's retirement through the same process used to address HI cost increases caused by the aging of the baby boom. We believe that prompt, effective, and decisive action is necessary.

To facilitate long-term reform, we recommend the establishment of a national advisory group to examine the Medicare program. The advisory group would develop recommendations for effective solutions to the long-term financing problem. This work will be of critical importance to the Administration, the Congress, and the American public in the extensive national discussion that any changes would require.

G. CONCLUSION

The HI program remains severely out of financial balance. As we have since 1992, we must report that the HI trust fund does not meet even our short-range test of financial adequacy. For the past 2 years, HI expenditures have exceeded income (by $2.6 billion and $5.3 billion, respectively). These shortfalls were met by redeeming trust fund assets, but future income and assets will be insufficient to support projected program expenditures beyond the next 4 years under the intermediate assumptions. Thus, without corrective legislation soon, the fund would be exhausted shortly after the turn of the century—initially producing payment delays, but very quickly leading to a curtailment of health care services to beneficiaries.

The long-range outlook also remains extremely unfavorable. The HI program fails by a wide margin to meet our long-range test of close actuarial balance, which is based on the intermediate assumptions. It would fail the long-term test even using the more favorable economic and demographic conditions assumed for the "low cost" scenario. To bring the HI program into actuarial balance, over just the next 25 years under the intermediate assumptions, would require either that outlays be reduced by 40 percent or that income be increased by 66 percent (or some combination of the two) throughout this 25-year period. That is, the current HI payroll tax of 1.45 percent (for employees and employers, each) would have to be immediately raised to about 2.46 percent, or benefits reduced by a comparable amount. Over the full 75-year projection period, substantially greater changes in income and/or outlays are needed.

We should note that steps have been taken to reduce the rate of growth in payments to hospitals, including the implementation in 1983 of the prospective payment system for inpatient services in most hospitals. Experience to date suggests that this reimbursement mechanism, together with subsequent payment limitation provisions enacted by the Congress, has helped to constrain the growth in hospital payments while encouraging increased operating efficiencies. Additional measures of this type could partially address the short-range financing concerns. For example, extension of a prospective payment system to other providers of HI services, and further legislation to limit payment increases to all HI providers, could help reduce expenditure growth rates. Such changes alone, however, would not be sufficient to insure payment of HI benefits over the next decade.

Moreover, substantially stronger steps will be needed to prevent trust fund depletion after 2010 as the baby boom generation reaches age 65 and starts receiving benefits. At that time, the ratio of workers to HI beneficiaries, currently about 4 to 1, is projected to begin declining rapidly to a ratio of about 2 to 1.

The HI trust fund's projected exhaustion by 2001 dictates the need for prompt, effective, and decisive action. We have called for this action in the past, and the situation is even more critical today. Further delay in implementing change makes the problem harder to solve. In the past, both the President and the Congress have made proposals that address the imminent depletion of the HI trust fund. We urge enactment of legislation this year to further control HI program costs and thereby extend the life of the trust fund.

Such legislation, however, would represent only a modest first step toward achieving long-range balance between HI costs and funding. The time gained by postponing the depletion of the HI trust fund should be used productively to determine feasible solutions to the more daunting long-range problems. This process should recognize that the nation's health care system is changing rapidly. The performance of alternative modes of treatment and service delivery over the next few years, in both quality and cost, should provide new information that will contribute to better legislative decisions regarding the long-range outlook for HI.

To facilitate long-term reform, we recommend the establishment of a national advisory group to examine the Medicare program. The advisory group would develop recommendations for effective solutions to the long-term financing problem. This work will be of critical importance to the Administration, the Congress, and the American public in the extensive national discussion that any changes would require.

The projections shown in this report clearly demonstrate the urgent need for timely and effective action to address the financial imbalance facing the HI trust fund. We believe that solutions can and must be found to restore and maintain the financial integrity of the HI program in both the short term and the long term.

1997-SE-006201 WATCH

June 6, 1997

Memorandum to: Secretary Rubin
Deputy Secretary Summers

From: Alan Cohen AC

Subject: Should we have Separate Commissions for Medicare and Social Security

It is my understanding that at the last minute, a meeting was scheduled for this morning on the issues related to possible Medicare and Social Security Commissions.

As this meeting was scheduled at the last minute, no Treasury staff could provide briefing of any issues for you. I wish to provide you with my thoughts on one critical issue. These views are mine only; others at Treasury may agree or disagree.

The issue is: If we have commissions to explore long-run changes in Social Security and Medicare, should the commissions be separate or together?

From a financing and budgetary viewpoint, I feel very strongly that the two issues should be handled under the aegis of one commission, although this commission could have two subcommittees. Here's my reasoning:

The issues of the solvency of individual trust funds such as Social Security and Medicare Part A are relatively meaningless. This becomes even more clear when solvency can be affected significantly by shifts such as for home health expenditures.

What does have fiscal importance is the difference between total Federal revenues and total Federal expenditures on a yearly basis. Social Security and Medicare budgetary policy must be evaluated from that perspective, in my opinion.

Therefore, it makes no sense to have completely independent commissions for each of them. At least for budgetary purposes, the programs must be analyzed together in the context of trends in the difference between total expenditures and revenues. The policies for each could be analyzed separately by two subcommittees. But there needs to be a "full committee" that ultimately views them jointly for budgetary purposes.

To: Alan Cohen
Fr: Bob Rubin
I don't know whether I agree or not, but this is a view we need [illegible] expressed. Please pass this on ~~Gene~~ to Gene, who is our coordinator on this, as on all else

648

Illustrative Baseline Tax Package: Preliminary Treasury Estimates (except where noted)
Dollar amounts in millions, June 8, 1997

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
Education package													
HOPE scholarship, $1000; Tuition Deduction, $10,000 \1	-78	-3,714	-5,556	-6,677	-9,219	-9,962	-10,113	-10,473	-10,732	-11,281	-11,447	-35,128	-89,174
K-12 allocable school finance credits	0	-400	-500	-600	-700	-800	-1,000	-1,000	-1,000	-1,000	-1,000	-3,000	-8,000
Make Section 127 Permanent \2	-82	-645	-670	-730	-796	-833	-874	-914	-951	-988	-1,042	-3,674	-8,443
Student Loan Interest deductibility	-15	-370	-322	-348	-376	-406	-439	-475	-513	-555	-600	-1,822	-4,404
Middle-Class Tax Relief and Saving Provisions													
Refundable Kidsave Credit \3	-732	-11,855	-14,049	-17,382	-17,302	-17,242	-19,891	-22,450	-22,287	-24,479	-26,520	-77,830	-193,457
Individual AMT reform, start in 2003 \4	0	0	0	0	0	0	-382	-760	-1,013	-1,412	-1,969	0	-5,536
Capital Gains, Estate Tax Relief and Business Relief													
Bumpers-Matsui Targeted Small Business Capital Gains Relief \5	-10	-40	-43	-68	-96	-118	-146	-217	-287	-316	-347	-365	-1,678
President's Home Sales Provisions \5	-10	-90	-241	-228	-214	-199	-183	-165	-147	-127	-106	-972	-1,700
Daschle Estate Tax Proposals (JCT)	0	-440	-540	-640	-740	-840	-1,000	-1,200	-1,400	-1,600	-1,800	-3,200	-10,200
Home Office Provision	-26	-90	-103	-118	-133	-150	-169	-189	-211	-234	-257	-594	-1,654
Urban Initiatives													
Distressed Areas Initiatives \6	-40	-426	-505	-509	-478	-421	-368	-326	-292	-260	-230	-2,339	-3,815
Welfare-to-Work	0	-68	-137	-163	-122	-61	-20	-5	-1	0	0	-551	-577
Other Tax Incentives \7	-10	-141	-214	-257	-301	-369	-345	-387	-429	-1,395	-2,405	-1,282	-6,243
One-year Extensions of Expiring Provisions	-438	-968	-747	-330	-145	-52	-8	0	0	0	0	-2,242	-2,250
Gross Tax Cut	-1,441	-19,247	-23,627	-28,050	-30,622	-31,453	-34,938	-38,561	-39,263	-43,647	-47,723	-132,999	-337,131
Revenue Offsets	623	8,488	9,073	9,951	10,411	12,078	11,202	11,679	12,080	12,538	12,988	50,001	110,488
Total Net Cut	-818	-10,759	-14,554	-18,099	-20,211	-19,375	-23,736	-26,882	-27,183	-31,109	-34,735	-82,998	-226,643

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1,000 in 1998 - 1999 and $1,500 in 2000 and indexed thereafter. The tuition deduction is $5,000 in 1998 and 1999 and $10,000 thereafter.
\2 Includes 10% employer credit for small business training.
\3 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for education or retirement. The credit is refundable only to taxpayers with earnings of $2,000 or more in 1997. The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each child credit allowed. The credit is $200 in 1997, $300 in 1998, and $500 in 1999 and indexed thereafter. The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed beginning in 2000.
\4 Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), and allows personal credits to offset AMT liability.
\5 The expansion of Section 1202 provides a 75 percent exclusion on up to $20 million of gain for companies with aggregate capitalization of less than $100 million.
\6 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI
\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

FYI Sent to Secretary via Driver Sunday Evening

The Secretary of the Treasury

June 9, 1997

NOTE FOR ALAN COHEN

FROM: BOB RUBIN

I don't know whether I agree or not, but this is a view no one else expressed. Please pass this on to Gene, who is our coordinator on this, as on all else.

Attachment

1997-SE-010527

September 12, 1997

Memorandum to: Secretary Rubin
Deputy Secretary Summers

From: Alan Cohen
Senior Advisor

David Wilcox

Subject: **Impact of "Transferring Budget Surpluses to Social Security**

Both OMB and CBO are projecting unified annual budget surpluses beginning in 2002 and continuing for some time thereafter. The suggestion has been made that these surpluses be transferred to the Social Security Trust Fund. The question arose: what impact would this proposal have on the Trust Fund's solvency.

To answer this question it was assumed that these surpluses would grow until 2010 and then diminsh each year until they reached zero near 2020. This pattern is similar to the pattern shown in the analysis in the President's FY 1997 budget of the impact of enacting the policies in the President's February budget.

If the "transfer" proposal were executed beginning in 2002 with the OMB projected surpluses, the life of the OASDI trust fund would be extended from 2029 to 2041. The 75-year actuarial deficit would be lowered from 2.23 to 1.53 percent of payroll if the transferred surpluses earn the government interest rate assumed by the Trustees (2.7 percent real). This is a reduction in the actuarial deficit of approximately one-third. The augmented trust fund would peak at 516 percent of annual outlays in 2016 (see attached table).

Using CBO's surplus estimates, the exhaustion date would be 2035 and the actuarial deficit would be reduced to 1.87 percent of payroll, a reduction of about one-sixth.

Alternatively, the surpluses could be partially invested in equities that earn the same real return assumed by the Advisory Council (7 percent). Under this scenario, half the trust fund addition created by transferring the surpluses would always be invested in equities and half always in government bonds, for an effective real return of 4.85 percent on this "increment" to the trust fund. In this alternative, the augmented trust fund would be exhausted in 2054 -- about 25 years later than the current projection -- assuming the OMB surplus estimates. The actuarial deficit would be reduced to 0.52 percent of payroll for the OMB estimates of the surpluses, a drop of about three-fourths. Using the CBO surpluses, the exhaustion date would be delayed about 10 years (to 2039) and the actuarial deficit would be reduced to 1.29 percent of payroll, about a 40% decline.

Caveats:

1. It is true that:

    a. Preserving the currently projected surpluses in the unified budget will help our long-run fiscal position in at least four ways -- as described in Alan Cohen's earlier memo and

    b. "Transferring" these surpluses to the Social Security Trust Fund may provide political fortification against those who would seek to dissipate the surpluses in one way or another

<u>However, "transferring" the surpluses to the Social Security Trust Fund -- in and of itself -- does nothing to improve the fundamental fiscal health of the overall Federal government (social security plus non-social security)</u>. This statement is true notwithstanding the fact that transfers of the type described here would push back the exhaustion date of the social security trust fund. Why? Because the transfers would neither raise the volume of taxes collected from the public, nor cut the volume of expenditures, and it is the levels of taxes and expenditures that determine the long-term fiscal health of the overall government.

2. Transferring general revenues equal to the unified surplus would be arbitrary because such transfers are not directly related to the surpluses currently projected to accumulate in the Social Security trust fund.

NEC to [illegible] (AB [illegible])

NEC cc to LS (reading)

NEC cc [illegible] MF SS

9/12/97

please [illegible]

Transferring Unified Surpluses to the Social Security Trust Fund

Effect on OASDI Trust Fund	*1997 TR*[1]	Govt. (2.7% real)		Mixed* (4.35% real)	
		CBO	*OMB*	*CBO*	*OMB*
Year of trust fund exhaustion	2029	2035	2041	2039	2054
Increase (years)	---	6	12	10	25
75-year actuarial deficit**	2.23	1.87	1.53	1.29	0.52
Reduction in deficit**	---	0.35	0.70	0.94	1.71
Peak trust fund ratio***	265	389	516	406	561
Year of peak	2011	2015	2016	2015	2017

1 TR means Trustees' Report

*Assumes fund increment created by transfer is held in equal amounts at a 2.7% and 7.0 % real return.

** Percent of payroll.

*** Trust fund as a percent of annual outlays.

Source: SSA-OACT; Sept. 8, 1997.

1997-SE-012185

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

November 13, 1997

MEMORANDUM TO: **DEPUTY SECRETARY SUMMERS**

FROM: **DAVID WILCOX**
JONATHAN GRUBER

RE: **Agenda for Social Security Research**

Following on your conversation with Ken Apfel yesterday, we attach a brief tentative agenda for Social Security research, with our thoughts on responsibility. Reflecting our perception of your wishes on this, we have assigned responsibility only to Treasury and SSA, and not to other agencies.

An Agenda for Studying Social Security Reform
Lead Agency in Caps

I) Budget Surplus Issues and Strategies - TREASURY

- Effects of alternative strategies for the fiscal health of Social Security, the rest of the Federal government, and national saving
- Politics/optics of alternatives

II) Defined Benefit Reform Issues - SSA

- Changing the early normal retirement age
- Lengthening the income averaging period
- Including state & local workers
- Reforming the structure of dependent/survivor benefits
- Inflation adjustment
- Disability Insurance issues
- Other changes to benefits generosity (e.g. through indexation of bend points)

III) Issues Around Investing Social Security Trust Fund in Equities - TREASURY

- Financial risk and return characteristics of alternative investment strategies
- Political risk of alternatives

IV) Moving Towards a Defined Contribution System - TREASURY

- Effects on fiscal health of Social Security
- Effects on individual rates of return and riskiness of that return
- Implications for redistribution through Social Security
- Implications for national saving

TREASURY CLEARANCE SHEET

NO.
DATE: 11-13-79

MEMORANDUM FOR: SECRETARY X DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
ACTION BRIEFING X INFORMATION ☐ LEGISLATION ☐ PRESS RELEASE
☐ PUBLICATION ☐ REGULATION ☐ SPEECH ☐ TESTIMONY ☐ OTHER ________

FROM: David Wilcox and Jonathan Gruber
THROUGH:
SUBJECT: Agenda for Social Security Research

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
- ☐ Customs
  - ☐ FLETC
  - ☐ Secret Service
- ☐ General Counsel
- ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
- ☐ Other ________

Name (Please Type)	Initial	Date	Office	Tel. No.
INITIATOR(S)				
REVIEWERS				

SPECIAL INSTRUCTIONS:

☐ Review Officer Date ☐ Executive Secretary Date

1997-SE-013779

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220
December 23, 1997

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: David Wilcox DW

SUBJECT: Social Security Distributional Analysis

The attached note, prepared by Jim Duggan of my staff, estimates the distributional effects of several of the social security reforms suggested by the members of the social security advisory committee. This note estimates the effects these reforms would have had if they had been fully phased in for recent retirees. We are working to expand our capability to estimate the effect reforms would have on future retirees as well.

DISTRIBUTIONAL EFFECTS OF SOME SOCIAL SECURITY REFORMS

This note describes some distributional effects of several possible reforms to the social security program:

- Increasing by three the number of years used in computing initial benefits.
- Reducing benefit formula adjustment factors by five percent.
- Raising the normal retirement age from 65 to 67.
- Reducing the COLA for post-retirement benefits.

In this note, we concentrate exclusively on estimating the distributional impact of these proposals on individuals who were born in 1927 and who chose to retire either at age 62 or age 65; in work going on right now, we are developing results for other birth cohorts and beneficiary groups.

Sample and Procedures

We begin with a sample of persons from the one-percent 1992 Continuous Work History Sample (CWHS) who were born in 1927, and therefore turned 65 in 1992, the last observed year in the data file. The total sample of 5,579 observations consists of persons in various beneficiary categories, deceased persons, and nonbeneficiaries. Our analysis is based on the 2,084 individuals who chose to start receiving retirement benefits either at age 62 or age 65.[1]

- About 37 percent of the (total) sample chose to begin receiving retirement benefits at age 62 (25 percent) or at age 65 (12 percent).
  - -- We used the observations on this subsample to evaluate the accuracy of our benefit calculation program. We found that the average absolute difference between actual and predicted benefit was less than 1 percent.

For each person in the sample, we compute a real rate of return on Social Security contributions using the following approach.

