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# Social Security - Reform Proposals

Social Security - reform proposals

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THE WHITE HOUSE

Office of the Press Secretary

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For Immediate Release January 29, 1999

**AS PREPARED FOR DELIVERY**

**REMARKS BY GENE B. SPERLING**
**ASSISTANT TO THE PRESIDENT FOR ECONOMIC POLICY**
**THE NATIONAL PRESS CLUB**
**JANUARY 29, 1999**

In his State of the Union address, President Clinton launched a national debate on how our country should best allocate resources during a remarkable period of prosperity and surpluses. The President's fundamental message is a clear one: with the budget deficit cured, but a long-term retirement deficit looming, the fiscally and financially responsible way for this nation to deal with this period of surpluses is not to consume them today and turn a blind eye to the retirement challenges of tomorrow, but rather to save and invest them. By doing this, we will pay down the debt and lift the burden of much of the long-term retirement deficit off the next generation.

While politicians are often criticized for supporting live-for-the day fiscal policies, the President's plan essentially reserves 90 percent of our surplus for the next 15 years for savings to address the long-term retirement challenge. The framework that the President put forward allocates 62 percent -- or $2.8 trillion -- of the projected surpluses to Social Security and 15 percent -- or $686 billion -- to secure the Medicare trust fund until 2020. Even the President's $536 billion tax relief proposal -- his Universal Savings Accounts or USAs -- is specifically designed to promote long-term savings among those moderate and low-income families who are least able to save and currently receive the smallest incentives to save from our tax system. In sum, of the $4.4 trillion in surpluses allocated in the President's framework, $3.4 trillion or 77 percent is allocated to be put towards shoring up the Social Security and Medicare Trust Funds with another $536 billion allocated for incentives to increase private savings through the USA accounts. The remaining 11 percent would be dedicated to military readiness and such further investment in education and research that are critical for future growth and productivity.

While I would like to make sure that I address some of the parts of the President's proposal that have raised the most commentary, I want to start by making clear why the core of the President's proposal is as unambiguously pro-savings, pro-debt reduction, pro-long-term growth as any plan ever put forward by a President.

At its core, the President's proposal sets aside nearly $3 trillion dollars over the next 15 years in projected surpluses for debt reduction and then allocates a portion of the benefits to shore up the solvency of the Social Security and Medicare Trust Funds.

Before any one gets lost in arcane budget accounting debates, it is important to understand the sound and substantial economic logic of the President's proposal: rather than consuming the surplus through new spending or new tax cuts, the plan will pay down nearly $3 trillion of our national debt, resulting in higher national savings, lower interest rates, higher investment, higher growth, and higher revenues and will, therefore, improve the fiscal and financial capacity for our nation to meet its unkept promises to future Social Security beneficiaries.

The impact of the President's plan in reducing the national debt is dramatic. Consider the following: in 1981, when Ronald Reagan took office, the debt held by the public was 26 percent of our national income. By the end of 1992, that number had nearly doubled to 50 percent -- so that the government's debt amounted to half of our annual income as a nation. Through fiscal discipline -- the 1993 economic plan and the bipartisan 1997 Balanced Budget Agreement -- we have turned our debt situation around. Right now, our national debt is 44 percent as a share of the economy, and under the President's plan will fall below 26 percent by year 2006. In short, within seven years, we will have wiped out the debt -- measured as a percent of the economy -- that was run up during the Reagan-Bush years. And by the end of the President's 15-year framework, the national debt held by the public will have fallen to 7.1% of GDP -- its lowest level since America entered World War I in 1917.

For all the debates about budget accounting terms today, if a Republican President had come forward with a plan to nearly eliminate the publicly held debt in 15 years, the only debate would be whether to build a statue or a pyramid on the mall to honor him or her.

It is no wonder that whatever their disputes on certain aspects of Social Security reform are, some of the most prominent budget experts in town, Alan Greenspan, Bob Greenstein, Robert Reischauer and Henry Aaron, agree on the fiscal wisdom of the President's effort to reduce our national debt and a lock-box through essentially a debt reduction allocating much of the benefits to Social Security and Medicare.

As Chairman Greenspan said yesterday and I quote, "[I]ncreasing our national saving is critical. The President's approach to Social Security reform supports a large unified budget surplus. This is a major step in the right direction in that it would ensure that the current rise in government's positive contribution to national saving is sustained."

Despite this support, some members of Congress have rushed out to criticize this part of the President's plan on the fundamental misunderstanding that the President was somehow increasing our existing Social Security obligations or making a "double obligation" to Social Security.

Let me explain why that notion is misguided. We as a nation right now have in place a promise to pay Social Security benefits to America's workers under an existing benefit structure. That promise exists today, but, as we all know, it is an unfunded promise as we get past the first few decades of the next century.

When people suggest that the government is double obligating, it gives the impression that we are increasing our obligations to retirees in the future. For example, they seem to think that we owe a retiree Social Security benefits in 2035, but are now increasing that obligation to include a new toaster, a calender and a rental car for a week. This is simply not the case. The president's plan is not creating any new promises or new obligations. He is simply seeking to pay down the debt and increase our national savings rate -- so that we are strengthening our fiscal and financial capacity to meet our existing Social Security promise for a longer period of time from 2032 to 2055.

Let me provide an example: A worker today with a high school degree makes $20,000 per year, but has $50,000 in credit card debts. This worker has additional debts of $10,000 per year that come due after 2032. The worker's wealthy aunt or uncle leaves him $100,000. The worker now faces two choices: he or she could simply consume the $100,000 now and remain in a terrible position to pay his debts 30 years from now. Or, that worker could save and invest the money, paying off his existing $50,000 credit card bill and investing $50,000 in an education that allows him to make $90,000 a year. That would put the worker in a dramatically better financial and fiscal condition to pay-off existing obligations while still maintaining a high standard of living.

The worker here has not increased his or her obligations or debts; he has simply saved and invested wisely so that he has a greater capacity to pay back his existing obligations. That is similar to the President's proposal for Social Security.

By saving and investing the surplus, the President's plan dramatically reduces our debt, increases our savings, lowers interest rates, and spurs investment to increase our nation's wealth, and thus, puts our government in a position to better meet our existing promises -- not new ones.

The fact that one aspect of the President's plan allocates new bonds to the Social Security Trust Fund when it pays down the debt does not increase our obligation -- it simply gives Social Security after 2032 a first call on some of the dividend created by debt reduction so that we can keep our existing promises to Social Security beneficiaries past 2050. Now some may say: "I support the President's plan to reserve a large amount of the surplus for debt reduction, but why allocate additional bonds to Social Security, when you can just pay down the debt without taking any additional steps?"

Let's call their case the "debt-reduction only" plan and let's call the President's plan the "debt-reduction lock-box for Social Security." Both plans would have precisely the same effect on the economy until 2032 because both plans would have the precisely same positive impacts on national savings, on capital stock accumulation, on lower private interest rates, and on lower debt service costs. Advocates of both plans agree that this degree of debt reduction will create debt reduction dividends. Paying down our debts today creates a small pot of gold for tomorrow. So what's the difference? The only difference is this: In the President's "debt-reduction lock-box for Social Security" plan, when we lock-in debt reduction today, we also allocate bonds to the Social Security Trust Fund that ensure that Social Security will get a portion of that debt-reduction dividend so that we can meet existing Social Security promises after 2032. In the "debt-reduction only" plan, the allocation of the dividend is left completely open for future Congresses, and there is no commitment to extend Social Security even a day longer.

Now some may disagree with our option of locking in the benefits of debt reduction for Social Security, but let's at least agree that it is not about double counting or double obligations. That's a specious argument. It is simply a decision about whether or not we decide today to lock in some of the dividends from the extraordinary debt reduction to fulfill promises we have already made about the future.

We are ready and willing to work with both parties in Congress on the effort to craft true bipartisan Social Security legislation. We simply must work in a bipartisan way to make the tough-minded but sensible choices that will extend the solvency of Social Security for 75 years. However, I do want to make the following challenge to some of the Republican critics who asked the President to come forward with a specific outline, but who then have only offered criticism, without putting forth better ideas. The independent Social Security actuaries who have analyzed plans during Democratic and Republican Administrations for the past three decades have determined that the President's plan extends the solvency of Social Security until 2055. Let those who only criticize come forward with how their opening bids lengthen the life of Social Security until at least 2055 while meeting all of the principles and tests that they have applied to the President's proposal. A few can meet the test. But only a few.

Second, I would challenge anyone to show how they would extend the Medicare trust fund before they come forward with either a popular consumption oriented tax cut or new spending measures.

The President set forth a comprehensive economic agenda and explained to the country exactly how he would allocate the surplus. But many people today put out proposals to cut taxes or spend new money without explaining how they would use the surplus to extend the life of Social Security and Medicare or to ensure that our nation was not draining away resources that are needed help with military readiness and critical education needs.

