EPB MEETING
Monday, April 26, 1976
8:30 a.m.
Roosevelt Room

THE WHITE HOUSE
WASHINGTON

Reminder: Paul Leach
is out of town this week.

j

Cannon f/I

April 23, 1976

ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE

Proposed Agenda

Monday, April 26, 1976 EPB/ERC Executive Committee Meeting

1.	Clean Air Act Amendments	Gorog
2.	Report on Adjustment Assistance for the Footwear Industry	Commerce/Labor

Tuesday, April 27, 1976

1.	Social Security Decoupling	Domestic Council
2.	Role of Departmental Consumer Representatives	Baroody

Wednesday, April 28, 1976

1.	Financial Reform Update	Treasury
2.	Status of Codes of Conduct and the MNC's	State

Thursday, April 29, 1976

1.	Report of the Subcommittee on Economic Statistics	Malkiel
2.	Task Forces to Reduce Waste and Inefficiency in Government Regulation	

Friday, April 30, 1976 (Principals Only)

1.	Arab Boycott	NSC
2.	Maritime Policy Review	Commerce

cc: Dawn Bennett
Paul Leach

THE WHITE HOUSE

WASHINGTON

April 23, 1976

MEMORANDUM FOR

THE ECONOMIC POLICY BOARD

As you know, the seventeen Executive Branch Departments and Agencies are now redrafting final consumer representation plans. Most of the departments and agencies have designated consumer advocates who should and can be expected to articulate responsible consumer positions within their department. Often the views articulated by each consumer advocate will differ substantially from the views or even the final decision of their secretary.

Given the political opposition to the consumer representation plans and Democrat congressional sentiment favoring a consumer protection agency, it is extremely important that these consumer representation units within the departments and agencies establish their credibility. One of the key criticisms of our plan has been an alleged lack of independence for the individual consumer advocates. Our critics attack our plans as an inferior substitute for an independent consumer agency and will try to embarrass the Administration by alleging that our consumer representatives will function primarily as flacks and merely hew to the "party line".

I believe that it is extremely important to do two things. First, we must make it clear that the consumer representative in each department will be given a wide latitude to argue for consumer viewpoints internally. These units should vigorously present and transmit the views of the many diverse consumer advocates. In this regard I would like to point out the procedure followed by the State Department in the shoe import decision. Joan Braden, State Department Consumer representative, was "out front" on the issue and publicly made a vigorous case for the course of action that the President ultimately took. I believe that all of our consumer representatives should be given this latitude, especially in economic policy questions that affect consumer interests.

Second, and this directly affects the EPB, I believe that the EPB should announce that on policy memorandums to the President affecting consumer interests that there will be a section highlighting the consumer views received from our departmental consumer representatives or from the Special Assistant for Consumer Affairs. Such a section would become an ongoing feature of the EPB's formal procedure.

I believe if the two procedures followed above are taken, our credibility in this area will be greatly enhanced and we will be able to defeat the pending consumer protection agency legislation.

I hope the EPB will give me some guidance on the above two issues, which I will then relay to Virginia Knauer and the other Administration consumer representatives for their comments. I will then return their comments to the EPB for final determination.

Bill Baroody

William J. Baroody, Jr.
Assistant to the President

THE WHITE HOUSE

WASHINGTON

April 23, 1976

MEMORANDUM FOR: MEMBERS OF THE ECONOMIC POLICY BOARD

FROM: JIM CANNON

SUBJECT: Social Security Decoupling

Attached for your review is the draft Social Security Decoupling memorandum which we are prepared to forward to the President.

This memorandum will be the focus of an EPB meeting on Tuesday, April 27th. At that time we will need your final recommendations.

Most of you have had a chance to review this document in earlier drafts during the past two weeks. Many of you participated in the discussions surrounding the President's decision on this issue in December. If, however, there are additional points which need to be discussed, these should be presented for consideration at the EPB meeting.

DRAFT MEMORANDUM

THE WHITE HOUSE

WASHINGTON

April 22, 1976

MEMORANDUM FOR THE PRESIDENT

FROM: JIM CANNON

SUBJECT: Social Security: Long-Range Financing

PURPOSE

The purpose of this memorandum is to re-open for discussion and review your December decision to "decouple" the Social Security System. The memo includes an expanded presentation of the issue, some new information relevant to the subject, and revised policy alternatives.