- We begin by estimating the initial benefit received at age 62 or age 65 under current law, and under each of the proposed modifications to current law.
- We then use a logit model for the probability of death to estimate a life expectancy for each element of the sample.

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[1]Of the remaining 3,495 observations, 31 percent receive nonretiree benefits (disability or survivor), 19 percent retired at ages 63 or 64, and 50 percent were nonbeneficiaries as of 1992.

- We next construct an entire trajectory for benefits, from the initial level in 1989 or 1992 to the date of death, using the intermediate assumption about CPI growth from the 1997 Trustees Report.

- Finally, we calculate the internal rate of return on the overall set of cash flows (contributions and benefits). We also use the historical and assumed OASDI trust fund interest rates to calculate the present-discounted value of benefits and contributions, and thus to estimate the impact of each proposal on net benefits.

Results

Our results are presented in four tables, two for each retirement cohort.

- The top panel of Table 1 shows, for age 62 retirees, the initial benefits payable, total net benefits payable, and real rates of return, under current law. The remaining panels show the same information under each of the proposed modifications.

- For convenience, Table 2 simply computes differences from the baseline (percentage differences for benefit numbers).

- Tables 3 & 4 repeat tables 1 and 2 for age 65 retirees.

In all tables, separate results are shown for low, medium, and high-income earners. Here, we define "income" as the average of covered wages from age 46 to age 60, with each year's earnings measured in thousands of 1997 dollars.

As is shown in the top panel of each table, higher-income persons receive higher initial benefits. Generally, higher-income persons also receive and higher net lifetime benefits, though the net benefit pattern is not monotonic across income classes. Real rates of return decline as income rises, which characterizes the basic progressivity of the system. The proposed modifications to the benefit structure will not change that fundamental result.

Increase in Computation Years. Under current law, initial retirement benefits for persons born in 1927 are based on the average of the 33 highest years of indexed earnings (35 for persons born after 1928). The denominator is 33 whether or not periods of zero earnings occur. The proposal would extend the period to 36 years (to 38 years for persons born after 1928).

As is shown in the tables, *initial* benefits fall by a greater percentage for low-income than high-income persons. However, in terms of net lifetime benefits, the opposite is true: high-income earners suffer a greater loss from current law. The impact on rates of return is greater for low- and middle-income workers than for high-income workers.

Reduce Benefit Formula Adjustment Factors. Under current law, a piece-wise linear formula is applied to average indexed earnings to obtain an initial benefit (primary insurance amount). The rates applied to the three segments of the formula are .90, .32, and .15. The proposal examined would reduce each rate by 5 percent, to .855, .304, and .1425.

As expected, initial benefits are cut across the board by 5 percent. This is also true for lifetime benefits. Net lifetime benefits (benefits - contributions) fall by a greater percentage for high-income beneficiaries, reflecting the fact that lifetime contributions (which do not change with the proposal) are much higher for those people. The rate of return falls by a relatively small amount in each case.

Raise Normal Retirement Age. Under current law, the initial retirement benefit is 100 percent of the initial primary insurance amount at age 65 ("normal retirement age"). The normal retirement age is scheduled to increase gradually to 67 but this will not affect eligibility for retirement at age 62. Rather, the effect will be an additional reduction in initial retirement benefits. Currently, the age-65 benefit is reduced by 5/9 of 1 percent for each month below 65 that retirement occurs. This means an age-62 retiree receives 80 percent of the age-65 benefit. As the "normal" retirement age begins to increase, months of early retirement after 65 will result in an additional 5/12 of 1 percent reduction, so that an age-62 retiree will receive 70 percent of the normal age benefit when the normal retirement age reaches 67. The fully phased-in proposal therefore results in a 12.5 percent reduction in initial benefits compared to current procedures.

The tables show the effect of a 12.5 percent reduction in initial benefits. The pattern of changes from current law is similar to that of the preceding proposal and, as expected, the magnitudes more than double.

Reduce Post-retirement COLA. Post-retirement benefits are increased annually according to increases in the CPI. The proposal would reduce the increase in the CPI by 0.2 percentage points each year beginning in the year 2000. As shown in the following tables, this would have a very modest effect on benefits and rates of return.

Future directions

We intend to extend the analysis in several dimensions: more cohorts rather than just the one born in 1927, married beneficiaries in addition to single, and those retiring at different ages. We look forward to your feedback.

Table 1. Distributional Effects of Social Security Reforms for Age 62 Retirees

Population Class	Initial Benefits (1997$)			Net Benefits (1997$)			Real Rates of Return		
	L	M	H	L	M	H	L	M	H
CURRENT LAW									
Males	5,396	8,620	10,950	62,611	71,050	58,439	5.98	4.83	4.12
Females	3,976	6,551	9,673	60,525	71,844	75,426	7.74	6.02	4.87
INCREASE COMPUTATION PERIOD THREE YEARS									
Males	5,220	8,235	10,694	57,441	63,385	53,341	5.81	4.66	4.02
Females	3,894	6,264	9,316	56,519	65,625	67,664	7.06	5.84	4.70
REDUCE BENEFIT FORMULA ADJUSTMENT FACTORS									
Males	5,230	8,189	10,402	57,379	62,439	47,669	5.82	4.64	3.90
Females	3,780	6,232	9,189	56,826	64,885	65,113	7.00	5.82	4.65
INCREASE NORMAL RETIREMENT AGE									
Males	4,809	7,543	9,581	51,889	54,074	37,289	5.67	4.48	3.73
Females	3,479	5,732	8,464	57,666	57,417	54,721	6.92	5.63	4.46
REDUCE COLA BY .2 PERCENTAGE POINTS									
Males				61,863	69,839	57,002	5.97	4.82	4.10
Females				59,779	70,701	73,856	7.23	6.01	4.86

L, M, and H refer to low, medium, and high incomes. Income is an average of real earnings over the fifteen years between ages 45 and 60.

Table 2. Distributional Effects of Social Security Reforms
Age 62 Retirees - Percent Difference From Current Law

	Initial Benefits			Net Benefits			Real Rates of Return		
Population Class	L	M	H	L	M	H	L	M	H
				INCREASE COMPUTATION PERIOD THREE YEARS					
Males	-4.8	-4.5	-2.3	-8.3	-10.8	-8.7	-.17	-.17	-.10
Females	-4.6	-4.4	-3.7	-6.6	-8.7	-10.3	-.18	-.18	-.17
				REDUCE BENEFIT FORMULA ADJUSTMENT FACTORS					
Males	-5.0	-5.0	-5.0	-8.4	-12.1	-18.4	-.16	-.19	-.22
Females	-4.9	-4.9	-5.0	-6.1	-9.7	-13.7	-.15	-.20	-.22
				INCREASE NORMAL RETIREMENT AGE					
Males	-12.5	-12.5	-12.5	-11.1	-23.9	-36.2	-.31	-.35	-.39
Females	-12.5	-12.5	-12.5	-14.6	-20.1	-27.5	-.32	-.39	-.41
				REDUCE COLAs					
Males				-1.2	-1.7	-2.5	-0.01	-0.01	-0.02
Females				-1.2	-1.6	-2.1	-0.01	-0.01	-0.01

L, M, and H refer to low, medium, and high incomes. Income is an average of real earnings over the fifteen years between ages 45 and 60.

Table 3. Distributional Effects of Social Security Reforms for Age 65 Retirees

Population Class	Initial Benefits (1997$)			Net Benefits (1997$)			Real Rates of Return		
	L	M	H	L	M	H	L	M	H
				CURRENT LAW					
Males	6,737	10,854	14,032	50,398	49,967	31,198	5.03	3.76	2.89
Females	5,368	8,626	12,195	62,701	65,568	65,533	6.84	5.03	4.20
				INCREASE COMPUTATION PERIOD THREE YEARS					
Males	6,397	10,467	13,789	45,468	44,263	27,527	4.79	3.60	2.81
Females	5,735	8,233	11,643	58,472	58,877	56,579	6.66	4.81	3.95
				REDUCE BENEFIT FORMULA ADJUSTMENT FACTORS					
Males	6,400	10,311	13,330	45,554	41,917	20,656	4.81	3.54	2.66
Females	5,131	8,198	11,585	58,574	58,289	55,290	6.68	4.80	3.95
				INCREASE NORMAL RETIREMENT AGE					
Males	5,895	9,497	12,278	46,552	29,851	4,850	4.44	3.18	2.28
Females	4,697	7,548	10,671	50,600	47,242	39,940	6.36	4.41	3.55
				REDUCE COLA BY .2 PERCENTAGE POINTS					
Males				49,772	48,887	29,721	5.02	3.75	2.88
Females				61,696	64,230	63,635	6.82	5.01	4.17

L, M, and H refer to low, medium, and high incomes. Income is an average of real earnings over the fifteen years between ages 45 and 60.

Table 4. Distributional Effects of Social Security Reforms
Age 65 Retirees - Percent Difference From Current Law

	Initial Benefits			Net Benefits			Real Rates of Return		
Population Class	L	M	H	L	M	H	L	M	H
				INCREASE COMPUTATION PERIOD THREE YEARS					
Males	-5.1	-3.6	-1.7	-9.8	-11.4	-11.8	-.24	-.16	-.08
Females	-4.3	-4.6	-4.5	-6.7	-10.2	-13.7	-.18	-.22	-.25
				REDUCE BENEFIT FORMULA ADJUSTMENT FACTORS					
Males	-5.0	-5.0	-5.0	-9.6	-16.1	-33.8	-.24	-.22	-.23
Females	-5.0	-4.9	-5.0	-6.6	-11.1	-15.6	-.16	-.23	-.25
				INCREASE NORMAL RETIREMENT AGE					
Males	-12.5	-12.5	-12.5	-7.6	-40.3	-84.5	-.59	-.58	-.61
Females	-12.5	-12.5	-12.5	-19.2	-27.9	-39.1	-.48	-.62	-.65
				REDUCE COLAs					
Males				-1.2	-2.2	-4.7	-0.01	-0.01	-0.01
Females				-1.6	-2.0	-2.9	-0.02	-0.02	-0.03

L, M, and H refer to low, medium, and high incomes. Income is an average of real earnings over the fifteen years between ages 45 and 60.

1998-SE-001411

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 4, 1998

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: David Wilcox DW
Assistant Secretary (Economic Policy)

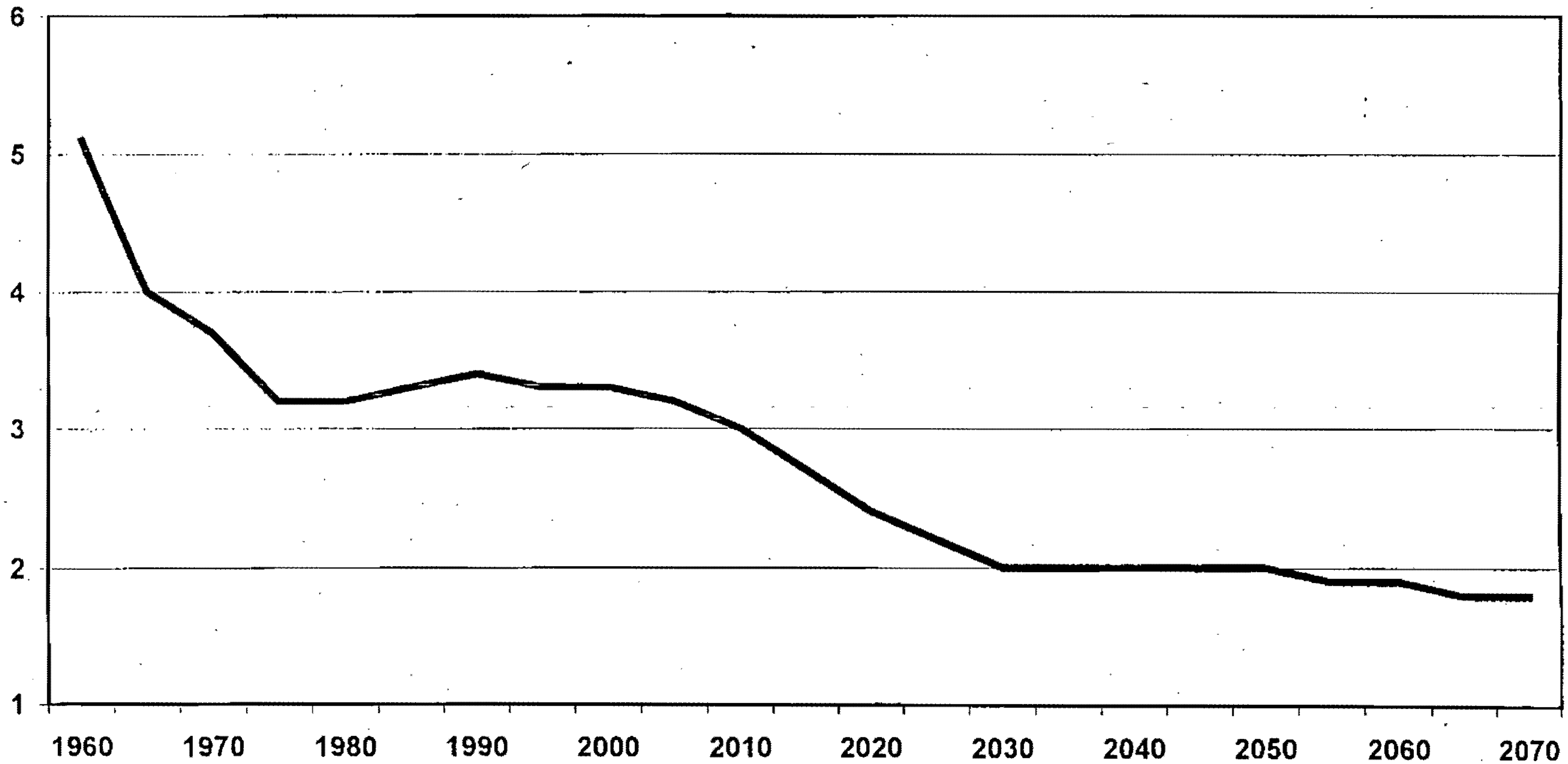
SUBJECT: Charts for POTUS announcement on Social Security

Attached are rough drafts of some charts pertaining to Social Security. At his event on Monday, the President might use a small number (perhaps three or four) of these charts to kick off the national conversation about Social Security in a substantive way. The idea is to illustrate as clearly as possible both the good that Social Security does, and the scope of the problem that it faces.

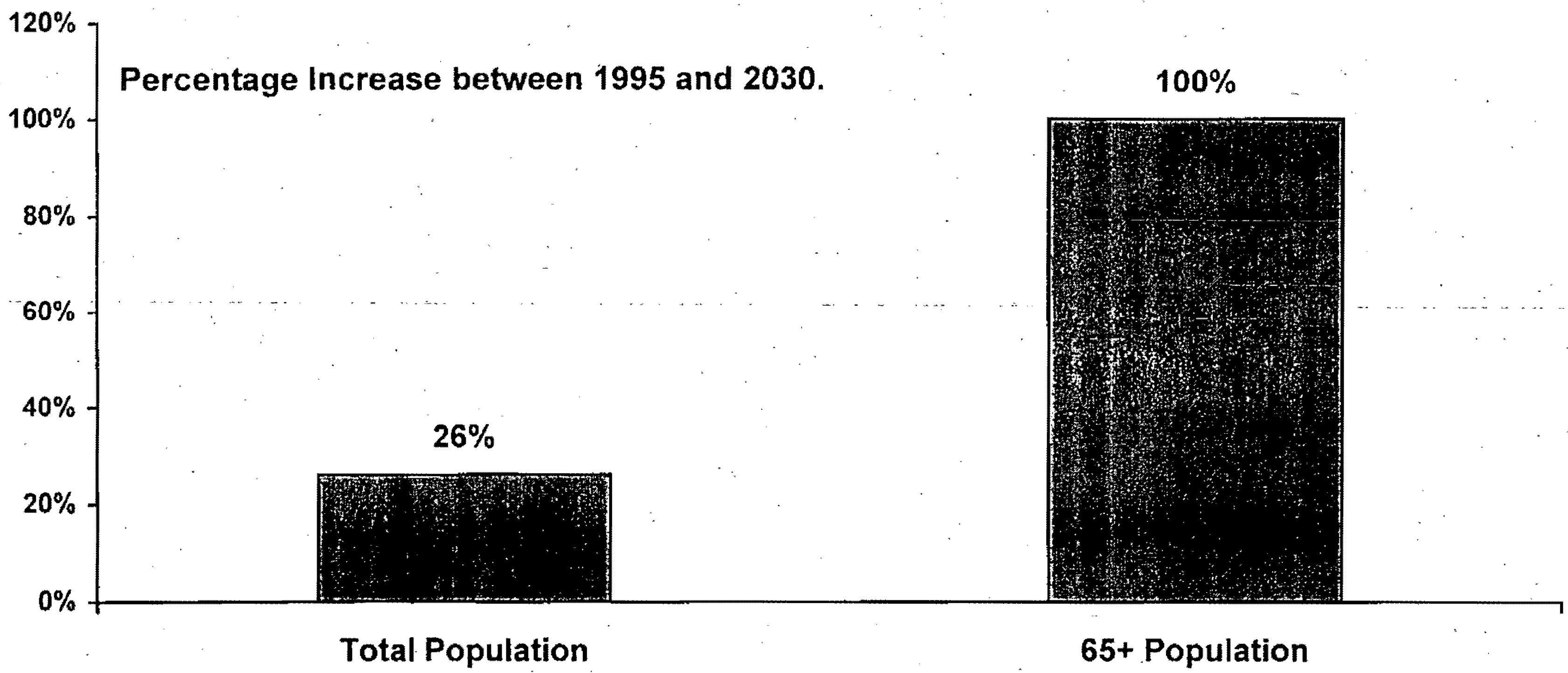
Any suggestions you might have about these — or other charts we might create — would be welcome.