The President's plan also proposes that we invest a portion of the surplus in the market to strengthen Social Security. We took very seriously the concerns that this investment option not allow any undue political interference. The President's plan would mean that on average, the Social Security investment would total less than 4 percent in the market -- 60 percent less than what state and local pensions control today and roughly as much as Fidelity controls. Second, the President's proposal insists that all investments be made only by private sector managers after a competitive bidding process. If for example, there were four or more private sector teams overseeing this investment, none would control more than a single percent of the market. Each private sector manager would be required to engage in the most broad-based passive indexes without any option to pick and choose stocks day-to-day so as to ensure there is insulation from political interference. Indeed, this investment option allows us to extend the life of the Social Security trust fund another 6 years. It also accounts for one-third of the improvement in the actuarial balance achieved under the President's proposal.

Finally, I'd like to say a few words about the President's $536 billion tax relief plan to create USA accounts.

During the President's year-long debate, he heard the case for two very powerful principles. One was the need to provide additional savings for the tens of millions Americans who do not have adequate savings or employer provided pensions and therefore are not enjoying the full benefits of higher returns and wealth creation that more and more middle and upper middle class Americans are reaping today.

But the other principle the President heard over and over again was that Social Security should remain the one critical leg of the retirement system that is a rock-solid defined benefit plan that people can count on no matter what. We felt that by having tax relief to create USA accounts outside of the Social Security system, we could keep these two powerful concepts in harmony rather than in tension.

The structure of the President's USA Accounts are designed specifically to improve our tax system's inadequate incentives for savings for low and moderate income families. Currently, we have a tax incentive structure for savings that provides generous incentives for Americans in higher income brackets. Americans in the 31 percent bracket essentially receive a 50-70 percent subsidy for every dollar they put in. Yet that subsidy is not even 20 percent for the 70 percent of Americans in the lowest income bracket. And for the many American families with virtually no income tax liability, there is almost no tax incentive to save at all.

It is hard to justify this as a complete and rational savings policy. Americans in upper income brackets clearly have a higher propensity to save than moderate or lower income Americans. Furthermore, tax incentives for more well-off Americans are more likely to simply lead to a shifting of existing savings from non-tax-subsidized to tax-subsidized accounts. It is families with low or moderate income, families that are under most pressure to spend all of their income on daily necessities, who need stronger incentives to save.

USA accounts seek to remedy this imbalance in our incentive system for savings by offering a flat tax credit for all working Americans up to some income level. This plan would ensure that most working families get a contribution for savings no matter what their tax liability. Then, we would add a progressive match so that there is a higher tax subsidy (or 'match') for families at lower income brackets who need stronger incentives to save.

In setting forth this proposal, the President seeks to empower the tens of millions of Americans who have inadequate individual savings or no employer-provided pension. We believe that is the right way to provide incentives for individuals to become part of the culture of savings and wealth-creation and to ensure that more Americans enjoy the higher returns that can come through equity investments and accumulated returns.

USA Accounts together with the President's commitment to Social Security, Medicare, as well as his continued commitment to increase the skills of our people -- reflects a commitment to launch the era of surpluses with the same commitment that helped create them: fiscal responsibility, savings for the future, and investing in the productivity of our people.

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Message Sent To: ______________________________

cc: Bruce

Social security - Reform proposals

# MEETING ON CONGRESSIONAL AND THINK-TANK SOCIAL SECURITY REFORM APPROACHES

## PART II

Cabinet Room
November 24, 1998
2:50 p.m.

**AGENDA**

**III. PLANS THAT USE SURPLUSES BOTH TO STRENGTHEN THE TRUST FUND AND ESTABLISH INDIVIDUAL ACCOUNTS**

***Discussed Last Time:***

**I. PLANS THAT TRANSFER SURPLUSES TO TRUST FUND**

**II. PLANS THAT USE SURPLUSES TO FUND INDIVIDUAL ACCOUNTS**

## A Basic Typology of Plans

We will be discussing six forms of Social Security plans. All of these plans use the surplus in one way or another, and all could be designed to do so to a greater or lesser extent.

| Title | Description |
|---|---|
| ***A. Plans That Use the Surplus to Shore up the Trust Fund*** | |
| 1. Bond-only plans | Maintain current policy of holding only Treasury securities. |
| 2. Equities in the Trust Fund | Introduce equities into the system, but hold them collectively. |
| ***B. Plans That Use the Surplus in Creating Individual Accounts*** | |
| 3. Add-on individual accounts | Continue to use all of the current 12.4 percent payroll tax to fund traditional Social Security benefits; make sufficient adjustments to the system (benefit cuts, revenue increases) to bring it into balance. Establish individual accounts in addition to the current system. |
| 4. Carve-out individual accounts | Divert some of the current 12.4 percent payroll tax into individual accounts. Individual accounts *replace* part of the current system, and could potentially be described as a tax cut. Relatively large surplus transfers and/or cuts to the traditional Social Security benefit would be necessary to restore solvency. So far, most carve-out plans have been "fiscally conservative" with significant cuts through such provisions as raising the retirement age. With more use of the surplus, the cuts could be softened. |
| ***C. Plans That Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts*** | |
| 5. Integrative plans | Use surplus to establish individual accounts. At retirement, part of the proceeds of the accounts are used to finance traditional benefits, while part provide an add-on individual account. |
| 6. Hybrid plans | Contribute part of the surplus directly into the Trust Fund, as under (1) or (2), and part into individual accounts as under (3) or (4). |

## THREE BASIC REFORMS

At this point, we want our discussion to focus on fundamental issues of plan design that could impact our short-term strategy for achieving reform, and to avoid spending too much time on details that can be worked out at a later date.

- **Many of our plans contain three basic provisions that are meant as place holders for benefit cuts and/or revenue increases to be determined later.** The three provisions we happen to have chosen close 44 percent of the 75-year actuarial imbalance. There would be many other ways to achieve similar solvency effects.

  -- **Raise the taxable maximum for the OASDI payroll tax so that 90 percent of earnings are taxed by 2010:** This would return the percentage of earnings that are covered to where it was in 1982 and 1983. In 1998 dollars, it would be equivalent to raising the taxable maximum from $68,400 to $95,100. It would raise taxes by up to $1,655 (each for workers and employers) for the six percent of workers with earnings above $68,400. We are exploring ways to raise revenues without having such a large effect.

  -- **Cover state and local government new hires beginning in 2011.**

  -- **Increase the number of years used in calculating Social Security benefits from 35 to 38.**

- **These proposals could be replaced with an across-the-board benefit cut of 10 percent.** While all three of these proposals are likely to run into serious political opposition, it is important to note that only one of these three provisions results in a reduction in Social Security benefits for future retirees, and that the reduction equals only 3 percent of current-law benefits. Replacing these provisions with an across-the-board benefit cut would require a 10-percent cut in benefits for 2015 and later (or 20 percent by 2040 if the cuts were phased in more slowly). Such benefit cuts may be even less palatable than these three basic provisions.

# I. PLANS THAT TRANSFER SURPLUS TO THE TRUST FUND

## TRANSFER UNIFIED BUDGET SURPLUSES TO SOCIAL SECURITY TRUST FUND AND INVEST IN BONDS ONLY

- Transfer **91 percent** of the *currently projected* unified budget surpluses to the Trust Fund for as long as they last (2033), and continue to invest the Trust Fund in government bonds only.

- Do <u>not</u> include common set of reforms.

| KEY ATTRACTIONS OF THIS APPROACH |
|---|
| • Continues the program on a completely defined benefit basis, avoiding potentially costly and risky alternative approaches. |
| • Preserves benefits at current law levels. |
| • Prevents nearly all of the surplus from being used for other purposes. |
| • Very consistent with our message of the past year that surpluses have been reserved pending Social Security reform. |

| KEY DISADVANTAGES OF THIS APPROACH |
|---|
| • See box on next page. |

| IMPACT ON 75-YEAR ACTUARIAL BALANCE (**current balance is -2.19**) | |
|---|---|
| Common set of reforms | NA |
| <u>General revenue transfer to Trust Fund</u> | <u>+2.22</u> |
| Remaining Actuarial Balance | +0.03 |

| IMPACT ON BENEFITS IN 2030<br>PERCENT OF CURRENT LAW BENEFITS | | | |
|---|---|---|---|
| | **Low Earner** ($12,000) | **Average Earner** ($27,000) | **High Earner** ($43,000) |
| Total | +0.0 | +0.0 | +0.0 |

### ALTERNATIVE VERSION WITH 3 COMMON REFORMS:

- Transfer **55 percent** of the *currently projected* UB surplus to Trust Fund for as long as they last (2031), and continue to invest the Trust Fund only in government bonds.