Because of the complexity and importance of this matter, it is recommended that in considering the alternatives, you meet with the Cabinet secretaries and staff advisers most closely involved and concerned with this issue so that views and assumptions may be carefully discussed.

BACKGROUND

In December you addressed three major problems threatening the financial integrity of the Social Security System:

1. The system is experiencing annual deficits.

   Your response to this problem was a proposal to increase revenues through a .6 percent (.3 percent each for employers and employees) Social Security tax increase, effective in 1977. This would solve the problem through the early 1980's,but there appears to be no chance that Congress wil enact such an increase this year.

2. <u>The system's cost-of-living indexing provisions enacted in 1972 are now expected to overadjust for inflation.</u>

   This problem is often referred to as "coupling" or "double-indexing" because two automatic adjustments for inflation are made in the determination of benefits. [One of these is a CPI adjustment to the benefit formula, and the other occurs because the level of earnings subject to Social Security taxes is increased annually to reflect average wage growth -- and wage growth also tends to incorporate CPI increases.] The projected net effect over the long term is to increase benefits faster than the rate of inflation and real wage growth.

   Your December decision on this issue was to "decouple" the system in a manner equivalent to Option A below. This decision was described specifically in your 1977 budget, the Economic Report of the President, and OMB's Seventy Issues book. (See specific language at Tab A)

3. <u>The system faces major long-term financial pressures.</u>

   Congress expects the trustees to project at least 75 years into the future to estimate the impact of current provisions. Revised projections now indicate huge deficits by 2050 averaging over 8 percent of annual payroll. This translates to more than $3 trillion at current tax rates. About half the deficit is attributable to the "coupling" problem, and the rest is largely due to revised demographic (i.e., birthrate) assumptions.

<u>RE-OPENING THE DECOUPLING DECISION</u>

We are asking you to review your December decision on decoupling for two reasons:

1. The belief held by many of your advisers that the complexities of this issue and its potential long term implications require more detailed presentation and discussion than was provided in December; and

2. Recent Congressional developments.

   Both the House Ways and Means Committee and the Senate Finance Committee have indicated that they will not accept your proposal to increase Social Security taxes by .6 percent in January, 1977. However, there is concern among the members of both committees about the long-range fiscal impact of "coupling."

   To advise them on "coupling" and other major Social Security issues, these two committees last year retained a panel of six economists and actuaries, chaired by Harvard economist William Hsiao. The final report of this panel was submitted to the Congress on April 5. It recommends a decoupling approach (Option B below) which is more fiscally conservative than Option A, and which would eliminate most, if not all, of the projected long term deficit with minimal tax increases.

For these reasons, we are asking you to review your decision of last December.

RELATED LONG-TERM ISSUES

Since the coupling problem is not the only major long-term Social Security issue requiring attention, we want to remind you of some of the others. Certain of these may be addressed to a degree in your decoupling decision, but all of them require additional in-depth study and analysis. Several major unresolved issues are:

- The long-range role of social security vis-a-vis private pension and savings plans.
- The acceptable economic limits of the Social Security program and its impact on capital formation.
- The preferred means of funding Social Security (i.e. should general revenues finance a portion of the system?)
- The impact of Social Security taxes on unemployment and of benefits on work incentives.

- The extent to which Social Security should redistribute income, and its relationship to public assistance programs.

- The fairness of spouse benefits.

- The inclusion of all workers under Social Security (including employees of State and local governments who now have optional coverage).

- Other related issues (e.g. sex discrimination, the retirement test and earnings' rules governing the receipt of benefits, etc.)

Further analytic work would enhance our understanding of these issues, and it is our recommendation that an order to proceed with this additional analysis accompany your decision on decoupling. Ultimately, however, any reform of the system will require fundamental value judgments. Several of your advisers believe that some of those judgments can be made on the basis of existing knowledge.

ALTERNATIVES FOR ACTION

Although there exists a virtually unlimited number of ways of correcting for the coupling problem, only two are presented here. They represent the two strategies most often argued as the appropriate direction for the program to take over time.