EXECUTIVE SECRETARIAT

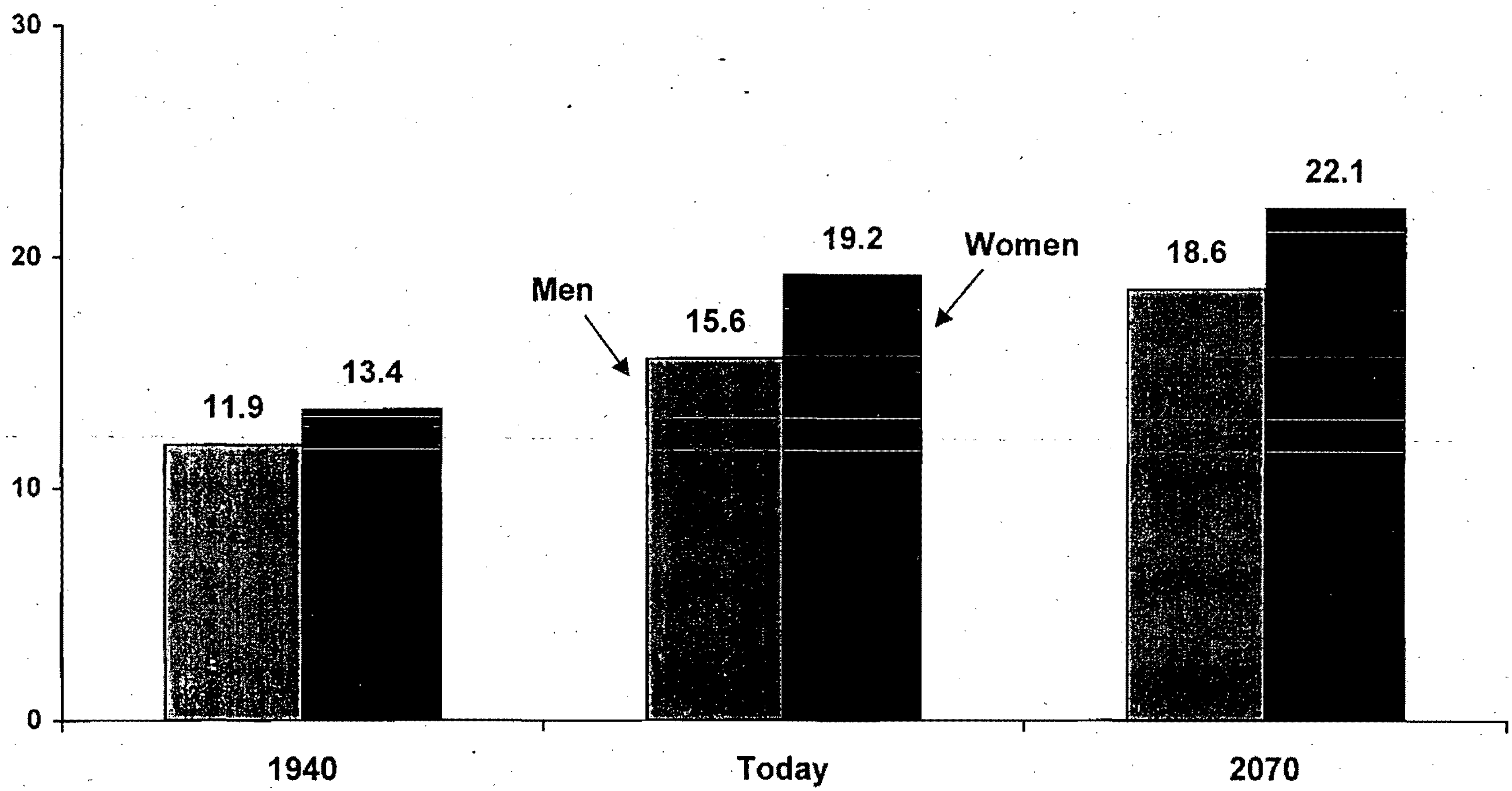
The number of workers per beneficiary will decline from more than 5 in 1960 to less than 2 in the coming decades.



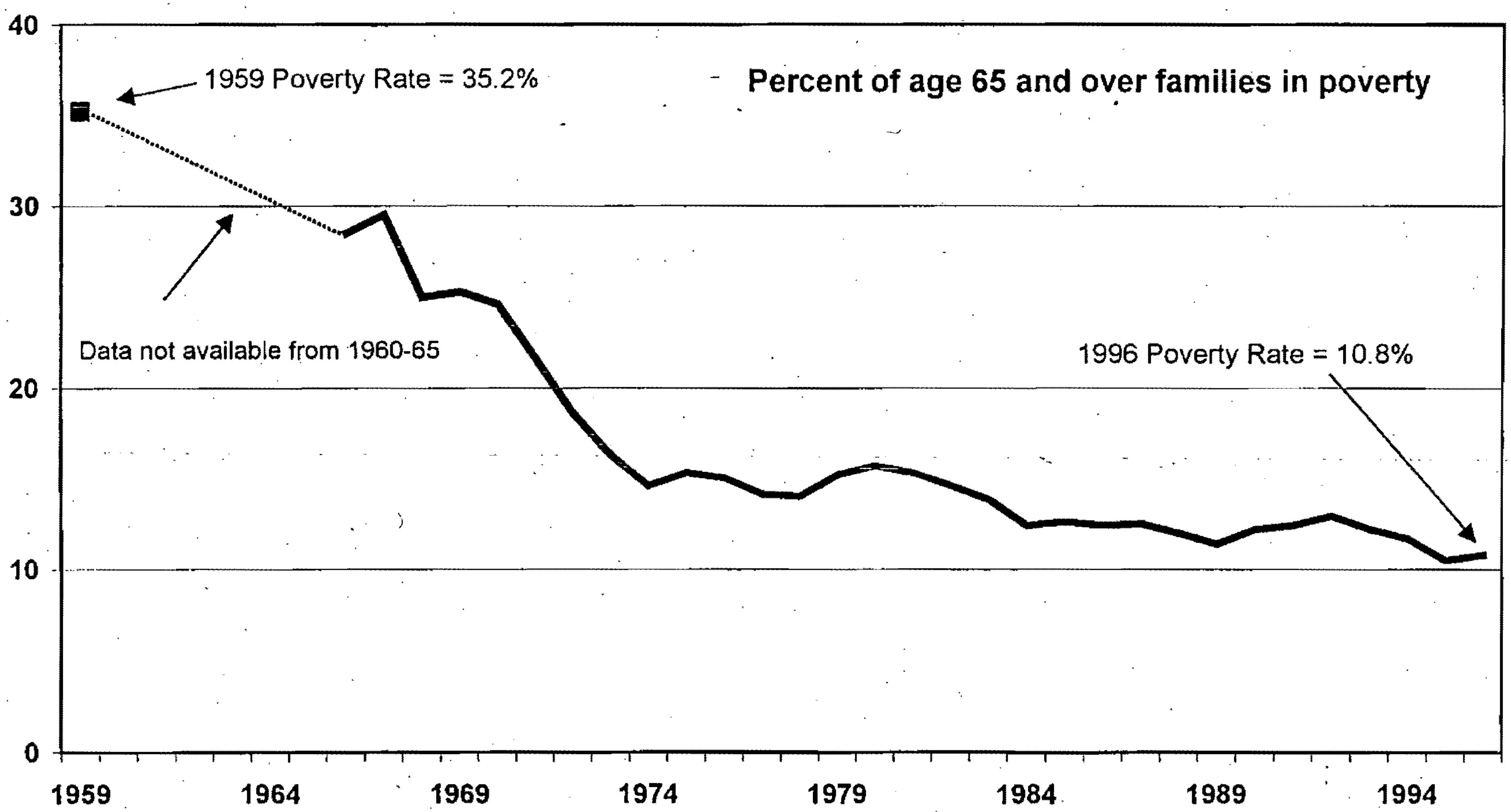
The increase in the age 65 and over population in the United States will be almost 4 times as great as the increase in the total population between now and 2030.



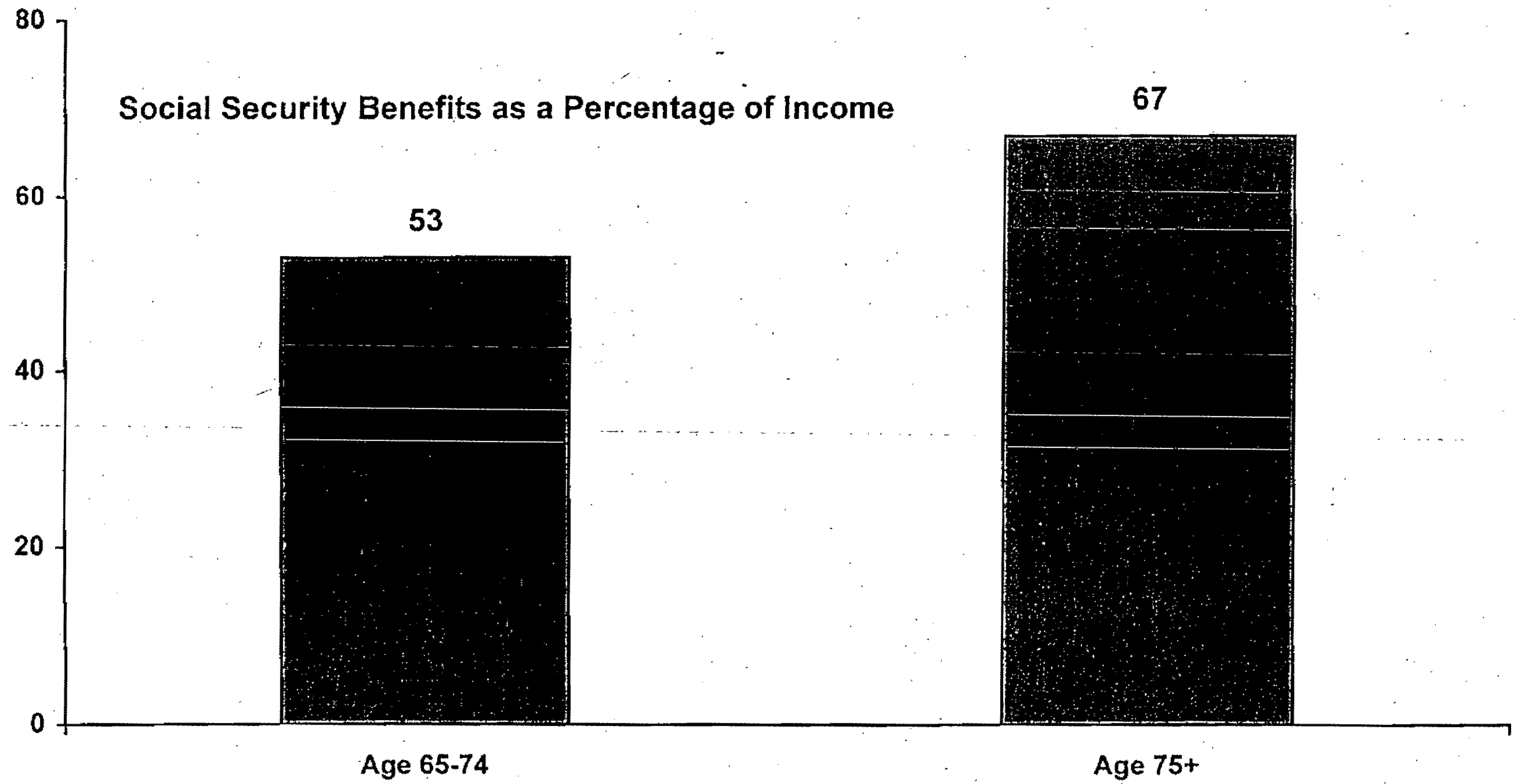
Years of life expectancy at age 65 has increased dramatically for both men and women since 1940.



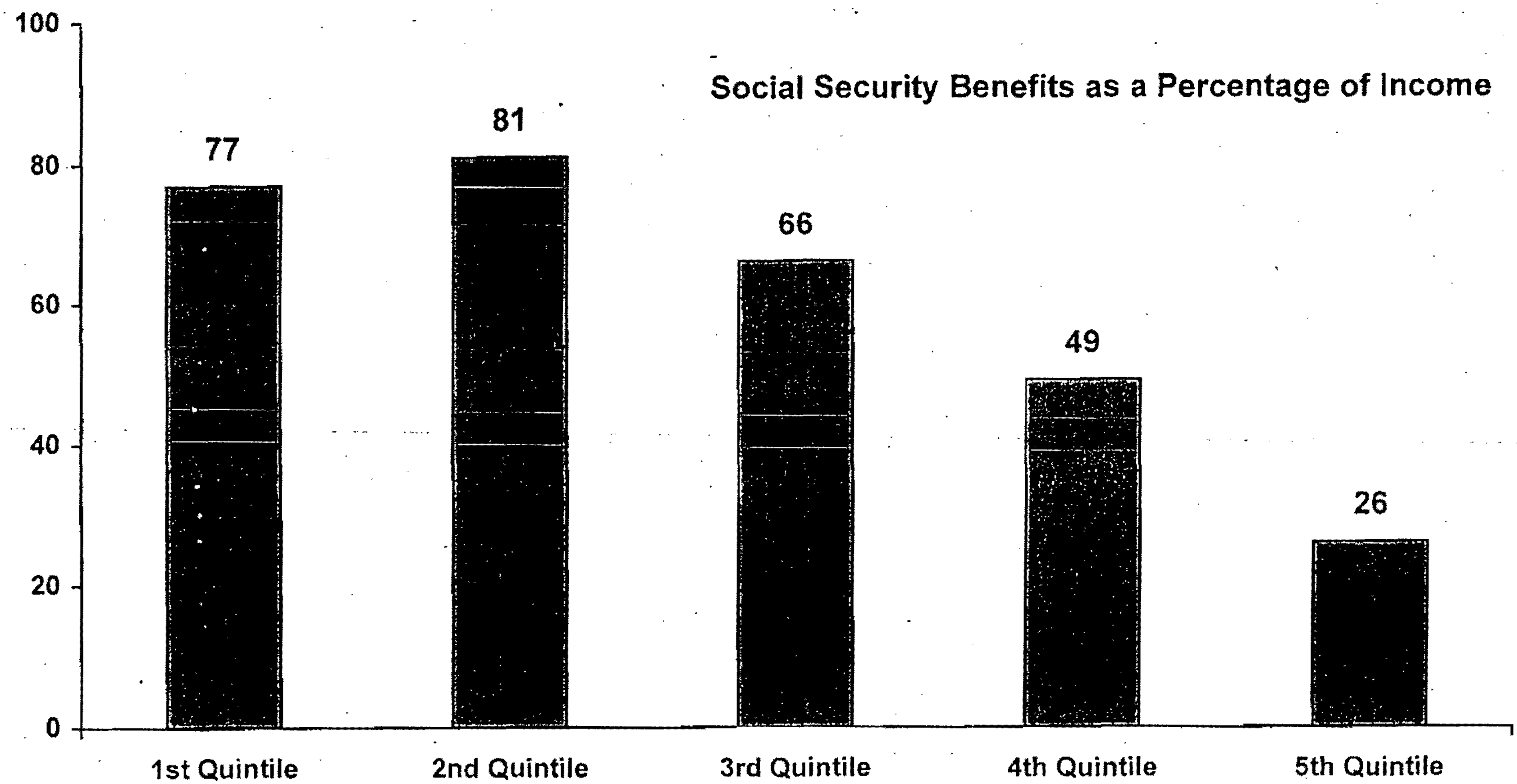
Social Security has helped reduce the poverty rate of the elderly.