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

## KEY CHALLENGES ASSOCIATED WITH BONDS ONLY PLANS

- **<u>Will Transfers of the Surplus Help Us Prepare for the Future?</u>** Transfers of the budget surplus to the Trust Fund do not reduce the mismatch between annual tax revenues and benefit obligations in the out years. However, to the extent that transfers allow us to use the surplus to pay off debt (or purchase private securities), they will leave us in a stronger financial position when the demographic challenges arrive.

- **<u>Will Transfers Succeed in Removing Surpluses from the Books?</u>** Under current budget scoring rules, transfers used to purchase government bonds would not remove any unified budget surplus from the books, and therefore would not prevent the surplus from being used for tax cuts or new spending. However, allocating the surpluses for Social Security could lead to a change in scoring rules.

- **<u>The Double Counting Problem.</u>** The Trust Fund has already been credited with the excess of Social Security taxes over benefits. The current unified budget surplus is entirely due to the Social Security surplus. Under OMB projections, 89 percent of unified budget surpluses over the next 10 years are due to Social Security (under CBO projections, 98 percent are due to SS). If we were to transfer the surplus to Social Security, some might complain that we were crediting the Trust Fund twice. Indeed, some people already argue that the Trust Fund is not "real" and that we are "raiding" the Social Security Trust Fund to mask non-Social Security deficits.

- **<u>Maintains and Expands Social Security Trust Fund Structure.</u>** Many Democrats and Republicans do not support the trust fund structure, saying that it does not truly set aside money for Social Security and does not prevent the funds from being spent. By transferring additional funds to the trust fund, this type of plan would expand Social Security's reliance on the trust fund structure.

- **<u>Sustaining Transfers If Surpluses Do Not Materialize.</u>** If the full projected surpluses do not materialize and transfers are scored as outlays, then the transfers could result in budget deficits. To the extent that these deficits are financed by issuing debt, then we will not have done anything to improve the long run fiscal situation. In addition, it the future it may appear strange to be transferring amounts based on projections of surpluses from many years before.

## TRANSFER SURPLUS TO TRUST FUND AND INVEST IN EQUITIES

- Transfer **68 percent** of the *currently projected* unified budget surpluses to the Trust Fund for **1999-2032** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.

### KEY ATTRACTIONS OF THIS APPROACH

- Continues the program on a completely defined benefit basis.
- Achieves higher returns with low administrative costs while spreading risk across the population and over time.
- Preserves benefits at current law levels.

### KEY DISADVANTAGES OF THIS APPROACH

- The government would own between 5 and 11 percent of the stock market depending on the methodology used. See the box on the next page for details

### IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

| | |
|---|---|
| Common set of reforms | NA |
| General revenue transfer to Trust Fund | +2.20 |
| Across the board cuts to achieve solvency | NA |
| Remaining Actuarial Balance | +0.01 |

### IMPACT ON BENEFITS IN 2030
### PERCENT OF CURRENT LAW BENEFITS

| | Low Earner ($12,000) | Average Earner ($27,000) | High Earner ($43,000) |
|---|---|---|---|
| Total | +0.0 | +0.0 | +0.0 |

**ALTERNATIVE VERSION WITH COMMON SET OF REFORMS:**

- Transfer **50 percent** of the currently projected UB surpluses to the Trust Fund for **1999-2008** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make across the board benefit cuts of 6 percent to achieve solvency.

## SUBOPTION:
## SAVE SOCIAL SECURITY WITH SOCIAL SECURITY PLUS ACCOUNT

- It would be possible to use the surplus remaining after achieving actuarial balance to fund individual accounts that are truly in addition to the traditional benefit. The equities in the trust fund would be preserving the traditional structure, and the individual accounts would be on top of the full traditional benefit. Therefore, doubts about sustainability and risk of the individual accounts would not threaten the traditional Social Security program. However, the plan would rely on essentially all of the currently projected surpluses for 30 years. Thereafter, this plan could create demands for deficit funding of the individual accounts.

## ISSUES ARISING FROM INVESTING THE TRUST FUND IN EQUITIES

- **Government Ownership of Private Securities.** In the plans shown on the previous page, the government would eventually hold between 5 and 11 percent of the overall stock market. This raises three important concerns:

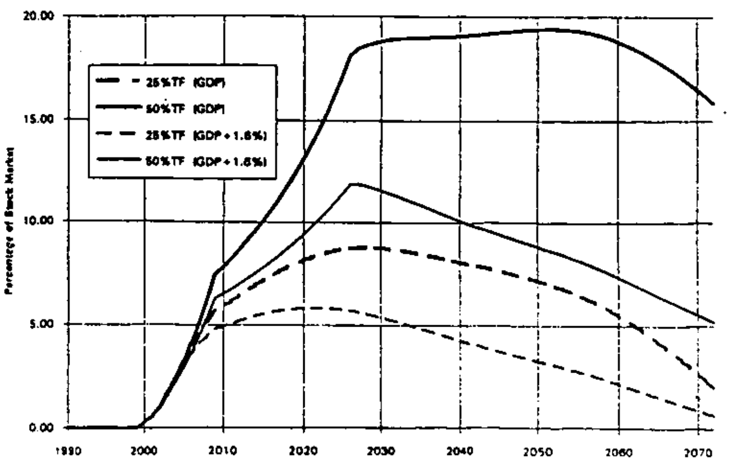
  1. **Largest Shareholder.** If the Trust Fund owned 10 percent of the stock market, the government would be the largest shareholder in at least 70 percent of U.S. publicly traded corporations.

  2. **Political Influence on Investment Choices.** Congress could legislate restrictions on what the funds could invest in (e.g. no tobacco stocks).

  3. **Corporate Governance Issues.** For example, how would government-owned shares be voted at stockholder meetings?

There are different methodologies for projecting the future size of the stock market. Depending on the methodology chosen, one obtains different estimates of the share of the total stock market held by the trust fund. The chart below shows the share of the stock market held by the trust fund for two different reform plans under two different assumptions about the future growth rate of the stock market.

Social Security Trust Fund Stock Holdings as a Percentage of the Total Stock Market--
Transfer 1/2 of Unified Budget Surplus 1999-2008, Limit to 25% (50%) of TF in Stock--
Total Market Value Grows at Rate of GDP (GDP + 1.6%)



**THE PERVASIVENESS OF CORPORATE GOVERNANCE ISSUES**

- While issues of government ownership of private securities do not arise in the case of individual accounts, issues of political influence over investment choices and of corporate governance could still be large, especially if investment choices were limited to a few government-authorized index funds.

**WHAT HAPPENS IF THE STOCK MARKET PERFORMS POORLY?**

- If the stock market performs worse than is projected, the balance in the trust fund will be lower than projected, creating pressure for additional revenue sources or benefit cuts. This is a common feature of plans that depend on stock market returns to fund traditional Social Security benefits.

# II. Plans That Use the Surplus to Fund Individual Accounts

# FIVE KEY ISSUES CONCERNING INDIVIDUAL ACCOUNTS

## KEY ISSUE #1: PERCEPTIONS OF BENEFIT LEVELS

- People might perceive that the individual account is part of the total Social Security benefit, and has more than made up for the reduction in the traditional benefit.

- Alternatively, people might think of their individual account as risky and uncertain, and perceive that they received a 16-percent reduction in their Social Security benefit.

- Plans which guarantee benefit levels or which integrate the individual account and the defined benefit may be more successful in getting people to look at their total benefit.

**Example:** Impact on Benefits (Percentage of current law benefits)

| | |
|---|---|
| Change in traditional benefit | -16.3 percent |
| Annuity from individual account | +20.8 percent |
| Total | +4.5 percent |

## KEY ISSUE #2: BENEFIT GUARANTEES

Because individual accounts expose individuals to more risk, it might be desirable to shift some of that risk to society as a whole.

- **Providing a Safe Investment Option.** One way to do this would be to offer a safe investment option -- for example, Treasury Inflation Protected Securities -- and to design a reform package to ensure that workers who chose this safe investment option have a reasonable level of benefits.

  -- The downside of this approach is that it might encourage individuals -- particularly low-income individuals -- to take too little risk.

- **Guaranteeing Current-law Benefits.** Another option would be to let people invest however they choose, but to guarantee that the combined benefit from traditional Social Security and the individual account would at least equal the current-law traditional Social Security benefit (Sen. Gramm's plan adopts this approach).

  -- A guaranteed benefit might encourage workers to take too much risk, since they would receive the upside gains, while the government would protect them on the downside. However, some argue that many investors do not take on enough risk. Moreover, if the portfolio choices were limited to basic index funds, the extent of this "moral hazard" problem would probably be minimal.

  -- A guarantee shifts risk away from individuals and onto the unified budget. We are currently trying to quantify the extent of this risk.