Both options would eliminate the overadjustment for inflation in the current formula. They differ in the manner in which they would calculate initial benefit levels in the future (and, therefore, the extent to which they would eliminate projected deficits). This difference is not particularly significant in the next ten to twenty years, but becomes quite dramatic after that.

Option A: This plan (your December decision) is designed to replace on the average a constant proportion (approximately 43 percent) of pre-retirement income for new retirees. Wages are expected over time to grow faster than the CPI, and Option A would fully reflect this wage growth by indexing initial benefit levels to wage increases. This approach ensures that the real value of the average social security benefit for new retirees grows at the same rate as the real income of the rest of the population. This option would eliminate only half of the long-term deficit and therefore should be viewed as a major step toward solving the total problem but not the complete solution.

Option B: This plan (the Hsiao panel recommendation) is designed to adjust future initial benefits for CPI increases, but reflect wage growth to a much lesser degree than Option A and only to the extent that an individual worker achieves it. The average real benefit grows, but not as fast as the real incomes of the rest of the population. Therefore, the average rate of earnings replacement declines over time. This option would substantially eliminate most of the long-term deficit.

Option C: Postpone action on decoupling until a more thorough analysis of the implications of Options A and B and other decoupling models can be undertaken.

DISCUSSION

To understand the mechanics of both Options A and B, it is useful to review how the current system operates with an oversimplified example. Social security benefits after retirement are often described by the extent to which they replace a certain percentage of a retiree's previous earnings. This percentage, known as the replacement rate, currently averages 43 percent for all wage earners. For various earnings' levels, the replacement rate is the following:

- Approximately 63 percent of the wages of a worker earning $3600 (a relatively "low" wage worker).

- Approximately 42 percent of the wages of a worker earning $8600 (a "middle" wage worker).

- Approximately 30 percent of the wages of a worker earning the covered maximum of $15,300 (a relatively "high" wage earner).

These figures reflect the progressivity of the benefit structure under Social Security, i.e., the lower a person's earnings, the higher the percentage of wages replaced by social security benefits.

The difference between Options A and B is how they would have replacement rates behave in the future. Option A would treat a person on the basis of his relative status among all wage earners, by indexing future initial benefits to wage increases. Option B, on the other hand, would treat a person on the basis of his real level of earnings, by indexing future initial benefits to price increases.

Under Option A, replacement rates for all wage earners on average would approximate 43 percent over time. As wages increase due to inflation and real wage growth, replacement rates would keep pace, continuing to replace the same portion of pre-retirement wages for persons similarly placed in the earnings spectrum.

Under Option B, replacement rates would remain constant over time for given levels of real earnings. Since all persons are expected to enjoy increasing real wages, average replacement rates are expected under Option B to decline gradually to 23 percent by 2050 due to the progressivity in the formula. Option B assumes that as living standards rise average workers will be able to afford to rely more heavily on private pensions and personal savings to supplement their social security income, just as wealthier workers are expected to do when they retire today.

(At Tab E is a chart which plots the behavior of average replacement rates under current law and Options A and B.)

Various examples can better illustrate the difference. However, a strong cautionary note with regard to actuarial assumptions should be made first since they have such a tremendous impact on the figures.

Actuarial assumptions. The key assumptions used for predictive purposes are inflation, real wage growth, and the birthrate. The problems with using a given set of assumptions over a 75-year period is that they have a compounding effect which can build in large distortions. When the 1972 amendments were passed, the coupled system was projected to have long range costs which would not require unscheduled payroll tax increases. Under significantly modified 1975 actuarial assumptions (6 percent wage growth, 4 percent inflation, and a birthrate of 2.1), the system was projected to have an actuarial deficit of 5.3 percent of taxable payroll -- this translated to $2.4 trillion and generated widespread public reaction.

In this year's Draft Trustee's Report now under review, the actuarial assumptions have been revised again (5 3/4 percent wage growth, 4 percent inflation, and a birthrate of 1.9). In conjunction with other changes, the revised assumptions project deficits averaging 8.4 percent, or more than $3 trillion. This is not to say that conditions are significantly different this year from last, but the changed assumptions have a large long-term impact.