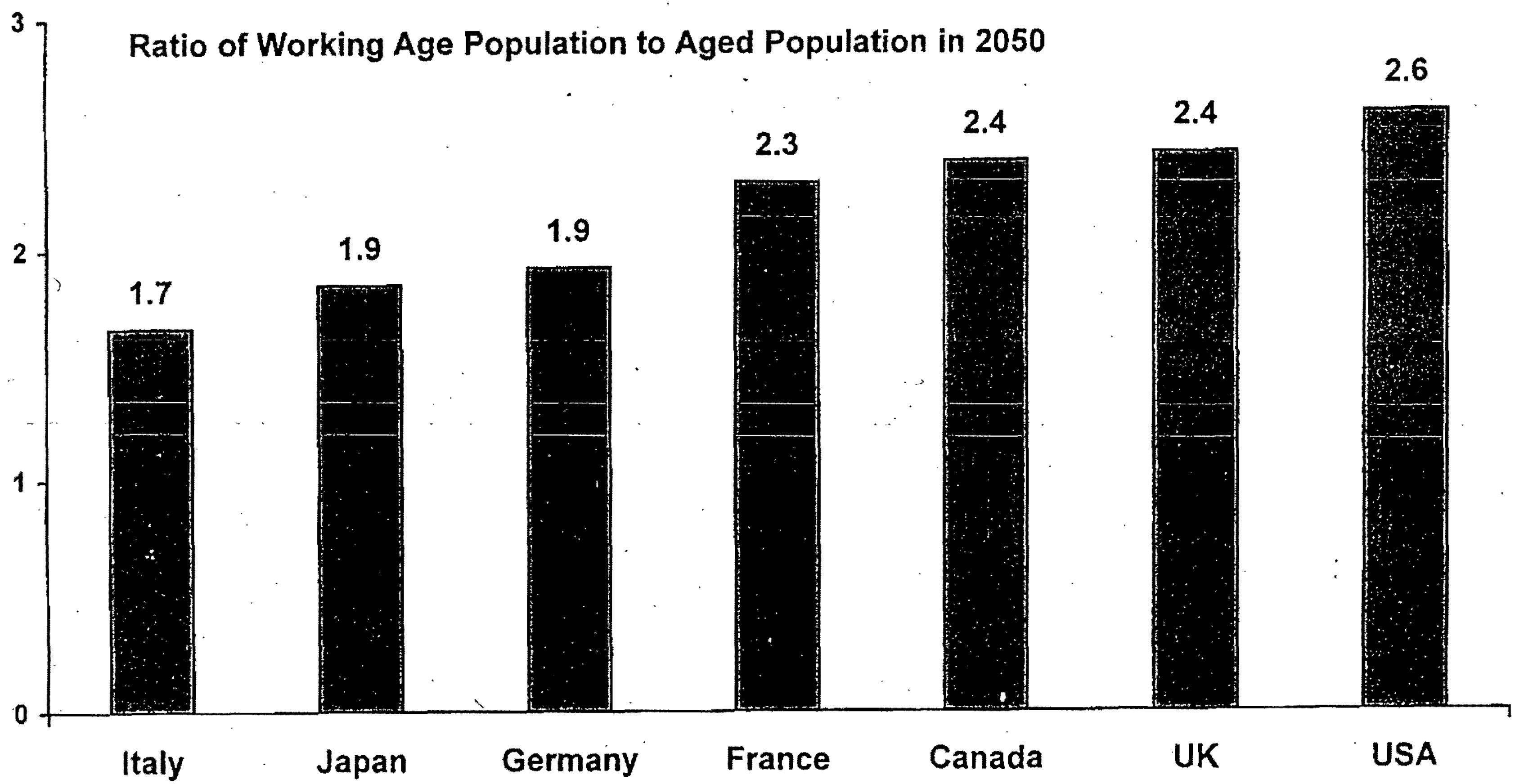
Social Security's importance in total income rises with age



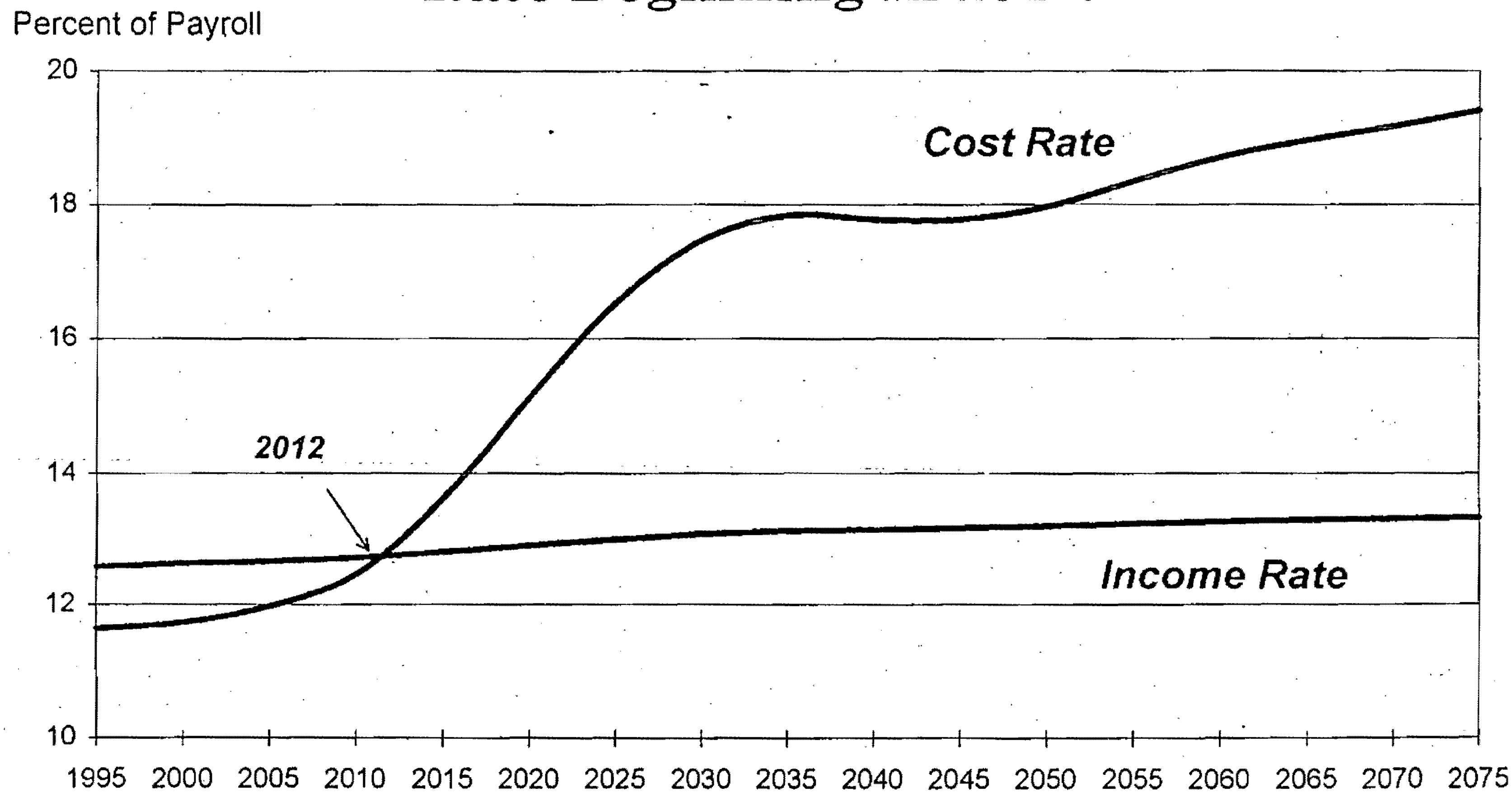
Social Security benefits decline in importance as total income rises



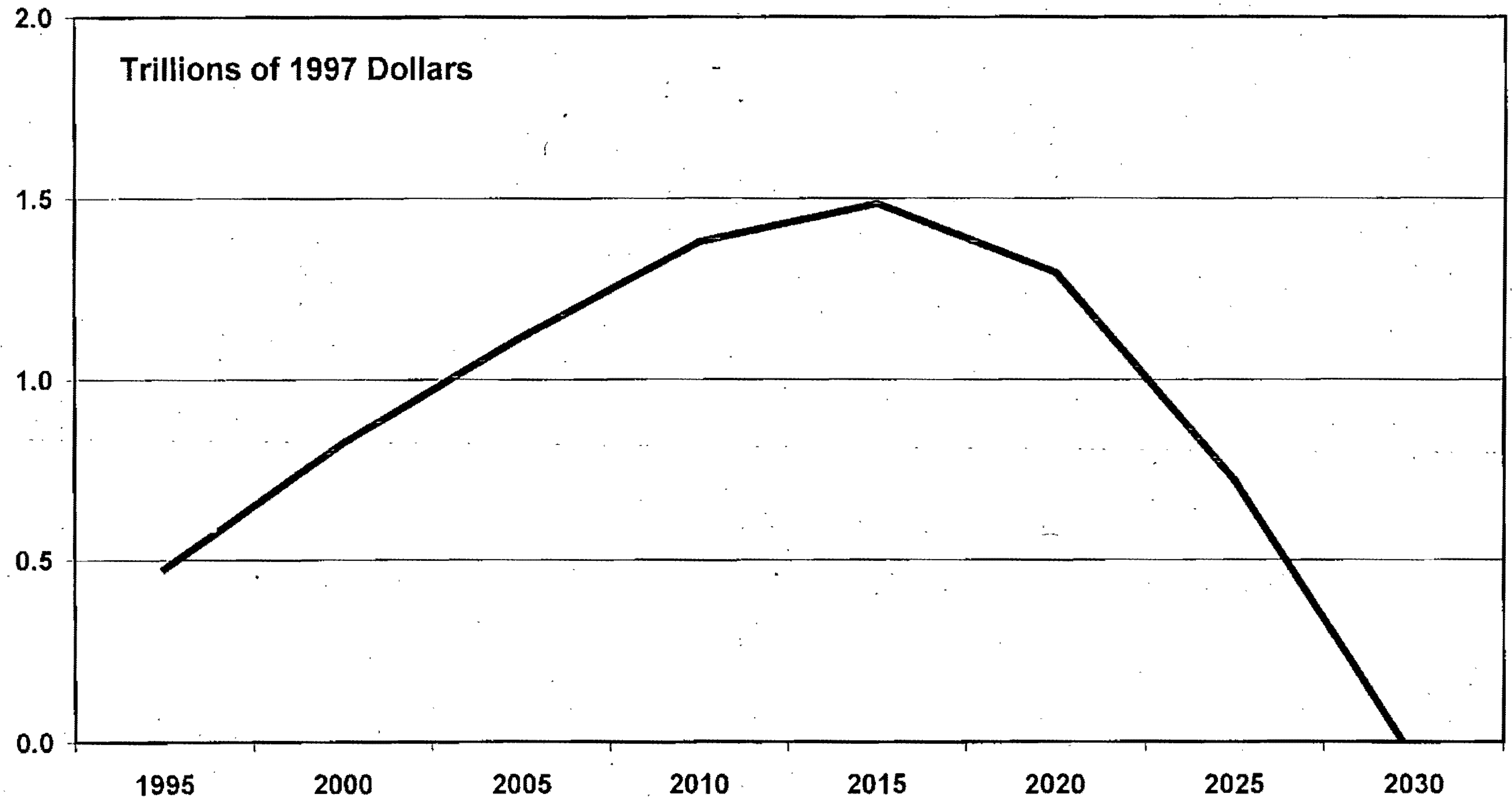
Compared to other G-7 countries, the aging of the US population will be less pronounced by 2050



OASDI Cost Rate Mirrors Aged Dependency Ratio. It Exceeds Income Rate Beginning in 2012.



The Social Security Trust Fund will be exhausted in 2029.



BRIEFING

February 20, 1998

Memorandum to: Secretary Rubin
Deputy Secretary Summers

From: Alan Cohen

Subject: Today's Special Issues Meeting on Social Security

Today's special issue meeting on Social Security dealt with a number of issues that could arise in the hearing next Tuesday at which Larry is testifying along with Frank Raines and Ken Apfel. At least one other issue also came up. Here is a rundown:

1. With regard to the controversial issue of whether the "Save Social Security First" applies to surpluses in FY 1998, and how to handle FY 1998 supplementals for Iraq and Bosnia, everyone accepted without controversy the formulation in the talking points and Q's and A's that I sent you earlier this week. That formulation is:

   1. "Save Social Security First" would apply even to a surplus in FY1998, if one should occur.
   2. "Save Social Security First" means that we will abide by the budget rules in all years.
   3. The budget rules include special provisions for emergencies. Emergencies can only be granted if both the President and the Congress agree.
   4. The size of a surplus is affected by many factors: economic conditions, revenue growth, as well as the need for emergencies. Once the size of the surplus is determined, then the surplus is reserved, pending Social Security reform.

2. Although there is an emergency reserve that is paid for that is set aside for emergencies for discretionary spending for FY *1999*, Jack Lew emphasized that it may not be big enough. Therefore, it could be necessary to invoke the emergency designation for some additional spending in FY 1999 above the amount in the reserve-- i.e. not pay for the additional spending. Thus, the formulation described in item #1 above can apply to FY 1999 as well as FY 1998 (it could also apply to years beyond FY 1999). This actually makes it easier to describe our policy, because it is the same for all years.

3. On the issue of what our previous position was regarding individual accounts, Frank Raines offered the following new nuance:

   Individual accounts could be part of the final reform plan for Social Security but individual accounts alone are insufficient, because they would leave the Social Security Trust Fund solvency problem unfixed. So individual accounts cannot be the whole solution for Social Security.

EXECUTIVE SECRETARIAT

The group agreed with this nuance.

4. Ken Apfel is testifying next week before a Ways and Means Subcommittee on the issue of raising the retirement age. Gene advised Ken that the President had helped a Senate candidate in 1994 by campaigning against his opponent's support for raising the retirement age. Nonetheless, Gene said in general, the President's position is that we should not be ruling out options before we have the national dialogue on Social Security. (Presumably, that does not apply to our opposition to radical privatization and our position that we do not foresee raising payroll taxes).

5 There was a lot of discussion on whether to oppose the Archer-Kasich bill to have an eight-member Commission to make a **single set of** recommendation regarding fixing Social Security. Note: this Commission would include two members appointed by the President. In the end, no definitive conclusion was reached and Gene indicated that this issue may need to be discussed in a meeting in Erskine's office.

6. Frank raised the possibility that if we actually have a surplus at the end of any fiscal year, we could have the Social Security Trust Fund redeem an amount of specials equal to the surplus and replace that amount with the same amount of Ginnie Maes -- bought on the private market. This would score as an outlay and would cause the surplus to vanish. Under current law, the Secretary of the Treasury has the authority to invest in Ginnie Maes, rather than in specials. A variation on this proposal that would require legislation is a proposal that would augment the Trust Fund with the amount of the unified budget surplus from any fiscal year and then invest that amount in Ginnie Maes.

There was a lively discussion on the pros and cons of these ideas. Needless to say, no conclusion was reached, and it was agreed that we had plenty of time to further analyze this.

Do you have any thoughts on Franks' ideas? Please advise us, at your convenience.

1998-SE-002866

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

March 9, 1998

MEMORANDUM FOR: DEPUTY SECRETARY SUMMERS
GENE SPERLING

FROM: DAVID WILCOX DW
PETER ORSZAG

SUBJECT: Earnings limit under Social Security

The earnings limit

Under current rules, Social Security beneficiaries can earn up to a threshold amount without any reduction in retirement benefits:

- For those aged 62-64, the earnings limit in 1998 is $9,120. Increases in that amount are tied to the average wage index.

- For those aged 65-69, the earnings limit in 1998 is $14,500. The Contract with America Advancement Act, which President Clinton signed on March 29, 1996, promulgates annual increases in that limit through 2002, when it will reach $30,000.

- For those aged 70 and above, there is no earnings limit.

The earnings test applies only to wages and earnings from self-employment; pension, interest, dividend, and other unearned income is not counted for purposes of this test. This earnings test is distinct from the treatment of Social Security benefits under the individual income tax.

Amounts exempt from earnings limit

	62-64*	65-69**
1998	$9,120	$14,500
1999	$9,360	$15,500
2000	$9,720	$17,000
2001	$10,080	$25,000
2002	$10,440	$30,000

* The figure for 1998 is the actual level. The figures for 1999 and beyond are based on the intermediate assumptions of the 1997 Trustees Report, which assumed a limit of $9,000 for 1998.
**These amounts are defined in PL 104-121, the Contract with America Advancement Act.

Benefit reduction and actuarial treatment

If beneficiaries earn more than the threshold amount, their current-year Social Security benefits are reduced.

- For those aged 62-64, benefits are reduced by $1 for every $2 of earnings over the earnings threshold. In other words, a 63-year-old beneficiary earning $11,120 in 1998 would have her current benefits reduced by 0.5*($11,120-$9,120)=$1,000.

- For those aged 65-69, benefits are reduced by $1 for every $3 of earnings. Thus a 67-year-old earning $16,000 in 1998 would have his current benefits reduced by 0.33*($16,000-$14,500)=$500.

<u>Any such reductions in current benefits from the earnings test are offset by an increase in future benefits</u>:[1]

- For those aged 62-64, any reduction in benefits from the earnings test decreases the actuarial reduction factor (6 2/3 percent per year of early retirement, up to 3 years of early retirement) used to compute subsequent benefits. In other words, benefits docked under the earnings test are effectively paid back at the rate of the actuarial reduction factor for early retirement.

- For those aged 65-69, any reduction in benefits is paid back through the delayed retirement credit (DRC). In 1998, the DRC is 5.5 percent for each year of delayed retirement. It is increasing gradually, and for workers reaching age 65 in 2008 will have reached the "actuarially fair" rate of 8 percent per year.

Impact on work incentives

- For workers aged 62-64, the actuarial adjustments are approximately actuarially fair; therefore, the expected lifetime tax imposed by the earnings limit system is roughly zero.