## Key Issue #3: Fiscal Sustainability

*For How Long Can We Afford to Fund Individual Accounts Out of the Surplus?*

- If remaining surpluses are spent, 2 percent individual accounts can be afforded until around 2023.
- Once the surpluses have run out we could continue to fund the individual accounts out of general revenues (this would cost around 0.8 percent of GDP), or we could trigger in traditional reforms to pay for the individual accounts.
- It might also be possible to set aside some of the extra surpluses in the early years to prefund individual account contributions in later years. We present a plan like this later in the packet.

## Key Issue #4: Designing a Package with "Wins" for Both Parties

- **Individual accounts can be provided in a way that is more progressive than the current defined benefit Social Security system.** We could propose a negotiating principle that the traditional benefit must remain as progressive as it currently is, and that any individual accounts must be *more* progressive.
- **Our reform package could include initiatives to reduce elderly poverty, particularly among widows, and to help other needy populations.** We are developing a list of policy options in this area. For example, if progressive individual accounts were at least partially bequeathable, low-income families with short life expectancies could potentially benefit more from the progressivity of the individual accounts than they do from the progressivity of the current system.

## KEY ISSUE #5: FEASIBILITY AND COST OF INDIVIDUAL ACCOUNTS

- **Individual accounts in foreign countries have proven very costly.** In both the U.K. and Chile, administrative costs absorb 20 percent or more of account accumulations under their systems of individual accounts.

- **Lower costs might be achievable by limiting choice.** At the cost of severely limiting choices, it may be possible to keep costs down significantly. Our benefit numbers assume a very low administrative cost of 10 basis points per year. This would correspond to a reduction in account accumulation of only 2 percent.

- **Low-cost plans would also be low-service plans.** The level of services associated with a plan this cheap would be very low, and in particular would compare unfavorably with the level of services offered through most 401(k) plans. Specifically, a bare-bones plan might offer annual reporting rather than monthly or even daily reporting, a much narrower range of asset choice, and a far lesser ability to switch among available assets.

- **Contributions would lag earnings.** For individual account funding approaches that are tied to past earnings, the delays in making contributions into accounts could be perceived to be very long. Under current procedures, workers' earnings for the prior year are not verified until November in the current year. Thus, if a system of this type were in force currently, workers' last recorded contribution as of today might be for 1996; or workers might just have received their contributions for 1997.

- **Funding out of the surplus might alleviate the perception problem.** It might be argued that since the funding of these accounts was coming from the surplus, individuals would not perceive the contributions to be tied to their earnings, and therefore not see it as arriving late.

- **Other approaches might be possible.** It is also possible, though not yet fully verified, that some acceleration of contributions could be achieved through a change in procedures.

## FLAT-DOLLAR ADD-ON INDIVIDUAL ACCOUNT WITH ACROSS THE BOARD BENEFIT CUTS TO RESTORE SOLVENCY

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

### KEY ATTRACTIONS OF THIS APPROACH

- Gives individuals control over their retirement savings. Could be described as building wealth.
- Achieves higher returns while avoiding government ownership of private securities.

### KEY DISADVANTAGES OF THIS APPROACH

- Surpluses are not sufficient to fund individual accounts forever.

### IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

| | |
|---|---|
| Common set of reforms | +0.97 |
| Across the board cuts to achieve solvency | +1.22 |
| Remaining Actuarial Balance | +0.01 |

### IMPACT ON BENEFITS IN 2030<br>PERCENT OF CURRENT LAW BENEFITS

| | Low Earner ($12,000) | Average Earner ($27,000) | High Earner ($43,000) |
|---|---|---|---|
| Common Set of Reforms | -3.0% | -3.0% | -3.0% |
| Across-the-Board Cuts Implied by Remaining Shortfall | -13.3 | -13.3 | -13.3 |
| Annuity provided by Individual Account | +34.4 | +20.8 | +15.8 |
| Total | +18.1 | +4.5 | -0.5 |

## PARTIALLY VOLUNTARY INDIVIDUAL ACCOUNTS

- Fund $290 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds. ***Allow workers to voluntarily contribute an additional 1 percent of earnings to their accounts.***

- Make common set of reforms.

- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

### KEY ATTRACTIONS OF THIS APPROACH

- Cuts in half the long-term fiscal obligation of the government to finance individual accounts.

- Preserves benefit levels for low-income workers even if they do not make voluntary contributions.

### KEY DISADVANTAGES OF THIS APPROACH

- Some may feel they are being asked to add an additional one percent of payroll taxes simply to maintain their existing Social Security benefit level.

**IMPACT ON BENEFITS IN 2030**
**PERCENT OF CURRENT LAW BENEFITS**

| | Low Earner ($12,000) | Average Earner ($27,000) | High Earner ($43,000) |
|---|---|---|---|
| Common Set of Reforms | -3.0% | -3.0% | -3.0% |
| Across-the-Board Cuts Implied by Remaining Shortfall | -13.3 | -13.3 | -13.3 |
| Annuity provided by Individual Account | +17.2 | +10.4 | +7.9 |
| **Total without voluntary contribution** | **+0.9** | **-5.9** | **-8.4** |
| Maximum annuity provided by voluntary Individual Account | +8.1 | +10.8 | +13.1 |
| **Total** | **+9.0** | **+4.9** | **+4.7** |

Under current law, annual benefit levels are $6010 for the low earner, $9925 for the average earner, and $13,112 for the high earner.

# III. Plans that Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts

Classic compromise - win/win

# HYBRID PLANS: INDIVIDUAL ACCOUNTS AND TRUST FUND EQUITY INVESTMENTS

- Create $290 per worker individual accounts funded out of general revenue.
- Invest Trust Fund assets worth 1 percent of payroll in stocks. Limit the share of the Trust Fund invested in stocks to 25 percent.
- Make common set of reforms.
- Make additional across the board cut in benefits to achieve solvency.

## KEY ATTRACTIONS OF THIS APPROACH

- Provides wins for both sides. Shores up traditional Social Security and establishes individual accounts.
- Because individual accounts are small, sustaining them in the out years will not create much pressure on other programs.
- Because transfers to the trust fund are modest, the peak share of the stock market owned by the trust fund will be between 3.7 and 5.7 percent.

## KEY DISADVANTAGES OF THIS APPROACH

- Has the downsides of both individual accounts and trust fund investments: the high administrative costs of small individual accounts and the problems of government ownership of private securities.

## IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

| | |
|---|---|
| Common set of reforms | +0.97 |
| Tax indiv. accounts like OASDI | +0.06 |
| Redeem TF assets to buy stocks | +0.58 |
| Across the board cuts to achieve solvency | +0.73 |
| Remaining Actuarial Balance | +0.00 |

## IMPACT ON BENEFITS IN 2030
## PERCENT OF CURRENT LAW BENEFITS

| | Low Earner ($12,000) | Average Earner ($27,000) | High Earner ($43,000) |
|---|---|---|---|
| Common Set of Reforms | -3.0% | -3.0% | -3.0% |
| Across-the-Board Cuts Implied by Remaining Shortfall | -8.0 | -8.0 | -8.0 |
| Annuity provided by Individual Account | +17.2 | +10.4 | +7.9 |
| Total | +6.2 | -0.6 | -3.1 |

## ARE THERE WAYS TO REDUCE GOVERNMENT OWNERSHIP CONCERNS?

- **Trust Fund investments could be allocated according to investment choices of individuals in their individual accounts.** In plans that combine Trust Fund investments with individual accounts, it might be possible to have the Trust Fund allocate its investments according to the aggregate investment behavior of individuals in their individual accounts. This idea -- and other ideas like it -- could allow defenders of government investment to say that it was millions of individual choices and not a government board that was allocating funds.

- **Many of the fundamental issues of corporate governance continue to arise in this approach.** Because the individual accounts being "mirrored" by the trust fund investments are presumed to be invested TSP-style, in government-authorized funds, issues of political influence over investment choices and of corporate governance could still be large.

## ADD-ON INDIVIDUAL ACCOUNT WITH ESCROW ACCOUNT TO SUSTAIN INDIVIDUAL ACCOUNTS

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- After funding individual accounts, place 70 percent of remaining surpluses in an escrow account invested 50-50 in stocks and bonds. Use the escrow account to fund individual account contributions after the unified budget surplus runs out.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

### KEY ATTRACTIONS OF THIS APPROACH

- Sustains individual accounts even after surpluses run out, thereby avoiding pressure to cut other programs to fund the new individual account "entitlement."

### KEY DISADVANTAGES OF THIS APPROACH

- Has same disadvantages as other plans that combine individual accounts and government investment in private securities.
- Some may find this proposal unusual and therefore not sound because it uses the escrow account to prefund individual account contributions rather than retirement benefits. People are used to the idea of prefunding pension benefits, but it would be novel to prefund pension contributions.

### IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

| | |
|---|---|
| Common set of reforms | +0.97 |
| Across the board cuts to achieve solvency | +1.22 |
| Remaining Actuarial Balance | +0.01 |

### IMPACT ON BENEFITS IN 2030
### PERCENT OF CURRENT LAW BENEFITS

| | Low Earner ($12,000) | Average Earner ($27,000) | High Earner ($43,000) |
|---|---|---|---|
| Common Set of Reforms | -3.0% | -3.0% | -3.0% |
| Across-the-Board Cuts Implied by Remaining Shortfall | -13.3 | -13.3 | -13.3 |
| Annuity provided by Individual Account | +34.4 | +20.8 | +15.8 |
| Total | +18.1 | +4.5 | -0.5 |

## FLAT-DOLLAR ADD-ON IA WITH 50 PERCENT INTEGRATION

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 stocks and bonds.
- Use 50 percent of individual accounts to fund traditional Social Security benefit. Tax other half of retirement income from individual accounts like Social Security
- Make common set of reforms and additional adjustments to traditional Social Security program to restore solvency.

### KEY ATTRACTIONS OF THIS APPROACH

- Traditional benefits (after six percent reduction) are guaranteed regardless of how the market performs.
- Achieves nearly the same outcome as a trust fund investment in equities plan without creating perception of government ownership of private securities. Indeed, some prominent Republicans have embraced this approach.
- Integration of the benefit may make people more likely to perceive that their individual account is added together to their traditional benefit in providing their overall benefit.

### KEY DISADVANTAGES OF THIS APPROACH

- When the government uses 50 percent of the individual account to fund the traditional benefit, people may feel that they are losing half of their account rather than understanding all along that the account has two parts -- one part which funds the traditional benefit and another part that provides additional retirement income.
- May be perceived as complicated.

### IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

| | |
|---|---|
| Common set of reforms | +0.97 |
| Tax individual accounts like OASDI | +0.06 |
| 50 percent clawback of indiv. accounts | +0.90 |
| Across the board cuts to achieve solvency | +0.26 |
| Remaining Actuarial Balance | +0.00 |

### IMPACT ON BENEFITS IN 2030
### PERCENT OF CURRENT LAW BENEFITS

| | Low Earner ($12,000) | Average Earner ($27,000) | High Earner ($43,000) |
|---|---|---|---|
| Common Set of Reforms | -3.0% | -3.0% | -3.0% |
| Across-the-Board Cuts Implied by Remaining Shortfall | -3.2 | -3.2 | -3.2 |
| Annuity provided by Individual Account | +17.2 | +10.4 | +7.9 |
| Total | +11.0 | +4.2 | +1.7 |

# Plans That Fund Individual Accounts Out of the Existing 12.4 Percent Social Security Payroll Tax

## BREAUX-GREGG-KOLBE-STENHOLM PLAN

- Use 2 percent of the existing 12.4 percent Social Security payroll tax to fund 2 percent of payroll individual accounts.

- Make reforms to traditional Social Security program:
  - -- Reduce second and third bend points by 2 percent per year for 20 years.
  - -- Reduce COLA by 0.5 percentage points.
  - -- Increase normal retirement age by 2 months per year until it reaches 70, then index.
  - -- Cover new state and local workers.
  - -- Reduce spouse benefits from 50 to 33 percent of PIA.
  - -- Increase computation period to 40 years, but count all earnings.
  - -- Eliminate earnings test.
  - -- Credit all taxation of Social Security benefits to OASDI.
  - -- Create new minimum benefit.

| KEY ATTRACTIONS OF THIS APPROACH |
|---|
| • Plan is fiscally responsible. |

| KEY DISADVANTAGES OF THIS APPROACH |
|---|
| • Reduces benefits compared to present law (though not compared to the 72 percent of benefits that are affordable in 2032 if no changes are made). |

| IMPACT ON 75-YEAR ACTUARIAL BALANCE **(current balance is -2.19)** | |
|---|---|
| Remaining Actuarial Balance | +0.00 |

**IMPACT ON BENEFITS IN 2030**
**PERCENT OF CURRENT LAW BENEFITS**

| | **Low Earner** ($12,000) | **Average Earner** ($27,000) | **High Earner** ($43,000) |
|---|---|---|---|
| Change in Traditional Benefits | -25.1% | -39.5% | -42.2% |
| Annuity provided by Individual Account | 16.2 | 21.6 | 26.2 |
| Total | -8.9 | -17.9 | -16.0 |

## 2 PERCENT CARVE-OUT FOR 2 PERCENT INDIVIDUAL ACCOUNTS WITH TRANSFER OF REMAINING SURPLUS FOR BONDS

- Redirect 2 percent of OASDI payroll tax beginning in 2000 to fund 2 percent of payroll individual accounts. Assume these funds are invested 50-50 in stocks and bonds. Transfer remaining *currently projected* surpluses to the trust fund and invest them in bonds.

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

- Make additional across the board cuts by revising the benefit formula.

### KEY ATTRACTIONS OF THIS APPROACH

- Plan is fiscally responsible and would reduce long-term budget deficits and increase national savings even compared with the baseline that uses the surplus to pay off debt.

- The combined retirement income from individual accounts and traditional benefit would be close to currently promised benefit levels.

### KEY DISADVANTAGES OF THIS APPROACH

- In the long run, the individual account would be providing roughly 40 percent of the total benefit. Benefit levels would depend heavily on stock market performance.

- Because it uses some of the current payroll tax to fund individual accounts, this plan could be perceived as the first step toward total privatization.

### IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

| | | |
|---|---|---|
| Common set of reforms | +0.97 | |
| Two percent carve-out | -1.92 | |
| Transfer of remaining surpluses to OASDI | | +1.45 |
| <u>Across the board cuts to achieve solvency</u> | | <u>+1.71</u> |
| Remaining Actuarial Balance | +0.03 | |

### IMPACT ON BENEFITS IN 2030
### PERCENT OF CURRENT LAW BENEFITS

| | Low Earner ($12,000) | Average Earner ($27,000) | High Earner ($43,000) |
|---|---|---|---|
| Common Set of Reforms | -3.0% | -3.0% | -3.0% |
| Across-the-Board Cuts Implied by Remaining Shortfall | -18.7 | -18.7 | -18.7 |
| Annuity provided by Individual Account | +16.2 | +21.6 | +26.2 |
| Total | -5.5 | -0.1 | +4.5 |

Note: if individual accounts were funded more progressively, the total benefits for low earners could exceed currently promised levels.

cc: Bruce

Social Security - reform proposals

11/24

POTUS Meeting

## STRATEGIC DISCUSSION OF A PLAN THAT INVESTS EQUITIES IN THE TRUST FUND

Many of the fundamental decisions related to Social Security reform can be framed by examining a plan that relies exclusively on prefunding and equity investment.

### BASE PLAN

- Transfer **60 percent** of the *currently projected* unified budget surpluses to the Trust Fund for **1999-2032** to purchase equities. Limit the share of the Trust Fund invested in equities to 33 percent.
- Roughly $500 billion would be available over 10 years for some combination of debt reduction, Medicare, readiness, or specific priority proposals.

### ALTERNATIVE A: SOCIAL SECURITY PLUS ACCOUNT

- Spend three-quarters of remaining surpluses on individual accounts and one quarter on discretionary spending. Account could be flat dollar or it could provide matches for voluntary contributions. Could afford approximately $200 per worker contributions for about 20 years (there would be shortfalls in early years).

### ALTERNATIVE B: DO TRADITIONAL REFORMS OR ACROSS THE BOARD CUTS AS WELL

- Include 3 basic provisions (increase computation years, cover state and local workers, increase taxable maximum). Do additional 3 percent across the board cut in benefits.
- Transfer 50 percent of the currently projected surpluses to trust fund to purchase equities for only ten years (1999-2008). Limit trust fund to 25 percent equities. Alternatively, could transfer 35 percent of the surplus for as long as it lasts.

## FISCAL DISCIPLINE – The use of the surplus (gen'l revenue finance of SS)

*Critiques of this approach:*

- **Allocates additional resources to the elderly.** For those who feel that society is spending too much on the elderly already, this approach directs additional resources to the elderly in order to maintain all of currently promised benefits.

- **Depending on surpluses and stock returns is risky.** This plan relies completely on 30 years of budget surpluses and on equity returns. Both components are uncertain. If budget surpluses do not materialize, then continuing general fund transfers to OASDI may result in pressure to cut other spending programs. If equity returns are lower than projected, then we will need to do Social Security reform again at a later date.

- **Does not directly address long-run funding gap.** This plan does not close any of the gap between current year tax revenue and benefit payments, and it has a trust fund that is declining at the end of the 75-year window.

- **Denies surplus for other needs.** Because the plan relies on substantial general revenue transfers, it precludes the use of these funds for other purposes (including Medicare financing, education spending, etc.).