You should know that there was disagreement among the trustees on whether to use the new assumptions. Most economists caution against relying on a single set of assumptions and prefer that a range be used. (The Trustee's Report uses an "optimistic," "intermediate," and "pessimistic" set but refers often to the results caused by the "intermediate" set).

No one seems to believe that the decoupling decision should be determined by the results of the revised assumptions, but you need to be aware of their existence. You also need to know that Option A is now expected to reduce the 8.4 percent annual deficit to 4.7 percent, whereas last year's figures for Option A indicated a reduction from 5.3 percent to 2.7 percent. Under the revised assumptions, Option B is no longer expected to eliminate all of the long-term deficit.

The illustrative figures in the table below are based on the 1975 assumptions -- 6 percent annual increase in wages consisting of a 4 percent increase in prices and a 2 percent increase in real wages (over 75 years, this 2 percent increase compounded annually results in more than a four-fold increase in real wages).

Three categories of wages are used in the table -- "low," "middle," and "constant." All figures are for single retirees. Under current law, spouse benefits add an additional 50 percent. Wages are expressed in constant 1976 dollars.

Today's "low" wage worker is expected to earn $15,000 in 2050. Option A continues to treat him as a low wage earner and replaces 63 percent of his salary. Option B treats him like today's high wage earner and replaces 30 percent of his salary. The "middle" wage worker would experience a similar decline in replacement rates.

The "constant" wage worker experiences no real wage growth and finds himself at the bottom of the theoretical 2050 earnings scale (similar to the relative position of a person today earning $2,000/year). Option A treats him as a "very low" worker and replaces 100% of his wages, whereas Option B treats him in essentially the same fashion as he is treated today. Additional detail is provided at Tabs B and C.

COMPARISON OF OPTIONS A AND B FOR "LOW," "MIDDLE" AND "CONSTANT" WAGE EARNERS, 1976/2050

WAGE LEVEL	ANNUAL PRE-RETIREMENT EARNINGS (1976 $)	ANNUAL BENEFIT AMOUNT (1976 $)*		REPLACEMENT RATES (%)*	
		Option A	Option B	Option A	Option B
"Low"					
1976	3,600	2,300	2,300	63	63
2050	15,000	9,000	4,500	63	30
"Middle"					
1976	8,600	3,600	3,600	42	42
2050	37,000	16,000	7,800	42	21
"Constant"					
1976	8,600	3,000	3,600	42	42
2050	8,600	8,600	4,000	100	46

*All figures are for single retirees. Spouse benefits would add 50 percent to annual benefit amounts and replacement rates. See Tabs B and C. It should also be noted that the benefits are tax free. Therefore, the replacement rates understate the relationship to after tax (net) income.

Long-term cost is also an extremely important consideration. Under the 1975 actuarial assumptions, Option A was expected to require 16.2% of taxable payroll in 2050 (the current law's tax rate is 9.9% with a scheduled increase to 11.7% in 2011). Option B was estimated to require 8.8%. As stated earlier, the 1976 assumptions result in significantly larger deficits. Tabs B, C, and D have additional comparative cost data.

PROS AND CONS

OPTION A: Decouple -- Index Future Benefits To Growth In Prices and Real Wages (Average benefits grow with average earnings.)

Pros:

- Option A eliminates the double-indexing for inflation and halts the trend over the last twenty-five years towards rising average replacement rates (See Tab E). By holding these rates constant, the Administration is not vulnerable to a charge that the Administration is using decoupling as a means of deliberalizing the program. This should assure its acceptability to the Social Security constituency, thus avoiding a major political controversy.

- Option A was described as your decision in the 1977 budget. The labor movement and other Social Security watchers received the decision favorably. Even though it solves only 50 percent of the long-range financing problem, it still allows the Administration to go on the offensive for initiating action towards the preservation of the integrity of the system. A change at this time would catch the Social Security constituency by surprise, and would draw their strong opposition.

- It provides ample opportunity to address broader issues about Social Security on a deliberate basis due to the long-run financing problem. This permits consideration of various changes falling between the somewhat extreme positions represented by Options A and B, but gives the Social Security constituency advance warning of possible changes, and perhaps a voice in the deliberations.