- For workers aged 65-69, the earnings test currently imposes a small expected tax because

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[1] One caveat to this statement is worth noting: The actuarial adjustments are only made at discrete earnings intervals, expressed in terms of the recipient's monthly benefits. In particular, if the benefit reduction in a given year does not amount to at least one month's worth of benefits (i.e., 1/12 of the annual benefit), then subsequent benefits are *not* adjusted upward. Once the benefit reduction exceeds one month's worth of benefits, an actuarial adjustment for that amount will be subsequently credited to the worker. Similarly, there is no additional actuarial adjustment for benefit reductions between one month's and two month's worth of benefits, until the reductions reach the equivalent of a full second month's worth of benefits, and so on. Thus, the marginal tax rate from this system on earnings immediately above the earnings limit and inframarginally between monthly benefit amounts is indeed 50 percent for those aged 62-64 and 33.3 percent for those aged 65-69. But the marginal tax rate precisely at the earnings limit plus the discrete monthly benefit intervals is correspondingly *negative*.

the DRC is less than actuarially fair. But the implicit tax rate from this source is much less than the 33 percent benefit reduction rate. Furthermore, the implicit tax rate for these older workers will approach zero by 2008 as the DRC rises to the actuarially fair level.

Three points are worth noting:

- First, the actuarial adjustments are intended to ensure *ex ante* neutrality. But *ex post*, some workers will be hurt by the reduction and subsequent increase (e.g., by dying earlier than expected), and others will benefit (e.g., by living longer than expected).

- Second, even on an *ex ante* basis, the actuarial adjustments reflect average mortality experience across the entire population. They are therefore never perfectly accurate for each individual or even sub-group of the population -- and thus the earnings limit mechanism subsidizes some workers while taxing others.

- Third, regardless of what the underlying actuarial reality may suggest, many elderly workers <u>perceive</u> the earnings test to be unfair, or at least an impediment to work. This perception may reflect a failure to recognize the actuarial adjustments. The attached figure from the Social Security actuaries shows that there is very substantial clustering of earnings at the limit points -- almost surely much more than could be explained on the basis of rational considerations.

Impact on OASDI imbalance and unified budget

The Administration does not have a proposal on the earnings limit. But some outsiders have proposed eliminating it: Gene Steuerle and Jon Bakija, for example, write that "the simple fact is that the earnings test is a tattered remnant of a bygone era...Eliminating the earnings test at all ages would...greatly simplify the administration of the system, since the earnings test is the largest source of errors in benefit calculations."[2]

Such an elimination would have almost no effect on the long-run actuarial balance of the OASDI program, especially once the DRC reaches an actuarially fair level. According to Steve Goss, eliminating the earnings test for all retirees (by removing the earnings test at age 62 and above) would expand the 75-year actuarial imbalance by about 0.01 percent of payroll.[3]

Such a change would have some short-run effects, however: In the near term, removing the earnings limit for those aged 62 and above would raise Social Security expenditures by about

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[2] Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century*, pages 228-229.

[3] The PSA plan eliminated the earnings test at the normal retirement age (so workers above the normal retirement age were not subject to the earnings limit). The 75-year actuarial impact amounted to less than 0.005 percent of taxable payroll.

$12 billion in 2001, and decline to about $10 billion by 2004. Additional expenditures would continue to decline thereafter, eventually reaching zero and then becoming small reductions. These estimates are very rough, and are being checked by OMB.

Larry:

In our conversation last night, you said that you thought a more "question driven" approach to the Social Security process would work better than the current approach which would emphasize a fair amount of discussion. Following up on that idea, I have worked with Peter to develop the attached list of questions that will probably need to be addressed at the level of the Principals. This list, or one like it, could provide a framework for the coming year.

One vision for how the year might go is as follows:

1. Principals' meetings are suspended for a while.

2. Staff gears up like crazy to prepare background papers teeing up each of the questions in the attached list.

3. Later in the year, principals' meetings are convened once again; at that stage, sufficient information should have been developed to allow informed decisionmaking.

Gene probably would not favor this approach, because his vision is quite different from yours: he probably would be quite comfortable with lots of meetings like yesterday's, at which there is no expectation of any decisionmaking, but lots of somewhat diffuse discussion.

If this approach has any appeal to you, the steps forward would involve the following:

1. You should talk to Gene, and suggest/state that we should take this question-oriented approach. To state the obvious, it would be helpful if Peter's role in helping devise this approach did not receive prominent play in your conversation with Gene.

2. You should revise the list of questions in whatever way you see fit.

3. Peter and I should convene a working group of folks at my level, so that work can be tasked out on the agreed-upon list of questions. Infer what you will about my views regarding the direction of this group subsequent to Peter's departure.

4. Some or all of the working group should have periodic regularly scheduled meetings with you, for mid-course corrections.

I'll be available over the weekend at home if you want to discuss any of this.

David Wilcox

<u>Questions for Policy-Makers on Social Security</u>

Question 1: Should the OASDI Trust Fund broaden its portfolio beyond Treasury bonds?

A. Should equity investments only be in broad indexes?
B. Should the Trust Fund invest in foreign stocks? Small businesses? Real estate?
C. Should an independent investment board be established?
D. How should proxies be voted?
E. Should private securities be limited to a given share of the Trust Fund?

Question 2: Should a system of modest individual accounts be part of the overall plan?

A. What is the allowable range of investments (i.e., 401k vs. IRA)?
B. If 401k, what is the structure of the governing board and what investments are allowed?
C. Should we force annuitization at retirement?
D. How progressive should the system be?
 Should we redistribute from those with above-average returns to those with below-average returns?
 Should the contributions be progressive?
E. Are the accounts on top of, or carved out from, Social Security?
F. Are the accounts described as "Part B" of Social Security?
G. How do we finance the individual accounts? What is the role of the unified surplus?

Question 3: Should we eliminate the earnings test?

Question 4: Should newly hired state and local workers be included in the Social Security system?

A. If so, do we provide resources to pay-as-you-go retirement systems in those states, to help offset transition?

Question 5: What other reforms should be undertaken?

A. Should we raise the normal retirement age?
 If so, do we raise the earliest eligibility age?
 Do we adjust the delayed retirement credit and the actuarial reduction factors for early retirement?
B. Should the bend points, or the 90/32/15 adjustment factors, be changed?
C. Should the averaging period for Average Indexed Monthly Earnings be extended from its current 35 years?
D. Should Social Security benefits be treated like other defined benefit pensions?
E. Should we adopt any changes to the spousal benefit?
F. Should we rely on a new BLS superlative price index?

Question 6: Is the 75-year actuarial balance the right metric for "addressing Social Security reform"?

DRAFT: Social Security Work Plan
February 26, 1998

I. Pre-funding and national saving

A. Impact of given increase in national saving on productivity growth rate, future output, income, and wages

B. Examination of recent productivity performance and future projections

C. Impact on actuarial balance from faster growth

D. Different approaches to Social Security reform and their effects on national saving

-- Discussion of impact on national saving from Gramlich Commission plans
-- Discussion of impact on national saving from bolstering Trust Fund

II. Individual accounts

A. IRA vs. 401(k)

-- If 401(k), what is the structure of the governing board? Range of investments? International? Small businesses? Real estate?

B. Progressivity and distributional implications

C. Transaction costs

D. Annuitization: forced or voluntary, or limit on withdrawals

E. Investment behavior and lack of sophistication -- moral hazard issue

F. Floors and ceilings on rates of return

G. Transition financing issues

-- Explanation of why transition from pay-as-you-go is an issue

-- Ways of financing transition
1. A single generation pays twice
2. Current elderly pay with reduced benefits
3. Issue debt and spread burden over many future generations
4. Use the surplus (which is actually the same as #3)

H. Steady-state financing:

-- Diverting part of current OASDI payroll tax and impact on Social Security

-- Adding additional contribution requirement above OASDI payroll tax

-- General revenue financing/surplus

I. Interactions with private pensions

J. Impact on other private saving and size of possible offsets

III. Equity investments of the Trust Fund

A. Rates of return, discounting, and impact on actuarial imbalance
-- Adjustments for risk?
-- Interactions with other reforms

B. Risk analysis
-- Treasury analysis of equity investments
-- Risk inherent in current system

C. Corporate governance
-- Create a new board?
-- Voting the shares?
-- Investment rules and range of investments?

D. Limits on equity investments within the Trust Fund
-- Why 40 percent?
-- Rules for determining limit

E. Debt outstanding with the public: broader issue of Federal investments

IV. Measuring actuarial health of the system

A. 75-year balance
B. 75-year balance, with constraint on decline in Trust Fund at tail end
C. Perpetual balance
D. Year-by-year constraints
E. Unified budget perspective

V. Retirement age

A. Current law: 65 until 2000, then start increasing, until 66 in 2005, then flat until 2016, then start increasing until 67 in 2022 and after

B. Trends in life expectancy, historical and projected

C. Life expectancy vs. work capacity (mortality and morbidity)

D. Different plans for raising retirement age:

1. Eliminating current hiatus between 2005 and 2016

2. (1) plus indexing to life expectancy after 2022

3. (1) plus indexing to maintain ratio of working to retirement years after 2022

4. Indexing immediately

5. Moving beyond future indexing (e.g., to 70 by 2022).

E. EEA

1. Percent of workers retiring before NRA.

2. Interactions with DI if EEA not adjusted.

3. Impact on monthly benefit if EEA not adjusted.

4. Impact on workers in physically demanding jobs if EEA is adjusted.

F. Impact of different plans for NRA and EEA on:

1. Actuarial imbalance

2. Monthly benefit, replacement rate, and rate of return for average 65-year old retiree in 2015, 2030, 2050

3. By income distribution

4. By race and gender

EP (Rosemary) to LS

NCC cc to MF
SS
NC
MB
DI/PA/AK

3/10/98

Please Log In and File

1998-SE-003818

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

March 26, 1998

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: David W. Wilcox DW
Assistant Secretary for Economic Policy

Gary Gensler GG
Assistant Secretary for Financial Markets

SUBJECT: Investment by the Social Security Trust Funds in Inflation Indexed Securities

This is in response to a request from the Deputy Secretary to investigate adding inflation indexed securities (IIS) to the combined Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds ("trust fund") portfolio.

Improving the Risk-Return Position of the Trust Fund

Background

The trust fund's cash outflows arise from benefit payments; its cash inflows, from payroll taxes and returns on investments. The trust fund invests the excess of inflows over outflows in a portfolio of nominal Treasury specials with maturities ranging from one to 15 years. The yield is set at the prevailing weighted average rate on issues outstanding at the time of acquisition and not due or callable for 4 or more years. These specials are not traded and are redeemable at par at any time. Since the return on each of the securities in the trust fund's investment portfolio is fixed in nominal terms, the trust fund is exposed to inflation risk.

Portfolio Options

Adding par-value, special issue IIS to the trust fund would provide a wider risk-return tradeoff than available under current investment policy. Investing the trust fund completely in par-value IIS would essentially eliminate the inflation risk to the trust fund.

Investing in IIS would also probably reduce the expected return to the trust fund slightly because the yield on nominal bonds is thought to include an increment for inflation risk. However, the price of this insurance against inflation risk at present appears to be very low.

Fully investing in IIS is almost certainly not the best policy because a minimum risk-return investment portfolio is almost certainly not optimal. Investing a portion of the trust fund in IIS would reduce the inflation risk associated with the current policy while still taking some advantage of the higher expected return on nominal bonds.

Currently, marketable IIS are less liquid than recently issued nominal Treasuries, so IIS holders probably are receiving an "illiquidity" premium. Since the yield on the par-value IIS would be tied to the average rate on marketable IIS, par-value IIS could, at least temporarily, earn a higher return until the IIS market matures.

Impact on the Trustees' Projections

Introducing IIS into the trust fund would give new prominence to the issue of whether the long-term assumptions about inflation and the real return on the trust fund should be based on market signals.

At present, the conventional 10-year note is priced to yield about 5.63 percent, while the 10-year IIS is yielding about 3.65 percent. (In the last week the 10 year IIS has actually backed up to 3.74 yield in anticipation of our pending 30 yr. offering.) Therefore, a crude estimate of the market's inflation forecast over the next 10 years is 2.0 percent.

The long-term real interest rate assumption underlying the projections shown in the 1997 Trustees' Report was 2.7 percent. At present, the 10-year IIS (the longest maturity IIS) has a real yield of about 3.65 percent. Bumping up the Trustees' long-term assumption to 3.65 percent would raise the actuarial balance (lower the deficit) by about 0.6 percent of payroll. The long-term inflation assumption in the 1997 Report was 3.5 percent. At present, the difference between nominal and real yields in the Treasury market is about 2 percent. Cutting the Trustees' assumption to 2.0 percent would *degrade* the actuarial balance by about 0.3 percent of payroll, if the real rate assumption were held at 3.65 percent. On net, the two assumptions together would improve the balance by about 0.3 percent of payroll.

Historically, the Trustees have shown great reluctance to make frequent adjustments to the assumptions underlying the actuarial projections. <u>If a decision were taken to tie the long-term assumptions about inflation and the real rate more closely to market signals, some mechanism would probably have to be put in place to satisfy the</u>

Trustees that the annual assumptions would not be subject to the "vagaries of the market." One way to do this might be to base the assumptions on a multi-year moving average of the market signals, possibly with an Ss-type threshold for action.

Implementation Issues

Legal Authority

According to the office of the General Counsel, excess trust fund moneys could be invested in par-value IIS under the existing law governing trust fund investments, if the Secretary determined that such investment was "in the public interest." See Appendix 1 discussing legal authority. An administrative record should be compiled establishing the foundation for any such determination before making the determination.

Although the Secretary, as Managing Trustee, appears to have statutory authority to invest all or part of the trust fund in IIS on his own, he probably should not do so without consulting with the other members of the Board of Trustees (especially the two public members) and with Congress.

Mechanics

The best way to structure the IIS as par-value specials for issue to the trust fund would be to create a formula for calculating the coupon that is nearly parallel to the current calculations of the coupons for nominal par-value specials.

This would involve the following steps:

(1) Calculate the current real yield of each outstanding marketable IIS with more than 4 years remaining to first call or maturity.

(2) Calculate the weighted average real yield of the outstanding issues, weighting each real yield by the total market value of the outstanding issue. This weighted average real yield, rounded to the nearest 1/8 of one percent, is the coupon rate for the par-value special.

(3) To determine the amount of interest to be paid on a semiannual interest payment date, the par-value IIS coupon rate (divided by 2) would be multiplied by the par amount outstanding and by the appropriate index ratio. Early redemption would be at the par value multiplied by the appropriate index ratio.

Appendix 2 contains a numerical example.

Attachments

Appendix 1: Legal Authority

Under section 201(d) of the Social Security Act (42 U.S.C. § 401(d)), excess moneys in the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund (collectively, the "trust fund") may be invested only in (1) Treasury special obligations, issued directly to the trust fund, that bear interest at a rate set according to a statutory formula (the rate is set at the prevailing average market yield on all marketable public debt securities then outstanding which are not due or callable for 4 or more years), or (2) "other interest-bearing obligations of the United States or obligations guaranteed as to both principal and interest by the United States, on original issue or at market price, only where [the Secretary of the Treasury] determines that the purchase of such other obligations is in the public interest."

Existing law gives preference to investing excess trust fund moneys in the Treasury special issues with statutory-formula interest rates. Indeed, even before the law was amended in 1960 to establish a preference for investment in such Treasury special issues, it was the long-standing policy of the Secretary of the Treasury, as Managing Trustee, to invest excess trust fund moneys in those special issues.

Nevertheless, the Secretary of the Treasury, as Managing Trustee, is also authorized to invest excess trust fund moneys in "other" United States obligations or United States-guaranteed obligations when the Secretary, as Managing Trustee, determines that investment in such "other" securities is "in the public interest." We understand that this authority under the Social Security Act has only been used to invest excess trust fund moneys in *marketable* Treasury securities, and then only when the yields on the marketable securities purchased exceeded the interest rates that were then available on the special issues with statutory-formula interest rates.

It important to note, however, that the statutory description of "other" eligible investment securities does not use the word "marketable." The phrase "other interest-bearing obligations of the United States . . . on original issue" may be read to embrace Treasury special issues *other than* the special issues with the statutory-formula interest rate that are routinely issued to the trust fund as investments. A reasonable argument may be made, therefore, that the Secretary of the Treasury, as Managing Trustee, is authorized under existing law to invest excess trust fund moneys in par-value, special issue inflation indexed securities if he determines that such investment is "in the public interest," because such special issue inflation indexed securities would be "other interest-bearing obligations of the United States . . . on original issue."

This argument is supported by the fact that, under 31 U.S.C. § 3121, the Secretary has discretionary authority to prescribe the offering price, interest rate, and other conditions of the Treasury bonds, notes, and bills, including special issues of the same, that the Secretary issues. That discretionary authority would extend to setting the terms and conditions of the "other interest-bearing obligations of the United States" that qualify as eligible investments for the trust fund. Under this argument, the Secretary would have authority to set par-value redemption and inflation indexed principal as terms and conditions of the Treasury special obligations that the Secretary issues to the trust fund as "other" eligible investments.

The argument is further bolstered by the general principle that the statutes governing many trust funds, including the Social Security Trust Funds, vest broad discretionary authority in the Secretary of the Treasury to manage those trust funds and their investments. In the past, the Secretary of the Treasury has exercised his trust fund management authorities under existing law creatively, notably during the 1995-96 debt limit impasse. Those creative actions were determined to be legally permissible by the Justice Department and the General Accounting Office.

The weaknesses in such an argument arise from the past administrative practice of Secretaries of the Treasury in exercising their trust fund investment authorities under the Social Security Act. First, to the best of our knowledge, the authority to invest in "other interest-bearing obligations of the United States" has up until now only been used to invest in marketable Treasury securities. We are not aware that it has ever been used before to invest in Treasury special issues, let alone special issues that were different from the preferred special issues with the statutory-formula interest rates.