*Rejoinders:*

- **Why do pain if there are surpluses available?** Those who argue that we should rely less on surpluses and higher returns and that we should rely more on traditional benefit cuts and revenue increases must explain why we should make painful adjustments to Social Security when the surpluses are otherwise likely to go for defense spending and tax cuts for the rich.

- **Uses Social Security surpluses for Social Security.** Since most of the surpluses are due to Social Security, it makes sense to use them to strengthen Social Security. If the surpluses are used for other things, we could be attacked for using Social Security tax revenue for non-Social Security purposes.

- **Tax cuts would make long run fiscal situation even worse.** If we fail to achieve Social Security reform and the surpluses are used for permanent tax cuts, the long run fiscal situation will be even worse when we finally do get around to fixing Social Security.

- **Still allows some use of the surplus.** The surpluses remaining after this plan is enacted could be used for a combination of individual accounts, tax cuts, and discretionary spending.

## GOVERNMENT OWNERSHIP OF PRIVATE SECURITIES

*Critiques of this approach*

- **Government ownership.**

    -- Government would own at least 7 percent of the stock market and perhaps as much as 14 percent. Critics could potentially use a methodology that produced estimates that are even higher.

    -- If the government owned 10 percent of the market, it would be the largest shareholder in more than 70 percent of U.S. publicly traded corporations.

    -- People would question why we were encouraging other countries to move toward private markets when our government was acquiring shares in private companies.

- **Political influence on investment decisions.** There might be pressure for the government to invest in socially desirable activities such as affordable housing that may have lower rates of return and to divest from companies in unpopular but profitable industries.

- **Corporate Governance.** Government voting of shares would likely be perceived as interference, but government abstinence from voting might give too much influence to remaining shareholders or management. Any structure of investment, no matter how independent could be altered by Congress and the President at any time in the future.

*Rejoinders*

- **Independent structures like the Federal Reserve System have proved resilient.** Could create an independent organization like the Federal Reserve. Reischauer and Aaron have proposed a Social Security reserve trust fund with triple insulation:
    -- 14 year staggered terms.
    -- The board would choose managers, not the investments themselves.
    -- Eliminating voting influence.

- **Independent funding**. Funding for the independent body could come out of the system's own revenue, so that the system would not to be reliant on Congress for annual appropriations.

- **Canada has recently adopted this approach**. While it is too early to tell how successful the Canadian system will be, the fact that Canada was able to set up such a system suggests that it may be possible to defend such a system politically.

- **TSP-style Individual accounts have many of the same downsides that trust fund investments do.** While individual accounts may avoid perceptions of government ownership, TSP-style individual accounts would still raise issues of political influence over investment decisions and of how shares would be voted.

# GOVERNMENT INVESTMENT IN EQUITIES

*Critiques of this approach*

- **Stock market could perform poorly.** In real terms, the Dow Jones did not rebound to its 1968 peak until 1987. On three occasions during the past 70 years, the S&P 500 index has declined over two years by more than 35 percent. Japan's Nikkei has fallen by 60 percent since 1989.

- **Individual does not get sense of control or of accomplishing personal saving**. Much of the appeal of individual accounts is the perceived opportunity to build wealth, leave bequests, and get more Americans into the spirit of saving. Collective investments do not offer these advantages.

- **Administrative costs could be kept low through a TSP-style individual account plan.**

*Rejoinders*

- **There is significant market risk in almost all public and private pension plans.** People generally find the higher rewards to be sufficient to justify the additional risk.

- **If the economy performs poorly over long periods of time it doesn't matter what type of Social Security system we have, it will be hard to pay full benefits.**

- **Collective investing permits risk-pooling both within and across cohorts.** During the 20th century in the US, even large stock market declines have been more than made up by subsequent rebounds. For example, a portfolio of a worker who lived through the 1929 crash would have fully recovered by the end of 1936. By pooling risk, the trust fund approach removes the sensitivity of worker's retirement income to the particular year in which they reached retirement.

- **Collective investing provides high returns with low administrative costs.** Wall Street won't receive 20 percent of people's retirement income as it might in a moderately expensive individual account plan.

| ALTERNATIVE A: SOCIAL SECURITY PLUS ACCOUNT |
| --- |
| • Spend three-quarters of remaining surpluses on individual account and one quarter on discretionary spending. Account could be flat dollar or it could provide matches for voluntary contributions. Could afford approximately $200 per worker contributions for about 20 years (there would be shortfalls in early years). |

Advantages:

- **Provides best of both worlds: saves Social Security and also provides individual accounts.**

- **Because the individual accounts are strictly in addition to the current law Social Security benefit, it is less essential that they be funded forever.** This reduces the "Stockman risk" of needing to fund them once surpluses run out.

- **Solidifies traditional Social Security while offering options for compromise with individual account supporters.**

- **Flat distribution would be progressive.**

Disadvantages:

- **Relatively high administrative costs.** Individual accounts will be very small, and therefore administrative costs will absorb a larger fraction of investment returns.

- **Just another tax-favored savings vehicle.** While small individual accounts may be a valuable new benefit for low-income workers, it may be perceived ~~is~~ a s just one more tax preferred savings vehicle by upper-income workers.

- **Still significant Stockman risk.** Even though the individual accounts will be small and are not essential to the total Social Security benefit, there may be some pressure to continue to fund them even after the surpluses run out, thereby creating pressure on other government programs.

- **Little surplus for other needs.** Leaves virtually no room for surpluses to be used to address other needs.

| ALTERNATIVE B: DO TRADITIONAL REFORMS OR ACROSS THE BOARD CUTS AS WELL |
| --- |
| • Include 3 basic provisions (increase computation years, cover state and local workers, increase taxable maximum). Do additional 3 percent across the board cut in benefits.<br>• Transfer 50 percent of the currently projected surpluses to trust fund to purchase equities for only ten years (1999-2008). Limit trust fund to 25 percent equities. Alternatively, could transfer 35 percent of the surplus for as long as it lasts. |

Advantages:

- More fiscally responsible. Closes some of the long run imbalance between taxes and benefits. Potentially relies on only 10 years of surpluses.

- **Frees up more of the long-run surpluses for Medicare and discretionary spending.** People might be willing to tolerate small cuts in Social Security if the savings were allocated to Medicare.

Disadvantages:

- **May not be able to prevent surpluses from being spent on tax cuts for the rich.**

- **Will have to compete with Republican individual account initiatives that promise no reductions in benefits.**

- **Preserving surpluses for Medicare may not be a viable strategy since there is unlikely to be a significant Medicare agreement this year.**

- **This plan has no individual accounts and no tax cuts. It is hard to see how such a plan results in a bipartisan consensus.**

cc: Bruce

social security - reform proposals



# Congress of the United States
Washington, DC 20515

November 24, 1998

The Honorable William J. Clinton
President
The White House
1600 Pennsylvania Avenue
Washington, D.C. 20050

Dear Mr. President:

We are a bipartisan group of members of Congress who stand ready to help you make the December Social Security summit a success. We applaud you for making Social Security the nation's top domestic policy priority and believe the summit must be a foundation for subsequent legislative action. In our view, this goal can be achieved by adopting the following principles.

*Bipartisanship:* Social Security can only be strengthened by bipartisan action. Both parties are committed to making Social Security work for the long run. Neither party has clean hands regarding "spending the surplus." There must be an end to all insinuations that disagreements over how to finance Social Security reflects different levels of commitment to the program.

*Substance over Style:* We recognize that no legislative solution can be fully negotiated at the December conference. But Congressional members will be disillusioned, not emboldened, if the conference creates only a forum for speeches, rather than laying real groundwork for an agreement. At the very least, participants should come out with a well-formed timetable and format for legislative action in 1999.

*Ground Rules for Reform:* We strongly believe Social Security reform will fail if reformers hide behind ideology, and do not compete on a playing field where the standards for success are defined for all. It is not enough to say that the program is actuarially sound, or that benefit promises have been made adequate to fulfill society's expectations. Every significant gap in the program must be filled before reformers can claim beneficiaries are being protected.

A multitude of reform options carry costs -- ranging from relying on future generations to redeem a Trust Fund, using general revenues to increase Trust Fund liabilities, floating additional debt to finance transition costs, and reducing non-Social Security savings income by investing Social Security assets in the private market, without otherwise changing revenues or outlay obligations. Every plan should state how costs will be met.

*Establish common objectives:* We must begin the process by reaching a consensus on the ultimate goals of reform. The December conference should focus on comprehensive, bottom-line objectives, not a menu of isolated reform options.