- It permits you to fulfill your commitment to "decoupling" while indicating it is not the final word on the subject. You could simultaneously announce the establishment of a study team to develop more far-reaching, long-term recommendations.

Cons:

- Option A solves only 50 percent of the long-term financing problem. Under the revised assumptions in the 1976 Draft Trustee's Report (whether one agrees with them or not), this translates to a long-term average annual deficit of 4.7 percent of covered payroll -- or nearly $2 trillion. This does not compare favorably with last year's estimated 5.3 percent average deficit costed at $2.4 trillion for the coupled system.

- It could be portrayed as an inadequate response to a major future financial crisis, requiring steep social security tax increases (or general revenue funding) in the long run. Such revenue demands could have adverse impact on employment, work incentives, and the rate of capital formation.

- It fails to take advantage of the unique opportunity presented by the "coupling" problem and the Hsiao panel recommendations to re-structure the entire system dramatically. As time passes, the system is likely to grow and become increasingly less susceptible to change.

- It may add to growing concern about long-term payroll tax increases and further erode public confidence in the system.

OPTION B: Decouple -- Index Future Benefits to Price Growth Only. (Average benefits grow less rapidly than average earnings.)

Pros:

- Option B would eliminate most of the long-range deficit, thus putting the Administration on the side of prudent fiscal management. It presents the strongest possible argument that the Administration is acting to preserve the financial integrity of the system.
- It is in keeping with the independent findings of the non-partisan Hsiao study panel. The financial pressures of the "coupling" problem may provide an unparalleled opportunity for implementing such changes.
- It would reduce the potential long-range burden of the social security tax on wage earners and the economy. It would stabilize payroll tax rates at a fairly constant percentage and may trigger increased individual savings and capital formation.
- It may enjoy some political appeal because it returns to Congress more financial latitude for making discretionary increases or other popular reforms.

Cons:

- Option B is likely to raise serious political questions. It would almost certainly be viewed by the Social Security constituency as a significant deliberalization of the system. Whether or not this is a fair characterization of Option B, the issues are sufficiently complex that this is the inevitable political interpretation.
- It would be viewed as a retreat from the decoupling plan described in the 1977 budget, etc. which is generally perceived as your position. This would catch social security watchers by surprise and could damage your political credibility.

- It replaces a steadily declining proportion of most workers' pre-retirement income, but does not permit a reduction in scheduled payroll taxes. This may promote public dissatisfaction with the system, particularly among higher paid workers who already have the highest taxes and the lowest replacement rates.

- It makes major changes in the system without detailed analysis and public debate of the underlying role, economic implications, and philosophy of social security. It also hampers the potential interest in and and impact of a major, in-depth social security study.

OPTION C: Postpone Action On Decoupling

Option C would postpone any initiative on decoupling until a thorough analysis of the implications of the various options could be undertaken in conjunction with a study of related economic and philosophical issues. In an effort to depoliticize the issue, you could announce your decision not to introduce a decoupling proposal now, emphasize the fact that there is still time to study these issues in depth before making changes, and cite the Hsiao panel recommendations as to support your own non-partisan position.

Pros:

- Option C would provide an opportunity for extensive analytic effort geared toward the preparation of a comprehensive social security reform package. It would permit the development of a more sophisticated data base for making projections and comparisons among decoupling options. It would also permit the study of some of the critical economic and philosophical questions related to social security.

- It would diffuse the politicization of the issue in an election year, since Option A is vulnerable to charges of fiscal irresponsibility and Option B will be labeled a significant deliberalization. It would also preserve the opportunity to link major structural reform to correction of the "coupling" problem.

Cons:

- Option C may invite criticism of indecisiveness and playing politics on a critical issue in an election year. This is particularly so in light of the widespread belief (and 1977 budget statement) that you already decided on Option A.

- It may lead to a massive study which fails to achieve consensus positions on major questions which are inherently difficult to answer and invite controversy. It also may lead to excessive delay since a major study would probably require a minimum of eighteen months.