Second, we understand that the authority to invest in "other" eligible investments was used in the past only when the yield on the other interest-bearing obligations of the United States was higher than the interest rate that was then available on the special issues with statutory-formula interest rates. Presumably, the yield on the par-value, special issue inflation indexed securities would be lower than the interest rate then available on the special issues with statutory-formula interest rates.

Third, to the best of our knowledge, it has been the practice of Secretaries of the Treasury up until now to issue special Treasury obligations that have par-value redemption features only when a statute specifically provides that such obligations may be redeemed at par. We are not presently aware of any practice of a Secretary of the Treasury relying upon the discretionary authority under 31 U.S.C. § 3121 as the basis for setting par-value redemption as a term and condition of a Treasury obligation (other than for certain long-term marketable Treasury obligations that were issued having a par-value redemption feature in the last five years of their term).

Notwithstanding these illustrations of the past administrative practice of Secretaries of the Treasury in exercising the statutory authority to invest excess trust fund moneys, the words of the governing statute would allow the Secretary of the Treasury to invest such excess trust fund moneys in par-value, special issue inflation indexed securities if the Secretary determined that investment in such securities was "in the public interest." The Office of the General Counsel would be pleased to provide the Secretary with a formal opinion to such effect if requested.

Appendix 2: Numerical Example of IIS Specials

Suppose it were desired to create a par-value special on February 15, 1998[1]. There are three outstanding marketable IIS, all with more than 4 years remaining to maturity. They appear in Table 1 below.

TABLE 1. IIS OUTSTANDING ON FEBRUARY 15, 1998

Coupon Rate	Maturity Date	Par Amount (A) ($ millions)	Price (P) in decimals	Current (R) Real Yield	P x A	PxAxR
3 5/8	7/15/2002	$16,817	99.59	3.72%	$1,674,868	$62,305
3 3/8	1/15/2007	$15,758	97.84	3.66%	$1,541,822	$56,431
3 5/8	1/15/2008	$8,410	99.81	3.65%	$ 839,423	$30,639
				Totals :	$4,056,113	$149,375
				Rate =		3.6827%
				Rounded Rate =		3 5/8%

The weighted average real rate, rounded to the nearest 1/8%, is 3 5/8% or 3.625%.[2]

The coupons for the nonmarketable IIS of $1,000,000 face amount presumed issued on 2/15/1998 would be calculated by multiplying the face amount by the interest rate divided by 2 and by the ratio of the CPI at the first interest date over the CPI at issue. For example, if the CPI on the first interest payment date were 161.6, the total inflation-adjusted payment would be $18,306.25. This calculation appears in Table 2 below.

---

[1] The 15th day of the month was chosen to make the illustration easier.

[2] The weighted average interest rate is rounded to the nearest 1/8% to be consistent with trust fund par-value investments in fixed coupons.

TABLE 2. CALCULATION OF THE INFLATION ADJUSTED PAYMENTS

	Example of CPI	Index Ratios	Unadjusted Interest Payment	Inflation Adjusted Payment
CPI, Date of Issue	160.0			
CPI, 1st Interest Payment Date	161.60	1.01	$18,125.00	$18,306.25

The trust fund and Public Debt would need to prepare software to track the daily accretion of the inflation index. This should not be difficult as Public Debt already has the ability to do this for marketable IIS.

CLEARANCE SHEET

Initiated by:

Lucy Huffman LH	Office of Policy Analysis	3/17/98	2-0714

Cleared by:

John C. Hambor JH	Director, Policy Analysis	3/17/98	2-2350
Robert Gillingham RG	DAS, Economic Policy		2-2220
Edward Knight ESK	General Counsel	3/24/98	2-0287
Gary Gensler GG	Domestic Finance	3/25/98	2-2044

with updated market rates on page 2

~~3.74~~

5.63

1998-SE-005382

NCC to NER
NCC to LS
NCC CC to MF
SS
NC/DI/PA/AK
4/29/98 MB

Please Log In and
file with NER's and
LS' 4/29 daybook
-NC

April 29, 1998

Memorandum for Secretary Rubin
Deputy Secretary Summers

From: Alan Cohen
Gary Gensler
David Wilcox

Subject: Today's Bowles' Meeting on Social Security

Two items are on the agenda for today's meeting with the Chief of Staff on Social Security: (1) developing our response to Chairman Archer's proposal for a Social Security commission, and (2) planning for the remaining regional Social Security forums.

The Archer proposal for a Social Security Commission

Chairman Archer has proposed a process for Social Security reform, which would be in addition to the President's process of forums and White House conference already underway. Archer's process consists of two parts:

Part I

This part would involve a complex structure of facilitators, advisory boards. Specifically:

- Two Facilitators would coordinate the "National Dialogue." One Facilitator would be appointed by the President, the other appointed jointly by the Speaker and the Senate Majority Leader. (The Minority Leaders would not have any appointees).

- The Facilitators would be advised by a Dialogue Council, which would consist of 36 members, 18 of whom would be appointed by the President, 9 by the Speaker, and 9 by the Majority Leader of the Senate. These appointments would be made from a pool of 54 candidates, consisting of 3 individuals nominated by each of 18 organizations, ranging from the Cato Institute and the Heritage Foundation to the Brookings Institution. (This is a clever way to coopt support from all the groups who feel who feel slighted by focus of the Clinton proposal on AARP, the Concord Coalition, and the Pew Foundation.)

- Members of Congress are encouraged to run their own Dialogues, especially utilizing the capabilities of the Internet. The Facilitators are to appoint an Internet Dialogue Coordinator. In addition, an Internet Advisory Board is created to advise the Internet Dialogue Coordinator. <u>The Internet Dialogue Coordinator shall "periodically report in writing to the Facilitators the results of this system of communication</u>".

Part II

Archer would also create a Bipartisan Panel to Design Long-Range Social Security Reform. The purpose of this panel would be to develop a **single** recommendation as to the reform of the system. The panel would have eight members:

- o 2 appointed by the President
- o 4 jointly appointed by the Speaker and the Senate Majority Leaders
- o 2 jointly appointed by the 2 minority leaders

There would be two co-chairs who would be chosen by the eight members of the panel. **Any recommendation made by the panel must have the consent of six of the eight members of the panel, including both co-Chairs.**

Analysis:

There are two broad dangers with the Archer legislation:

1. The Administration will have relatively little control over the panel and co-chairs. Yet, the panel is designed to produce a single set of recommendations at precisely the time that Congress will be beginning to work on legislation. If the panel is able to make recommendations, they will carry a great deal of weight.

   The best way for the President to control the results of the panel is to pick two members who will reflect the Administration's views and to have the minority leaders pick at least one member who will also support the Administration's views. But the Administration has not yet determined what its views are. This is a serious problem. Also, it is by no means clear that even one joint appointment by the Minority Leaders will reflect the Administration's views, even if we knew what those views are.

2. The "National Dialogue" will completely overlap the process of fora and White House Conference. The results could be a great deal of confusion for the public. This duplication of effort is also quite wasteful.

Options:

1. President signs the bill. We then have all the problems mentioned above.
2. President vetoes the bill. But the veto might be overridden and even if it were not, this veto might have serious political repercussions.
3. We enlist help of Senate Democrats to offer many amendments to the bill to slow it down and/or change it. Some amendments could be talked about indefinitely to further slow down the bill -- indefinite talk would, however, require holding 40 Democrats together. Also, if any amendments passed, then Senate-House conference would be required, further slowing down the bill. With the White House conference in December, any additional delays for the bill could make its process irrelevant. Moreover, amendments in the Senate could lead to a negotiation between the White House and the Hill leading to legislation with a process more acceptable to us.

4. Open up negotiations now with the Hill to get a process more acceptable to us.

1998-SE-005510

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

INFORMATION

ASSISTANT SECRETARY

May 4, 1998

MEMORANDUM FOR SECRETARY RUBIN

FROM: David W. Wilcox DW
Assistant Secretary (Economic Policy)

SUBJECT: Two Questions Related to Social Security

Attached are two notes addressing questions you posed recently.

- The first note attempts to make the strongest possible case *against* investing part of the Social Security Trust Fund in equities. To facilitate the assessment of the strength of this case, we have included our best guess as to the rejoinder for some of the arguments we raise. This note was prepared by James Duggan, Gus Faucher, John Hambor, and Lara Muldoon, under my supervision.

- The second note discusses the likely impact on capital markets of investing part of the social security trust funds in equities. Specifically, the note discusses the likely impact on equity prices, prospective rates of return on equities, and interest rates. This note was prepared by Alison Shelton, under Gary Gensler's supervision.

Both notes benefitted substantially from comments supplied by several other colleagues around the building.

Attachments

INVESTING THE SOCIAL SECURITY TRUST FUND IN EQUITIES
THE CASE AGAINST

Corporate Governance and Social Investment

- **There could be pressure to use voting proxies to advance social or political agendas, to target investments toward or away from certain companies, industries or sectors, or to intervene during market downturns.**

- Political interference with investment decisions has not been uncommon. For example:

  -- In 1991, when sanctions against South Africa were lifted, 27 states, 88 cities, and 24 counties had laws forbidding investment in as many as 40 US blue chip stocks that were actively tied to South Africa.

  -- Under the Sullivan principles, several states also banned investing in Northern Ireland. And, recently, there have been calls by human rights groups to limit investments in China and Burma.

  -- These same social or political pressures could be used in the future to discourage investing in the tobacco and other industries.

- Several groups, such as the Center for Policy Alternatives, have increased pressure on pension funds to direct part of their portfolio to economically targeted investments (ETIs).

  -- For example, the California public employees retirement system (CalPERS) invested $735 million from 1992-1995 to promote single-family and low-income housing construction in the state.

Possible rejoinder:

- It might be possible to ameliorate these pressures if a sufficiently robust institutional structure can be devised.

  -- Peter Diamond (MIT, National Academy of Social Insurance) has proposed the formation of a separate Social Security Investment Board. The SSIB would have the same range of investment options as are available to individual participants in the Thrift Savings Plan. Indeed, SSIB and TSP monies would be commingled, and placed (as TSP monies are currently) with private managers who, in turn, would commingle them with private money. Peter argues that this approach would create an overlapping system of constituencies intent on preventing any distortion of the investment decision.

<u>Investment Risk</u>

- **Returns from equity investments are highly uncertain.**

  -- The S&P 500 index declined 10 percent or more *in nominal terms* in eight of the past 70 years. Total return from the S&P 500 index (price appreciation plus dividends) has declined 10 percent or more 13 times since 1871.

  -- On three occasions during the past 70 years, the decline in the S&P 500 over a year or two was more than 35 percent.

  -- The Nikkei index fell by more than 50 percent between 1989 and 1992 and was still off 60 percent by the end of 1997.

- Today's U.S. stock market may be overvalued.

- **One especially worrisome possibility that cannot be ruled out is that the retirement of the baby boom generation, and the associated widespread liquidation of assets, could provoke a sustained downturn in the stock market.**

- Absorbing fluctuations in market returns could be painful. Given the lead time that ought to be allowed, adjusting benefits would be cumbersome; calibrating the payroll tax rate to the market would be equally unappealing. Perhaps the most likely outcome is that the government would provide a one-sided guarantee on stock market returns, by using general revenues to supplement the Trust Fund in the wake of poor market performance.

  Possible rejoinder:

- The impact of fluctuations in investment returns could be spread over many generations of workers and beneficiaries.

- Even a 60 percent decline in the market, as occurred from 1989 to 1997 in Japan, could be seen as not having devastating implications for the Trust Fund. A Nikkei-type market downtown would increase the actuarial deficit by 0.84 percent of payroll relative to a baseline in which 40 percent of the Trust Fund is invested in equities, and equities enjoy their average historical performance.

However, even this outcome is scored as slightly better, in actuarial terms, than simply continuing to invest exclusively in government securities.

Effect on National Saving

- **Investing the Trust Fund in equities, by itself, would not raise national saving.** To a first approximation, the saving rate would rise only if the act of investing in equities prevented the government from cutting taxes or increasing spending more than it would otherwise do.

Implementation Issues

- **Monetary policy actions that could have short-term effects on the markets might become more controversial and difficult to implement if a significant portion of the Social Security Trust Fund is affected.** The Federal Reserve and the Administration would have to be very sensitive to the potential fallout of a big drop in the value of the Social Security trust fund tied to a monetary tightening.

INVESTING THE SOCIAL SECURITY TRUST FUND IN EQUITIES
Effect on Capital Markets

A decision to invest Social Security trust funds in the stock market would clearly have an effect on capital markets.

- Share prices would be likely to rise as a result of the OASDI trust funds' purchase of equities. Consequently, the rate of return on equities would fall.

- Bond prices could fall, and bond yields rise, as the government sells additional marketable Treasuries to finance the trust funds' purchase of equities and the drawdown of the trust funds' non-marketable debt.

- Consequently, there is likely to be a change, which is difficult to quantify but likely to be small, in the relative returns to equity and debt. This would result from the increased supply of marketable securities in private hands and the increased demand for equities.

The initial result would be a portfolio shift in the economy as a whole, with the private sector holding fewer equities and more debt. Over the long run, although it is impossible to predict with certitude, the potential changes in the relative returns to debt and equity could lead to a shift in the economy-wide ratio of debt to equity, towards more equity.

There is considerable uncertainty, however, about the magnitude of these effects. Many analysts believe, however, that the price effects in the stock and bond markets would be small, because of the small size of the trust funds relative to the financial markets. Great uncertainty also exists about the possible impact of secondary effects, which could offset some of the initial effects.

Effect on Stock Prices

One would expect an initial increase in share prices to result from the government's announcement that it plans invest a portion of the OASDI trust funds in equities. A windfall gain to current holders of equities would result.

In the long-run, however, there are several possible offsetting effects which could somewhat reverse the increase in share prices. First, corporations could respond to the lower cost of equity by increasing their reliance on equity financing. This additional supply of equity could bring stock prices back down somewhat. Second, when the SSTF begins to run a deficit and starts to sell off equities, there could be a depressing effect on equity prices. Third, individuals could reduce their own equities holdings in response to the trust funds' equity purchases. Fourth, to the extent that the government's investment and voting policies were not neutral, this could have a distorting effect on capital markets, thereby reducing returns.

The size of the potential change in equity prices is not likely to be large, although the share price change is very difficult to estimate. Many analysts base their prediction of a small rise in equity prices on the fact that the Social Security trust funds are currently, and are likely to remain, small relative to the size of equity markets. The Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) funds together totaled about $655.5 billion at the end of December, 1997. The equity market was $12.8 trillion at the end of December, 1997 (netting out corporate cross-holdings, ADRs and mutual fund shares). Thus, the OASDI trust funds are currently equivalent to about 5.6% of the equity market. Investing 40% of the OASDI trust funds in equities all at once would amount to about 2% of the stock market. For further comparison, state and local pension plans held roughly $954 billion in equities in 1996.

It is also useful to compare inflows into financial markets. Net inflows into equity mutual funds were $259 billion during 1997. These mutual fund inflows have been credited with driving up share prices. Note also that in 1997 there was a further $41 billion decline in net issues, due to buy-backs. By contrast, 40% of current OASDI trust fund assets would amount to $262.2 billion.

There has not been much academic research on the price response to changes in the demand for equities. Economist Andrei Shleifer reviewed several studies and found some evidence suggesting that individual securities do experience a price increase when demand increases. However, studies of large block trades were inconclusive.

Individual share prices could be affected when companies are added or dropped from an index used by OASDI trust fund investment managers, such as the Russell or Wilshire indices.

We talked to the Canadian Finance Ministry about the impact on Canadian share prices of the recent announcement that the Canadian Pension Plan (CPP) will invest in equities. The Finance Ministry believes that the announcement has been responsible for some of the recent runnup in Canadian share prices, although they have not done a rigorous examination. CPP funds will not begin to flow into equities markets until next year. The CPP is a small player is Canadian financial markets, although it covers all Canadian employees and self-employed persons, except residents of Quebec. The CPP expects to invest only C$75 billion over the next 10 years. Two other Canadian pension plans hold larger amounts of Canadian equities, and other Canadian registered pension plans combined currently hold C$400 billion in equities.

Effect on the Return on Equity

Some have suggested that the equity risk premium, which is a component of the return on equity, could decline. One of the few studies of this issue found that a shift to 40% equities in the trust funds would lower the equity premium by 10 bps. (Henning Bohn, Federal Reserve Bank of Boston conference on Social Security Reform, June, 1997.)

Some suggest that a decline in the equity risk premium could cause conservative investors to shift from equities to bonds. Conversely, investors with a higher appetite for risk might shift into risker assets.

If the return to equity falls, this would reduce the return accruing to the OASDI trust funds.

Effect on Interest Rates

The research on government debt is inconclusive. However, some researchers suggest that the additional proportion of government debt in private hands might slightly drive up the government's borrowing costs. As a result, current holders of debt could face a loss. As with equities, this conclusion is in part based on a comparison of the relative sizes of the Social Security trust funds with the size of the government debt market. Privately held government debt (including non-marketable savings bonds and SLGs) currently stands at about $3.4 trillion. Selling marketable Treasuries equivalent to 40% of the OASDI trust funds all at once would increase by 7.7% the government debt held by the public.

Corporate borrowing rates would initially be affected by any changes in government rates. To the extent that government rates go up, it is likely that corporate rates would go up by a similar amount.