*Leadership:* Mr. President, it is time to move beyond vague assurances that Social Security stability is a priority, and toward specific proposals to achieve it. Many of us have developed proposals paving the way for the leadership of both parties to come forward. Each of the principal authors of the Gregg-Breaux-Kolbe-Stenholm plan accepted the risk of doing so in an election year. Now you bear a unique responsibility, not only because of the office that you hold, but also because the political climate of Social Security means the Republican leadership faces political risks that are greater than your own. You must decide which existing reform plans include elements you support, and provide clear guidance about your priorities and objectives for Social Security legislation.

Mr. President, you know from our proposal that we are willing to surmount the obstacles and to help you achieve a lasting legacy of preserving Social Security for future generations. Bold, specific action on your part will make this possible.

Sincerely,

Judd Gregg (R-NH)
U.S. Senator

John Breaux (D-LA)
U.S. Senator

Jim Kolbe (R-AZ)
U.S. Representative

Charles W. Stenholm (D-TX)
U.S. Representative

Social security - reform proposals

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02/05/98 4:04 pm 

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today. I am especially pleased that the topic of my first congressional hearing as Commissioner of Social Security is identifying the goals of Social Security, because I can think of no issue more important than ensuring the program's future.

President Clinton's message on Social Security in his State of the Union message is clear: we must assure the long-term solvency of the Social Security system. A recent Washington Post poll shows that the American public agrees with that view. When people were asked what they thought were the most important goals in America today, almost 90 percent said that Amaking sure Social Security is financially sound@ was the number one goal, ahead of protecting the environment, reducing taxes, and fighting crime. I strongly believe that we can meet that goal, and today I would like to discuss how we can begin to take steps to accomplish it.

Importance of Social Security

It would be almost impossible to overestimate the importance of Social Security in American lives. Only ~~1 in 8~~ 1 in 9 elderly people are living below the poverty line today, compared to 1 in 3 in 1959. About 42 percent of beneficiaries age 65 and olderCmore than 10 million peopleCare kept out of poverty by their monthly Social Security benefits.

Social Security is the most successful antipoverty program we have. It is the major source of income (providing 50 percent or more of total income) for 63 percent of

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90 percent or more of income for about 25 percent. It can be the difference between poverty and a decent retirement for older Americans. Some elderly are well off, but many are not. The inflation protection that Social Security retirement benefits offer can be vital for an elderly widow whose savings have dwindled and whose pension (if she has one) is not worth much. Older Americans in the bottom half of the income distribution only receive 7 percent of U.S. pension and asset income.

Much of the current debate concerning the future of the Social Security program has centered exclusively on the retirement program. But this ~~tunnel vision of~~ narrow perspective on the program ignores the vitally important insurance benefits that the program provides in the event of the death or disability of a worker. For instance, people tend not to focus on the fact that ~~one in five~~ one in six of today's 20-year-olds will die before retirement, and three in 10 will become disabled. Over 30 percent of our Nation's Social Security beneficiaries are receiving disability and survivors benefits, and those programs make up over 30 percent of the benefits Social Security pays.

This protection can be extremely valuable, especially for young families that have not been able to protect themselves against the risk of the worker's death or disability with insurance policies. The average benefit paid today to a disabled worker with a spouse and children is about $1,200 per month. For a family in which the worker has died, leaving a widow with two children, the average monthly survivor benefit is about $1,500.

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02/05/98 4:02 pm



Serious Problems Must Be Addressed

From its inception in 1935, the Social Security program has been financed on close to a pay-as-you-go basis, with current costs met from current revenues and relatively small excess amounts held in the trust funds. The Social Security Amendments of 1977 and 1983 have created a temporary period where the trust funds will build up reserves beyond the level needed for a contingency reserve. Currently, the combined Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds are projected to peak in the year 2011, and become exhausted in 2029, at which time revenues will be sufficient to pay about 75 percent of benefits due.

The underlying reason for the shortfall is that the demographics of America are changing. People are living longer. Today, the average life expectancy for an individual reaching age 65 is 17 and one-half years; back in 1940, the average 65-year-old was expected to live an additional 12 and one-half years. In addition, the number of people over age 65 is climbing. We expect that the current population of elderly--currently 35 million--will double between now and 2030.

At the same time that the population of retired workers is increasing, the number of workers contributing Social Security taxes to pay benefits will be shrinking. Today, there are 3.3 covered workers for each retiree, but by 2030 there will be only about 2 covered workers per retiree. That ratio generally holds for far in the future.

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While these demographic changes raise serious long-range solvency issues, Social Security is not a program in crisis. President Clinton has said that the time to act is now--the budget has been balanced, the economy is strong, and our fiscal discipline provides us with the opportunity to ensure economic security for future generations of retirees. In fact, I believe that under the President's leadership, we have the opportunity to avoid a crisis, and early action in approaching the solvency problem is the safest course. If we wait ten or twenty years to make changes, the changes will need to be more drastic, and the American people deserve early action to be able to plan for changes. The earlier we can determine the changes that must be made to the current program, the better off we will be.

When it comes to a program as important as Social Security, there are no such things as "minor" changes. Any change is going to impact on the lives of some Americans, and as such deserves serious consideration, if the program is to be fair to all workers. However, the history of the program is one of evolution and change. As the program has evolved over the past decades, through the additions of the disability and Medicare programs and the changes of the 1977 and 1983 Amendments, so must it now evolve again.

Process For Reaching Consensus For Change

During President Clinton=s State of the Union address, the President voiced his strong commitment to strengthening Social Security for generations to come. He has proposed that decisions on spending Federal budget surpluses be deferred until we address how to restore the program's long-range solvency. In doing so, President Clinton has made it clear that he intends to work with Congress in a bipartisan effort to preserve the program.

Toward this end, the President is calling for a national dialogue this year on how we can best achieve this goal. The President has called on the American Association of Retired Persons and the Concord Coalition to hold jointly three or four regional nonpartisan forums throughout the country on Social Security. The President, Vice President, and members of the Cabinet will participate in these forums.

At the end of the year, the President will convene a conference on Social Security at the White House, followed by bipartisan negotiations with congressional leadership on how to best achieve Social Security reform. This bipartisan, national debate can achieve, as the President has said, "a landmark for our generation--a Social Security system that is strong in the 21st century."

Principles to Guide Reform of Social Security

As part of this process, we need to assure the American people that the Social Security program will continue to provide economic security. In order to accomplish this, I believe that there are five principles which must guide the process of reform in order for the future Social Security program to be successful:

- The program should be strengthened and updated to meet the challenges of the 21st century. We need to be able to meet the challenges of the demographic changes I have just discussed and be sure that Social Security will be there for younger workers, just as it was for

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their grandparents and parents.

- The program should maintain the universality and fairness of the current system. We are all at risk of becoming disabled and unable to work or dying young and leaving a spouse and children without adequate income. Social Security spreads the risks associated with disability, premature death, and old age among the entire working population. The system should also ensure that all workers receive a fair and equitable benefit under the Social Security system.

- The system should provide a benefit that people can count on, a benefit that maintains a floor of protection to ensure that most Americans will not have to live in poverty as a result of retirement, disability, or death of a wage earner. For over six decades, Social Security has been there for Americans, and we have an obligation to ensure that the program remains solvent so that people can plan their financial futures confidently.

- The system should continue to give the low-income disabled and retired workers and their survivors financial security. Before Social Security, many of our elderly citizens who could no longer work were forced to depend on family or the county poorhouse for support. Whatever steps we take to make Social Security sound through the next century, we must not allow those to whom we owe so much to be left with so little again.

- The system should preserve fiscal discipline and not increase the Federal deficit. For the sake of our children and future generations, we must not jeopardize the progress we have made in balancing the budget and reducing the deficit. No one wants to revisit the hard choices that were made to reduce the deficit in 1993 and last year.

These principles should serve as broad guidelines as the discussion of Social Security reform advances.

Options to Restore Long-Term Solvency

One conclusion is clear: there is no option available which provides a simple, uncomplicated solution that will allow us to continue to pay the current level of benefits to all future beneficiaries.

The range of alternatives available will involve very hard choices among six basic options. These options are: (1) reducing benefits; (2) raising revenues; (3) raising the retirement age; (4) improving the system=s rate of return, possibly by investing some trust fund reserves in riskier but potentially higher-yielding investments; (5) establishing mandatory individual savings accounts on top of Social Security; and (6) shifting large portions of responsibility from government to individuals through privatization of a large part of the system.

These are complex issues. The advantages and disadvantages of each will have to be examined and discussed nationally before we can reach any consensus as to which of these options best resolves the financial imbalance while

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maintaining a guaranteed floor of financial protection for workers and their families.

Public Education Critical

As President Clinton has said, we must inform Americans about Social Security and the issues confronting it. The President's proposal to conduct regional forums to raise public awareness of the problems facing Social Security acknowledges an important truth: educating the American public is critical to achieving a resolution of the long-term solvency issue. An accurate understanding of the facts is needed as the foundation for public discussion. We have been focusing our efforts on educating the public about the Social Security programs to put them in the best possible position to be able to enter into public debate about options for the future of Social Security.