PUBLISHED DESCRIPTIONS OF PRESIDENT'S DECOUPLING DECISION

TAB A

The Budget of the U.S. Government FY 1977

> "The Administration is also proposing legislation to delete the inadvertent feature of the 1972 social security amendments which not only assures new retirees of future benefit increases as the CPI rises, but also -- under present projections -- raises the initial benefit levels more rapidly than wages increase. Under this proposal, future initial benefit levels will continue to reflect the general rise in covered wages in the economy, and maintain the same proportion of a retiree's prior earnings as at present." (p. 137)

Economic Report of the President, January 1976

> "The Administration will propose a specific plan to modify the (Social Security) system so that benefit levels will rise at the same rate as average wages. The goal is to make a person's benefits rise solely in accordance with wages during his working years and in accordance with the CPI in years after his retirement." (p. 117)

Seventy Issues, FY 1977 Budget, January, 1976

> "The Administration is proposing to eliminate this flaw by maintaining for all future beneficiaries the same ratio of benefits to pre-retirement earnings that exists for people who retire today. By making this change, roughly half of the projected long-term actuarial deficit would be eliminated." (p. 185)

Comparison of real benefits under Options A and B for the average worker whose earnings rise over time and of required tax, 1976-2050.

OPTION A

Year	Annual pre-retirement earnings (1976 $)	Annual Benefit (1976 $) Single Person	Annual Benefit (1976 $) Married Couple	Replacement Rate 1/ Single Person	Replacement Rate 1/ Married Couple 3/	Payroll Tax required 2/ (% of taxable payroll)
1976	$8,600	$3,600	$5,400	42%	63%	10.9%
1990	11,300	5,000	7,500	44	66	11.2
2000	13,800	6,000	9,000	44	66	11.5
2030	25,000	11,000	17,500	44	66	17.0
2050	37,200	16,400	24,600	44	66	16.2

OPTION B

Year	Annual pre-retirement earnings (1976 $)	Annual Benefit (1976 $) Single Person	Annual Benefit (1976 $) Married Couple	Replacement Rate 1/ Single Person	Replacement Rate 1/ Married Couple 3/	Payroll Tax required 2/ (% of taxable payroll)
1976	$8,600	$3,600	$5,400	42%	63%	10.9%
1990	11,300	4,000	6,000	35	53	10.1
2000	13,800	4,600	6,900	33	50	9.3
2030	25,000	6,000	9,000	24	36	10.7
2050	37,200	7,800	11,760	21	32	8.8

1/ Primary insurance amount at age 62 as a percent of earnings in the preceding year.

2/ Social security expenditures as a percent of taxable payroll.

3/ Married couples refer to couples where the wife has no social security benefit in her own right.

NOTE: Projections assume that earnings rise 2 percent faster each year than the CPI and that the fertility rate rises from 1.8 to 2.1.

Comparison of real benefits under Options A and B for a worker with a constant level of real earnings and of required tax, 1976-2050.

OPTION A

Year	Annual pre-retirement earnings (1976 $)	Annual Benefit (1976 $) Single Person	Married Couple	Replacement Rate 1/ Single Person	Married Couple 3/	Payroll Tax required 2/ (% of taxable payroll)
1976	$8,600	$3,600	$5,400	42%	63%	10.9%
1990	8,600	4,900	7,400	57	86	11.2
2000	8,600	5,600	8,400	65	98	11.5
2030	8,600	7,100	10,700	83	125	17.0
2050	8,600	8,600	12,900	100	150	16.2