In the longer run, corporate spreads might decline as corporations issue more equity. Corporations could have more incentive to issue equity than debt, because the rise in share prices would lower the cost of equity financing. Although the ultimate outcomes are impossible to predict, some corporations might become less levered, and others might have less incentive to remain private.

1998-SE-006846

The Deputy Secretary of the Treasury

June 2, 1998

TO: David Wilcox

We need to discuss the whole assumptions issue. Could you send me your take on Social Security assumptions and your preferred assumptions and the difference they make.

Larry

Attachment

Room 3326 **622-1080**

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

INFORMATION

May 18, 1998

DW - we need to discuss the whole assumptions issue. Could you send me your table & story and your preferred assumptions and the difference they make. L.

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: David Wilcox DW
Assistant Secretary (Economic Policy)

SUBJECT: **Update on the Public Trustees' Review of Social Security Assumptions**

As you will recall, most of the modifications we suggested were rejected when the economic and demographic assumptions were determined for the 1998 Trustees' Report. In return for our agreement with the Public Trustees to accept their recommendation, and in light of the heightened importance of the actuarial calculation this year, the Public Trustees agreed to sponsor a review of the economic and demographic assumptions used in the Trustees' reports. This review is anticipated to consist of a number of expert-panels (3 to 5 participants apiece) discussing each of the major economic and demographic assumptions used in the reports.

The first of these sessions is scheduled to occur on Friday, May 29, with a review of the projection of CPI inflation and the wedge between GDP inflation and CPI inflation. This session will provide input into the Trustees' decision about updating the 1998 Trustees' report for the recent BLS technical adjustment to the CPI, as well as focus the Trustees on consideration of the most appropriate long-run inflation assumptions. The CPI session was scheduled first in order to position the Trustees to issue quickly a set of revised estimates based on the BLS improvement alone, if they so choose.

As the summer progresses, we plan to have review sessions on the short-term economic assumptions; long-term productivity growth and the linkages between real wage growth and productivity growth; the real and nominal interest rates; trend labor force growth; and a session on fertility and mortality projections. We expect to complete this review by early fall, at which point the assumptions for the 1999 Trustees Report and for analysis of the Administration's Social Security reform proposal will be developed, potentially by Nov 1.

Prepared by John Hambor

EXECUTIVE SECRETARIAT

Adjustment for BLS Improvement in the CPI

With respect to updating the 1998 Report for the announced BLS adjustment in the CPI, at least three courses of action are available:

- Incorporate a full direct effect of the CPI change and present it as essentially a mechanical adjustment, subject to further revision when the full set of assumptions is developed for the 1999 report. A difficulty with this approach is that it would cause the CPI projection to be the same or lower, over the long haul, than the GDP deflator projection; many analysts, including the Social Security actuaries, believe that the differential should go the other way, in light of the fact that the CPI remains a fixed-weight index at the upper level of aggregation, whereas the GDP deflator is a variable-weight index.

- Negotiate an adjustment now, perhaps less than a full effect, that accommodates the views of all Trustees about the appropriate values for economic assumptions affected by the CPI change (productivity growth, the real interest rate, and the inflation wedge). In particular, this approach could accommodate a projection for the wedge that some analysts would view as more reasonable than the one that would result from mechanical feed-through of the CPI change.

- Incorporate the CPI adjustment as part of the full review of assumptions that will be completed early this fall and be used to evaluate the President's Social Security reform proposal, and as the assumptions in the 1999 Trustees Report.

Of the first two options, both of which could be completed quickly, the first runs a lesser risk of undercutting the validity of the full "fall" review of the assumptions. If the Trustees simply apply the BLS adjustment now and let the chips fall where they may with regard to other long-term assumptions, the fall review, incorporating a full examination of all assumptions using the input from the expert sessions, should remain credible. If changes in other assumptions are made now to accommodate the views of all the Trustees (second option), additional changes in the fall may be viewed with skepticism.

The third option, which does nothing now, means waiting until the review process is completed before saying anything about the BLS change. This might prove difficult as members of Congress are likely to ask the actuaries to incorporate the effect of the CPI change into evaluations of their reform proposals, which are expected to proliferate between now and the completion of our review.

Over the next few weeks, we will be refining our analysis of the "wedge" issue, which we see as the key stumbling block to mechanical implementation of the CPI change in methodology. Once that is completed, we will consult with you as to your views on the matter.

Department of the Treasury

to:

room: date:

Deputy Executive Secretary for Policy Coordination

5/22

For Wednesday, May 27 mtg. on D.C. Pensions.

Very interesting/good memo. I strongly think this should be structured so Secy does not make an asset allocation decision.

L.

David Icikson
room 3414
phone 622-0498

1998-SE-007622

The Deputy Secretary of the Treasury

June 29, 1998

Note to David Wilcox

From: Larry Summers

Don't we want to highlight chart 7? Better be careful.

Attachment

Room 3326 622-1080

98-SE-007622

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

INFORMATION

HOLD CLOSE

June 24, 1998

Don't we want to highlight Chart 7 better to control.
L

MEMORANDUM TO DEPUTY SECRETARY SUMMERS

FROM: David W. Wilcox DW
Assistant Secretary for Economic Policy

SUBJECT: Background Material on Social Security and Retirement

In your absence, I attended a briefing with the VP this morning for the July 1 Social Security forum. Following are brief notes. Proposed charts are attached.

I. Other participants in Providence:

1. Sen. Sue Collins (R-ME)
2. Rep. Mark Sanford (R-SC). Has a very conservative proposal but has been friendly on a personal level. 4% carve out. How he would pay is not known. Raise retirement age.
3. Rep. Charles Rangel (D-NY)
4. Sen. Jack Reed (D-RI)
5. Rep. Earl Pomeroy (D-ND)
6. Sen. John Chafee (R-RI)

II. Ron Klain highlighted Chart 7 as showing how "policy is moving opposite of practice."

III. How increase in NRA interacts with disability: If you raise NRA and save $1 on retirement, you lose about $20 in disability benefits.

IV. Lots of conversation about fact that nobody knows how to "solve" problem of tired-out workers.

V. Klain highlights optimistic path of Chart 5; says Left will attack on this.

NOTE: THESE MATERIALS ARE NOT FOR CIRCULATION.

cc: Gary Gensler
Alan Cohen

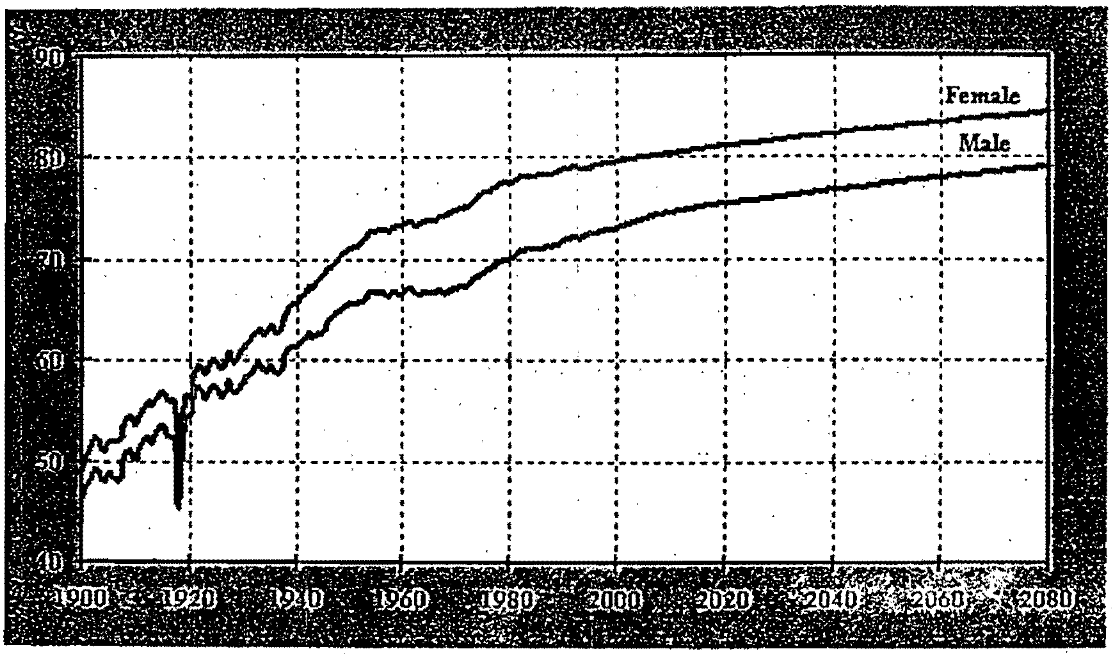
EXECUTIVE SECRETARIAT

Background Material on Social Security and Retirement

June 23, 1998

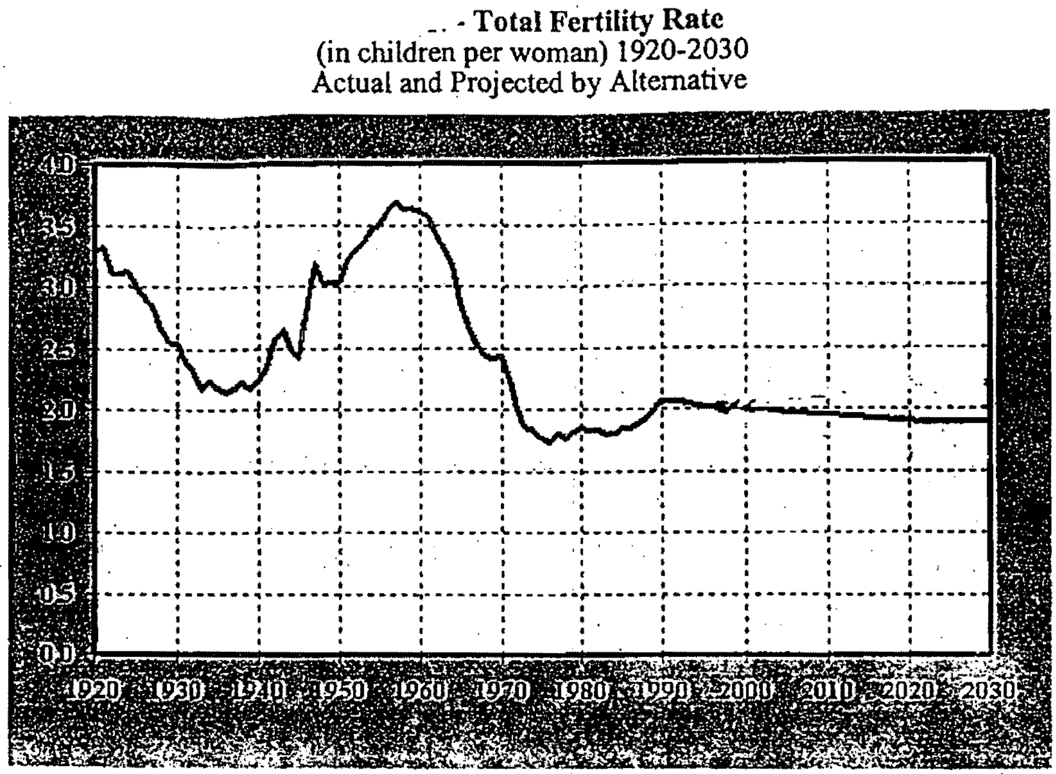
1. Life expectancy is increasing

Male and Female Life Expectancy
(in years) 1900-2080
Actual and Projected Intermediate Alternative



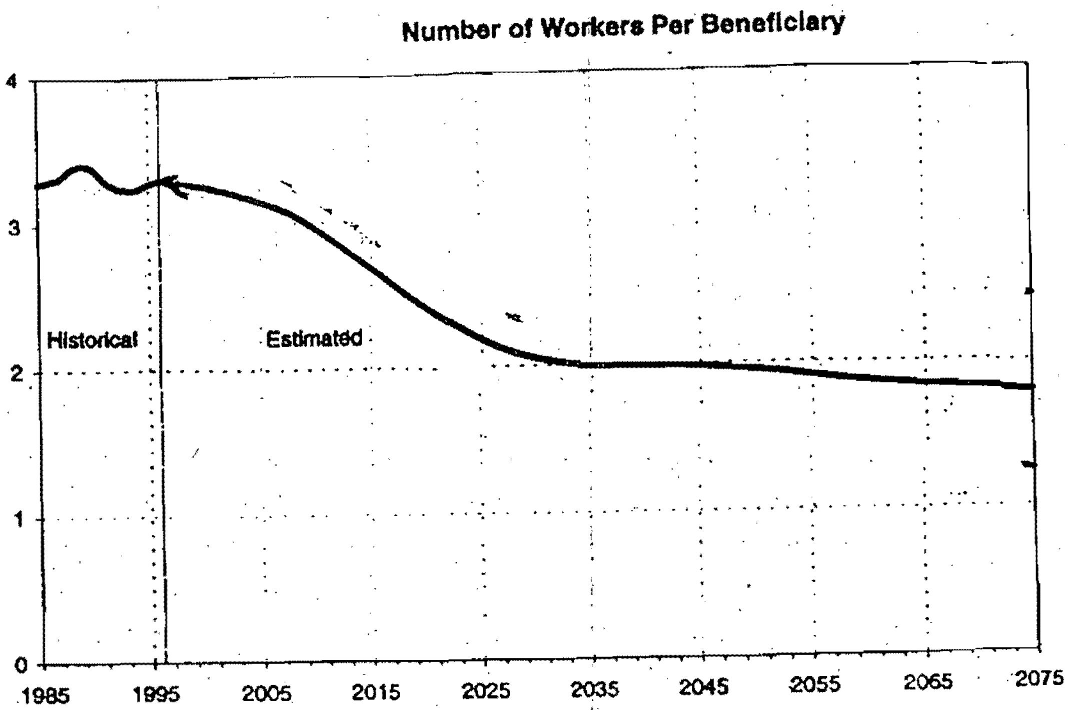
- **When Social Security began, life expectancy at birth was 61 years for a male and 66 years for a female. Today, life expectancy at birth is 73 years for a male and 79 years for a female. In 2050, it is forecast to be 78 years for a male, and 83 years for a female.**

2. The baby boom generation is approaching retirement and fertility rates are projected to remain low.



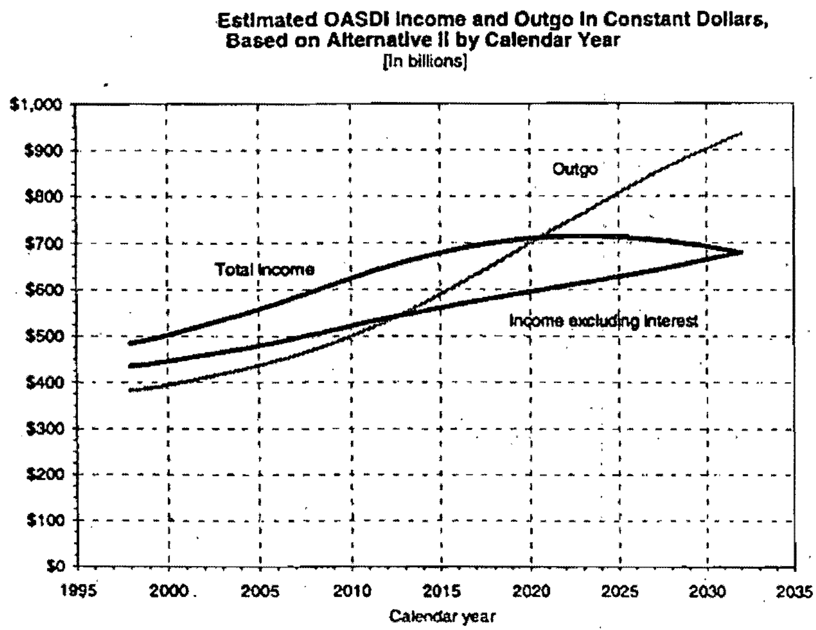
- The chart illustrates the dramatic increase in fertility during the baby boom.
- It also shows that US fertility rates are projected to fall below 2 early in the next century.

3. An implication of these trends is that the number of workers per beneficiary will fall.



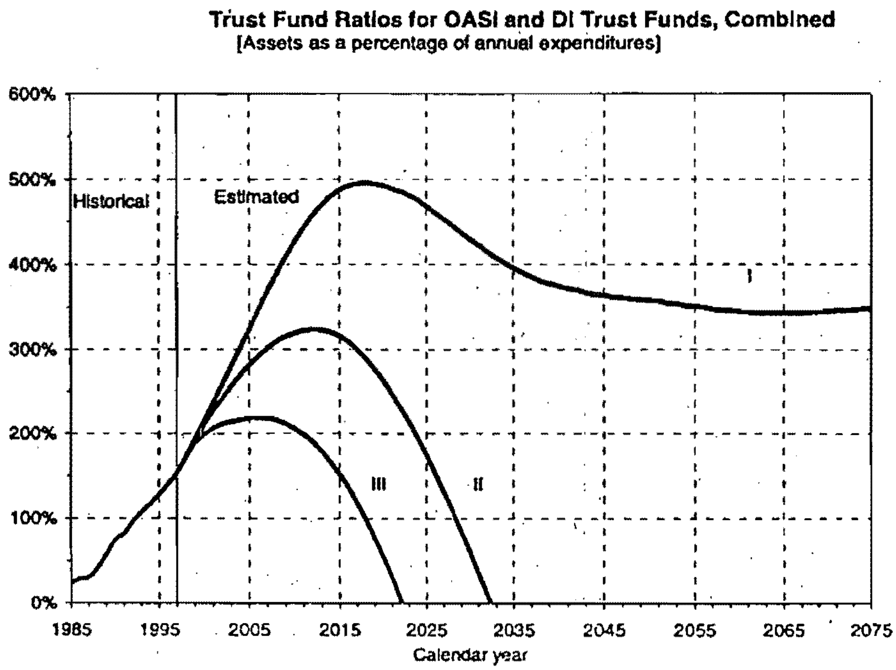
- In 1960, there were 5.1 workers for every OASDI beneficiary.
- Today there are 3.4 workers for every OASDI beneficiary.
- In 2030, there will be only 2.0 workers for every OASDI beneficiary.