What do I believe Americans should understand about our Social Security program? What is it about this program thatCreduced to essentialsCmakes it of such importance to the American electorate?

First, I want all Americans to understand what Social Security has meant to older Americans. The plight of older Americans used to be a national disgrace. Now, Social Security provides them with a solid measure of economic securityCa floor of protectionCeven if they outlive the actuarial tables . . . . and their savings. It also provides many of them, and their children, the advantages that only living independently can offer.

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Second, I want to stress that Social Security is more than a retirement program. I want younger people to know that not only will Social Security be there for them in the future, but it is there for them NOW. How many people know that 1 out of every 3 Social Security beneficiaries is not a retiree but a disabled worker, a family member, or a survivor of a worker who has died? They need to know that.

Third, I want to remind everyone that Social Security was never intended to provide for all of a worker=s retirement income needs. Pensions and personal savings have always beenCand should always beCpart of a sound financial retirement plan.

Fourth, I want everyone to understand that the changing demographics of the country are the primary driver of the need for change. There is an unalterable dynamic at work: there are more Americans, and we are living longer and healthier lives. By 2030, there will be twice as many older Americans as there are today, putting great strains on our retirement system.

Finally, I think it essential that people everywhere understand one important fact: there is no free lunch. As attractive as any option for change might be, there are tradeoffs that must accepted if we choose it.

Let me remind you again that the purpose of public education is to enable members of our society to participate in an earnest and informed dialogue about this most important

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issue. Not only will we be talking to the public but we will be listening to them as well. Their feedback on the tradeoffs is clearly important because Social Security is their program.

Conclusion

I strongly support the President's initiatives to begin to restore the Social Security program to long-term fiscal health. The best decisions on big issues are made after America thinks them through and discusses them openly and honestly. What is needed now is a full and open public debate about the options available and the role Social Security has played and will play in American society. Part of SSA=s role in this process will be to continue the process of educating the public about Social Security: how it works, what it has achieved, and the nature of the long-range actuarial problem. The public discussion must occur not just in congressional hearing rooms but in the living rooms and kitchens throughout the country.

I worked for Senator Bradley and with the Senate Finance Committee in 1983 when the historic Social Security reform legislation was enacted. It was an example of bipartisan cooperation, goodwill and wisdom. This Administration and Congress have demonstrated that they are capable of coming together in a bipartisan way to fashion solutions important to this nation, and I look forward to working closely with the members of this Committee in that spirit on this important endeavor.

Social Security - reform proposals

**PRESIDENT CLINTON:**
**SAVING SOCIAL SECURITY FIRST**

February 9, 1998

*"Social Security is far more than a line in the budget. It reflects our deepest values as a society -- the duty we owe to our parents, to one another, and to the next generation, and our determination to move forward together as one nation. Social Security has been there, strong and sound, for America's parents in the 20th Century; I am determined that it will be just as strong and just as sound for our children in the 21st Century. That is our next great national mission"*

President Bill

Clinton

February 9, 1998

Today, President Clinton speaks at Georgetown University renewing his call for Americans to join him in a national discussion on how to best strengthen the Social Security system for the 21st century. During his remarks the President announces that he will participate in the first of a series of non-partisan forums to be held around the country in April in Kansas City, MO. These conferences will culminate in a White House Conference on Social Security.

**THE MOST SUCCESSFUL GOVERNMENT PROGRAM EVER.** Since its inception in 1935, the Social Security system has provided security for the retired and disabled, as well as their families. It currently provides benefits to about 45 million Americans, and keeps roughly 15 million of them out of poverty.

**THE LONG-RUN CHALLENGE.** Today, just over 3 workers contribute for every Social Security beneficiary. By 2030, it is expected that only 2 workers will contribute for every Social Security beneficiary. According to the intermediate projection of the Social Security Trustees Report, the retirement of the baby boomers is expected to cause the Social Security Trust Fund to start falling by 2019, and to be exhausted by 2029.

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

- **Putting our fiscal house in order.** To address the long-run problems in Social Security, we must continue to put our fiscal house in order. Today, we have the strongest economy in a generation: More than 14 million new jobs. Wages on the rise. The lowest unemployment rate in 24 years. The highest home-ownership rate in history. And a budget deficit that has been cut by more than 90% -- from $290 billion in 1992 to $22 billion last year. Now, under the President's proposal, the budget will be balanced by next year.

- **Social Security First.** The President is calling for the projected budget surpluses to be reserved pending Social Security reform. Until we address the critical challenge of strengthening the Social Security system and ensuring retirement and disability security for America's hard-working families, we should not use the projected surpluses for anything else.

- **Nonpartisan Regional Conferences in 1998.** The President believes 1998 should be used to engage all Americans in a national debate about Social Security reform. The President has asked two pre-eminent organizations, the Concord Coalition and the AARP, to host bipartisan and balanced regional conferences. The national dialogue should allow Americans to express their views as we work together to strengthen Social Security for the 21st Century.

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

- **Bipartisan Negotiations in January 1999.** Following the White House conference at the end of the year, the President and his team will begin bipartisan negotiations in January 1999 on how best to achieve Social Security reform. The President is firmly committed to strengthening the Social Security system.

Social security - reform proposals

12-4 Special Issues Meeting

GS: If people want part of surplus for other uses, have to start putting options on table now.

Possible goals of reform -

1. For 75 yrs - actuarial balance

more expensive 2. Assuring adeq rate of return or benefit level - floor in real $s

3. Go beyond 75 yrs - more permanent basis

FR: This is all SS service - has to all go into retirement options. If IRAs part of this, they would be considered part of + linked to SS. Use surplus over 10 yrs - That's all anyone thinks is real anyway.

Deposit unified surplus
invest in equities
until equities become 40% of fund

Social Security - reform proposals

# Issues Related to Investing Part of the Social Security Trust Funds in Private-Sector Securities

Stat. guaranteed benefit -
our risk; our problem if mkt
goes down.

I. Rationale

II. Financial risks

III. Political risks

IV. Capital market effects Yr's mutual fund investing - 280b   Mkt is 10 trillion
Size of surplus - 100b /
unified

V. Macroeconomic effects

VI. Social security politics

VII. Budget scoring

FR: Temptation to take $ out of mkt after good yrs.

III. Govt buying cos? like socialism!
how does govt vote etc? (interference w/ cos.)
how does govt decide whom to invest in?
~~us~~ → tobacco companies!
mkt behavior - e.g., govt as contrarian investor
Statute could handle all these issues, but...

Rubin - Japanese mkt 38,000; now at 16,000.
What would happen?

**The Effects of Alternative Starting and Ending Dates in the Last Seven Decades.**

Equity Premium (difference between stock returns and Treasury bill returns)
Average Annual Rates Over Varying Periods, in Percent
'(starting date shown in left column; ending date acrosss top row)

| start\end | 1929 | 1939 | 1949 | 1959 | 1969 | 1979 | 1989 | 1996 |
|---|---|---|---|---|---|---|---|---|
| **1926** | 15.50 | 2.82 | 5.39 | 8.90 | 7.31 | 5.50 | 6.57 | 6.86 |
| **1930** | | -0.61 | 3.99 | 8.28 | 7.19 | 5.68 | 6.14 | 6.48 |
| **1940** | | | 8.80 | 13.04 | 9.96 | 7.35 | 7.59 | 7.82 |
| **1950** | | | | 17.50 | 10.56 | 6.86 | 7.28 | 7.61 |
| **1960** | | | | | 3.90 | 1.75 | 3.94 | 4.98 |
| **1970** | | | | | | -0.40 | 3.96 | 5.39 |
| **1980** | | | | | | | 8.60 | 8.98 |
| **1990** | | | | | | | | 9.50 |

The following table shows the premium relative to Social Security Trust Fund returns.

Equity Premium Relative to Social Security Returns

| | 1929 | 1939 | 1949 | 1959 | 1969 | 1979 | 1989 | 1996 |
|---|---|---|---|---|---|---|---|---|
| **1926** | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **1930** | | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **1940** | | | 7.0852 | 11.932 | 9.4157 | 6.9487 | 6.9847 | 6.8641 |
| **1950** | | | | 17.007 | 10.607 | 6.9022 | 6.958 | 6.8146 |
| **1960** | | | | | 4.5023 | 2.0719 | 3.6771 | 4.1028 |
| **1970** | | | | | | -0.371 | 3.2463 | 3.947 |
| **1980** | | | | | | | 7.1262 | 6.6467 |
| **1990** | | | | | | | | 5.9758 |

n.a. -- not applicable: trust fund not established and holding assets until 1937.

# Figure 3
# OASDI Trust Fund/Cost Ratio With Unified Surplus in Equities)