4. These demographic trends imply that Social Security revenue will no longer be sufficient to pay full benefits.



- Excluding interest received by the trust fund, benefits first exceed revenue in 2013.
- Including interest income received by the trust fund, benefits first exceed revenue in 2021.

5. The 1983 Social Security reform anticipated these trends, and we started accumulating a surplus in the Social Security trust fund.



- **The Social Security Trustees make three sets of projections: intermediate (II), high cost (III), and low cost (I). The different projections use different assumptions about economic growth, life expectancy, fertility, immigration, and other factors.**

- **Under the intermediate assumptions, the trust fund is forecast to be exhausted in 2032.**

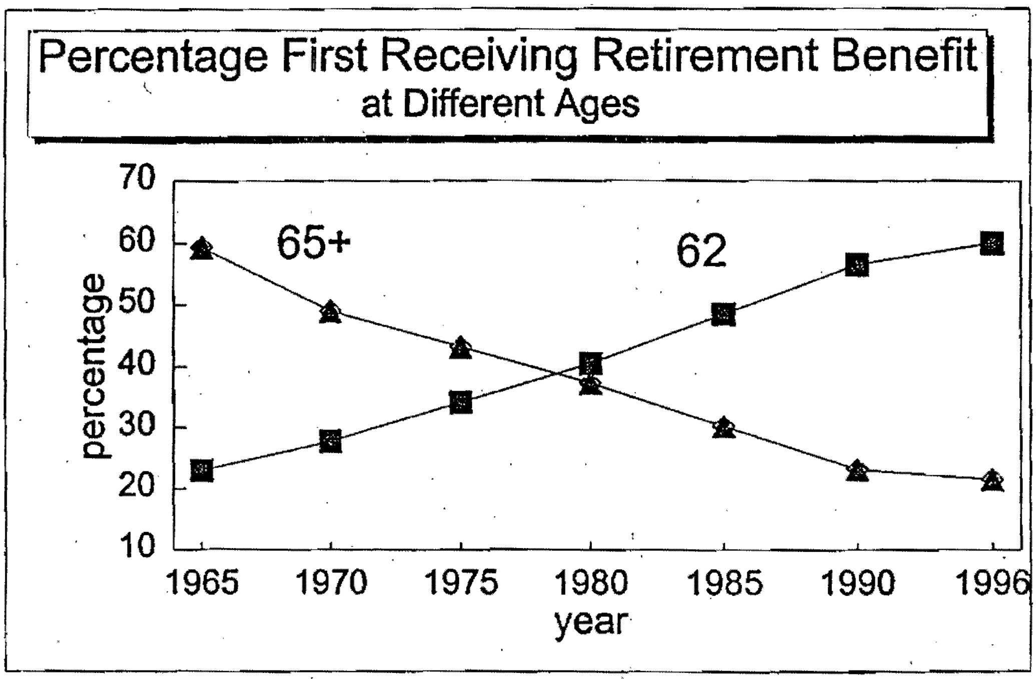
- **Even after the trust fund is exhausted, income to the system will still be sufficient to pay about 75 percent of current law benefits.**

6. This same challenge of financing the retirement of an aging population is being faced around the world. Indeed, the US population is aging less rapidly than that of many other countries.

Ratio of People Age 65 and Older to People Ages 20 to 64 (In Percent)

	1990	2010	2050
Japan	19.3	35.8	60.1
Germany	23.6	32.9	57.5
France	23.4	27.2	48.4
Italy	24.3	33.8	66.7
United Kingdom	26.7	28.6	45.8
Canada	18.6	22.9	46.5
United States	20.8	21.3	37.0

7. **In the U.S. people are not only living longer, but they are also retiring earlier.**



- **In 1965, only 23 percent of Social Security recipients began receiving retirement benefits at age 62. 59 percent began receiving benefits at age 65 or above.**

- **In 1996, 60 percent began receiving benefits at age 62, while only 22 percent began receiving benefits at age 65 or above.**

1998-SE-0093369

98-SE-009336

ACTION

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

August 7, 1998

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: **David W. Wilcox** DW
Assistant Secretary
(Economic Policy)

Gary Gensler KG for
Assistant Secretary
(Financial Markets)

SUBJECT: Investment by the Social Security Trust Funds in Inflation Indexed Securities

ACTION FORCING EVENT:

The introduction of Treasury Inflation Indexed Securities (IIS) has provided the means for reducing the exposure of the combined Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds ("trust fund") portfolio to inflation risk.

RECOMMENDATION:

That you recommend at the Fall Meeting of the Social Security Board of Trustees that par-value special-issue Treasury Inflation Indexed Securities (IIS) be added to the combined Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds ("trust fund") portfolio.[1]

Agree ✓ Disagree ______ Discuss ✓

If we do this, how will that affect projected imbalance.

[1]The Fall meeting is normally in December. If we want to beginning adding IIS to the trust fund sooner we could schedule a meeting in October or November, or do it without a meeting after full consultation with the other Trustees. A meeting provides a convenient vehicle for a joint announcement of the new policy by the Trustees.

EXECUTIVE

BACKGROUND:

Current Trust Fund Investment Policy

The trust fund currently is invested in a portfolio of nominal par-value, special-issue Treasury securities with maturities ranging from one to 15 years. The yield is set at the prevailing weighted average rate on outstanding issues not due or callable for 4 or more years. These specials are not traded and are redeemable at par at any time. The return on these securities is fixed in nominal terms.

Adding IIS to the Social Security Trust Fund

Inflation is a liability to the trust fund because Social Security benefits are indexed to inflation. Adding par-value, special-issue IIS to the trust fund would improve the match between the asset and liability sides of the trust fund.

In principle, investing in IIS might also reduce the return on trust fund assets below the rate obtainable on nominal bonds, because the return on IIS does not include a premium for inflation risk. However, this reduction in yield is probably not very great for two reasons:

- At present, the price of "inflation insurance" appears to be very low;
- Marketable IIS may be priced to include an "illiquidity" premium. Since the yield on par-value specials would be tied to the average rate on marketable IIS, par-value IIS would temporarily capture this premium.

Legal Authority

According to the office of the General Counsel, excess trust fund moneys could be invested in par-value IIS under existing law governing trust fund investments *provided such investment were determined to be "in the public interest."* A full discussion of the legal authority is contained in Attachment 1.

Although you appear to have statutory authority to invest all or part of the trust fund in IIS on your own, by virtue of your position as Managing Trustee, we advise that you not do so without consulting with the other members of the Board of Trustees (especially the two public members) and Congress.

Pricing

There are a number of policy options available for pricing IIS, including mirroring outstanding TIPS (Treasury Inflation Protected Securities) or constructing a yield curve based on outstanding TIPS. If you approve the recommendation to invest the trust fund in inflation indexed securities, we will come back to you with a recommendation for a pricing methodology.

Allocation

If you approve the recommendation to invest the trust fund in inflation indexed securities, we will come back to you with a recommendation for the proportion of the trust fund to be invested in IIS.

Impact on the Trustees' Projections

Introducing IIS into the trust fund would give new prominence to the issue of whether the Trustees' long-term inflation and real interest rate assumptions should be based on market signals. For example, a literal reading of current TIPS yields would raise the Trustee's assumption for the long-term real interest rate from 2.8 percent to about 3.7 percent, and cut the inflation rate assumption from 3.5 percent to 2.0 percent. Together, these changes would reduce the actuarial deficit by about 0.3 percent of payroll. There is considerable question as to whether the institutional bias toward gradual changes could be overcome, allowing us to implement changes of this magnitude.

Attachment 1: Legal Authority

Under section 201(d) of the Social Security Act (42 U.S.C. § 401(d)), excess moneys in the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund (collectively, the "trust fund") may be invested only in (1) Treasury special obligations, issued directly to the trust fund, that bear interest at a rate set according to a statutory formula (the rate is set at the prevailing average market yield on all marketable public debt securities then outstanding which are not due or callable for 4 or more years), or (2) "other interest-bearing obligations of the United States or obligations guaranteed as to both principal and interest by the United States, on original issue or at market price, only where [the Secretary of the Treasury] determines that the purchase of such other obligations is in the public interest."

Existing law gives preference to investing excess trust fund moneys in the Treasury special issues with statutory-formula interest rates. Indeed, even before the law was amended in 1960 to establish a preference for investment in such Treasury special issues, it was the long-standing policy of the Secretary of the Treasury, as Managing Trustee, to invest excess trust fund moneys in those special issues.

Nevertheless, the Secretary of the Treasury, as Managing Trustee, is also authorized to invest excess trust fund moneys in "other" United States obligations or United States-guaranteed obligations when the Secretary, as Managing Trustee, determines that investment in such "other" securities is "in the public interest." We understand that this authority under the Social Security Act has only been used to invest excess trust fund moneys in *marketable* Treasury securities, and then only when the yields on the marketable securities purchased exceeded the interest rates that were then available on the special issues with statutory-formula interest rates.

It is important to note, however, that the statutory description of "other" eligible investment securities does not use the word "marketable." The phrase "other interest-bearing obligations of the United States . . . on original issue" may be read to embrace Treasury special issues *other than* the special issues with the statutory-formula interest rate that are routinely issued to the trust fund as investments. A reasonable argument may be made, therefore, that the Secretary of the Treasury, as Managing Trustee, is authorized under existing law to invest excess trust fund moneys in par-value, special issue inflation indexed securities if he determines that such investment is "in the public interest," because such special issue inflation indexed securities would be "other interest-bearing obligations of the United States . . . on original issue."

This argument is supported by the fact that, under 31 U.S.C. § 3121, the Secretary has discretionary authority to prescribe the offering price, interest rate, and other conditions of the Treasury bonds, notes, and bills, including special issues of the same, that the Secretary issues. That discretionary authority would extend to setting the terms and conditions of the "other interest-bearing obligations of the United States" that qualify as eligible investments for the trust fund. Under this argument, the

Secretary would have authority to set par-value redemption and inflation indexed principal as terms and conditions of the Treasury special obligations that the Secretary issues to the trust fund as "other" eligible investments.

The argument is further bolstered by the general principle that the statutes governing many trust funds, including the Social Security Trust Funds, vest broad discretionary authority in the Secretary of the Treasury to manage those trust funds and their investments. In the past, the Secretary of the Treasury has exercised his trust fund management authorities under existing law broadly, notably during the 1995-96 debt limit impasse. Those actions were determined to be legally permissible by the Justice Department and the General Accounting Office.

The weaknesses in such an argument arise from the past administrative practice of Secretaries of the Treasury in exercising their trust fund investment authorities under the Social Security Act. First, to the best of our knowledge, the authority to invest in "other interest-bearing obligations of the United States" has up until now only been used to invest in marketable Treasury securities. We are not aware that it has ever been used before to invest in Treasury special issues, let alone special issues that were different from the preferred special issues with the statutory-formula interest rates. Second, we understand that the authority to invest in "other" eligible investments was used in the past only when the yield on the other interest-bearing obligations of the United States was higher than the interest rate that was then available on the special issues with statutory-formula interest rates.

Notwithstanding these illustrations of the past administrative practice of Secretaries of the Treasury in exercising the statutory authority to invest excess trust fund moneys, the words of the governing statute would allow the Secretary of the Treasury to invest such excess trust fund moneys in par-value, special issue inflation indexed securities if the Secretary determined that investment in such securities was "in the public interest." If such inflation indexed Treasury special issues are purchased for the Social Security Trust Funds, our current thinking is that those Treasury special issues should include a par value redemption right. Section 201(e) of the Social Security Act (42 U.S.C. § 401(e)) provides that public-debt obligations issued "exclusively" to the Trust Funds, i.e., Treasury special issues, may be redeemed at par plus accrued interest. This par value redemption right would apply to Treasury special issues purchased for the Trust Funds that bear interest at the statutory formula; it would also apply to inflation indexed Treasury special issues purchased for the Trust Funds as "other interest-bearing obligations of the United States."

The Office of the General Counsel recommends that it be allowed to more fully analyze these issues in a formal opinion to the Secretary.

CLEARANCE SHEET

Initiated by:

John C. Hambor	Director, Office of Mircoeconomic Analysis	JCH	8/4/98	2-0714

Cleared by:

Gary Gensler	Assistant Secretary for Financial Martkets		2-2044
Edward Knight	General Counsel	PB for ESK by his instruction	2-0287

8/5/98

Please call Terri or Lynn at 2-2350. Thank You

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Friday, August 07, 1998

PROFILE #: 1998-SE-009336

DATE CREATED: 08/07/1998

ADDRESSEE: Robert E. Rubin
Secretary

AUTHOR: Wilcox, David W.
Economic Policy

SUBJECT: Investment By The Social Security Trust Funds In Inflation Indexed Securities

ABSTRACT: Investment by the Social Security Trust Funds in Inflation Indexed Securities. (Also, prepared Gary Gensler).

RM 3419 TO REVIEWERS TO EXECUTIVE SECRETARY

IN: IN:

TO THE SECRETARY

To PA 8/10/98
PA to NCC 8/10/98
PA cc DL/AK

DATE SIGNED:

DISTRIBUTION: AS, ECONOMIC POLICY

NCC to LER (ACTION)
NCC to LS (ACTION)
NCC cc to MF
SS
8/10/98

08/07/1998 06:16:00 PM

The Secretary of the Treasury

AUGUST 13, 1998

NOTE FOR GARY GENSLER

FROM: BOB RUBIN

If we do this, how will that affect projected imbalance?

Attachment

cc: D. Wilcox

1998-SE-009910

9910

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON

August 21, 1998

MEMORANDUM FOR SECRETARY RUBIN

FROM: David W. Wilcox DW
Assistant Secretary (Economic Policy)

SUBJECT: Response to Your Question about Investment by the Social Security Trust Funds in Inflation Indexed Securities

In response to a recent memo about investing the Social Security Trust Funds in Treasury Inflation Indexed Securities (IIS), you asked how such an action would affect the projected imbalance of the system.

Putting IIS into the Trust Funds will in and of itself have no effect in improving the projected actuarial imbalance. What would be required to achieve such an improvement would be to effect a change in the assumptions used to construct the Trustees' projection. A key motivation for putting part of the Trust Fund assets in IIS would be to bolster our case that an increase from the current assumption of 2.8 percent is reasonable.

EXECUTIVE SECRETARIAT

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Friday, August 21, 1998

PROFILE #: 1998-SE-009910

DATE CREATED: 08/21/1998

ADDRESSEE: Robert E. Rubin
Secretary

AUTHOR: Wilcox, David
Economic Policy

SUBJECT: Response To Your Question About Investment By The Social Security Trust Funds In Inflation Indexed Securities

ABSTRACT: Response to your Question about Investment by the Social Security Trust Funds In Inflation Inexed Securities.

RM 3419

TO REVIEWERS

IN: To AK 8/24/98
cc Froman
SS

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

RER Reading
8/25/98

DATE SIGNED:

DISTRIBUTION: AS, ECONOMIC POLICY

The Secretary of the Treasury

September 1, 1998

NOTE TO DAVID WILCOX

FROM: Bob Rubin

Let's discuss.

1998-SE-011753

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

October 14, 1998

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: David Wilcox DW
Assistant Secretary (Economic Policy)

SUBJECT: Report from Treasury's Social Security Team

I have begun convening a weekly meeting of Treasury's Social Security team. Participants are Marti Thomas, Gary Gensler, Alan Cohen, Len Burman, Mark McClellan, Lynda de la Viña, and Bob Cumby. This is the first of what will likely be a fairly regular series of memos resulting from these meetings.

Our overriding concern at this point is how the Administration will pivot from a "year of discussion" to actual engagement with Congress on a Social Security reform plan. A number of questions were discussed:

- Will the Administration have its own proposal, or will we only issue a set of principles?

- What, if anything, will be included in the FY 2000 budget? What will go into the State of the Union?

There is a principals meeting scheduled for Friday on budget-related aspects of Social Security. We would like to meet with you before that meeting to discuss topics that may be raised and issues that you may wish to raise, including:

- The need for a legislative strategy for Social Security reform remains a major hole in the process. Members of Congress have begun to inquire about the process, but there has not yet been any discussion of how the Administration will proceed.

- The December White House Conference on Social Security ought to be a major piece of our legislative strategy. At this point, however, the NEC is not moving on planning the conference or inviting speakers and participants. By not moving, we are effectively narrowing the range of possibilities for what we can accomplish at the conference. We recommend that you prod Gene to have a principals-level discussion of the format and objectives of the conference.

You will receive a separate memo on the budget and Social Security, including recommendations on a legislative strategy, before the Friday meeting.