OPTION B

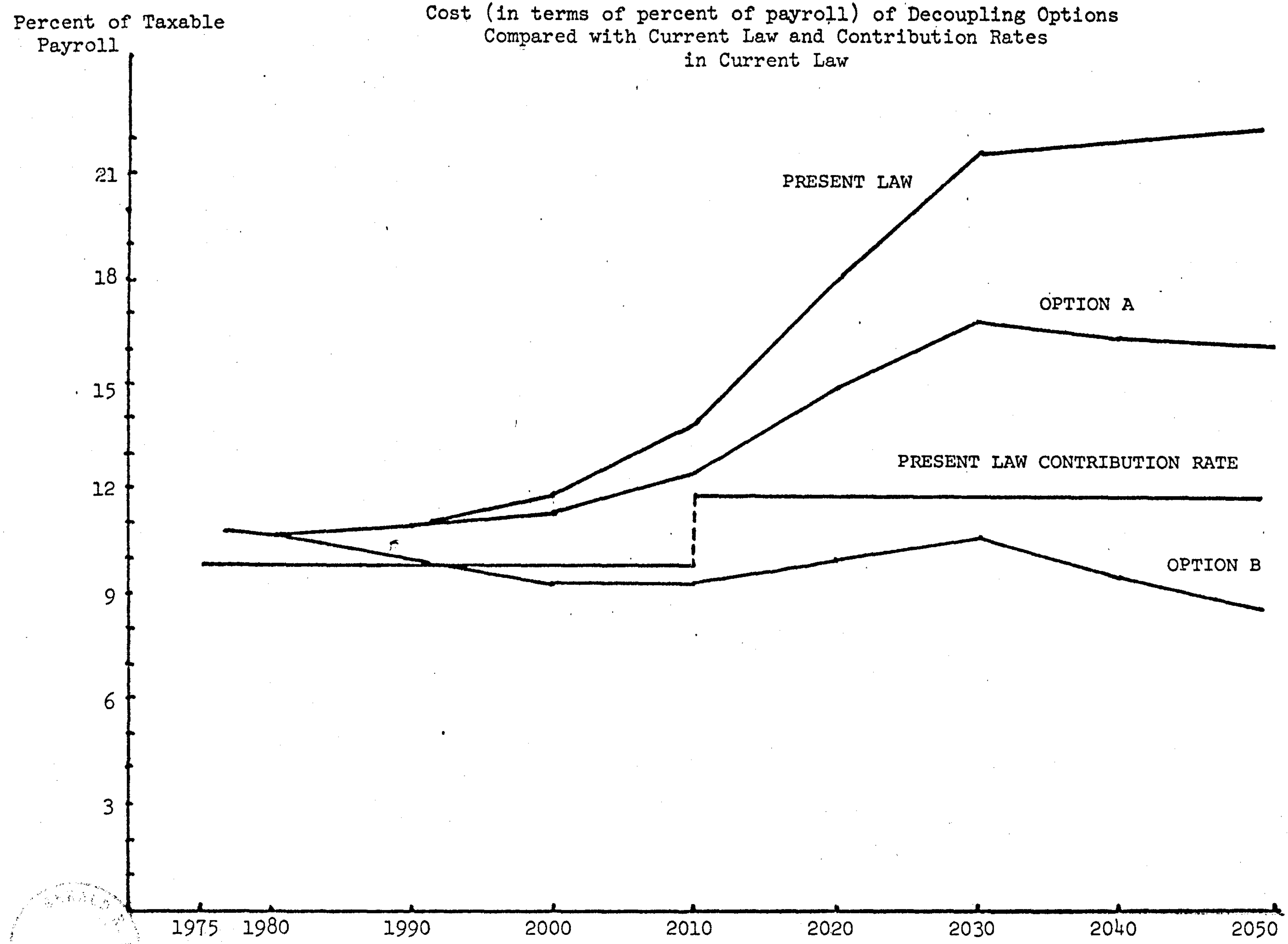
Year	Annual pre-retirement earnings (1976 $)	Annual Benefit (1976 $) Single Person	Married Couple	Replacement Rate 1/ Single Person	Married Couple 3/	Payroll Tax required 2/ (% of taxable payroll)
1976	$8,600	$3,600	$5,400	42%	63%	10.9%
1990	8,600	3,800	5,700	44	66	10.1
2000	8,600	4,000	6,000	46	69	9.3
2030	8,600	4,000	6,000	46	69	10.7
2050	8,600	4,000	6,000	46	69	8.8

1/ Primary insurance amount at age 62 as a percent of earnings in the preceding year.

2/ Social security expenditures as a percent of taxable payroll.

3/ Married couples refer to couples where the wife has no social security benefit in her own right.

NOTE: Projections assume that earnings rise 2 percent faster than the CPI and that the fertility rate rises from 1.8 to 2.1.

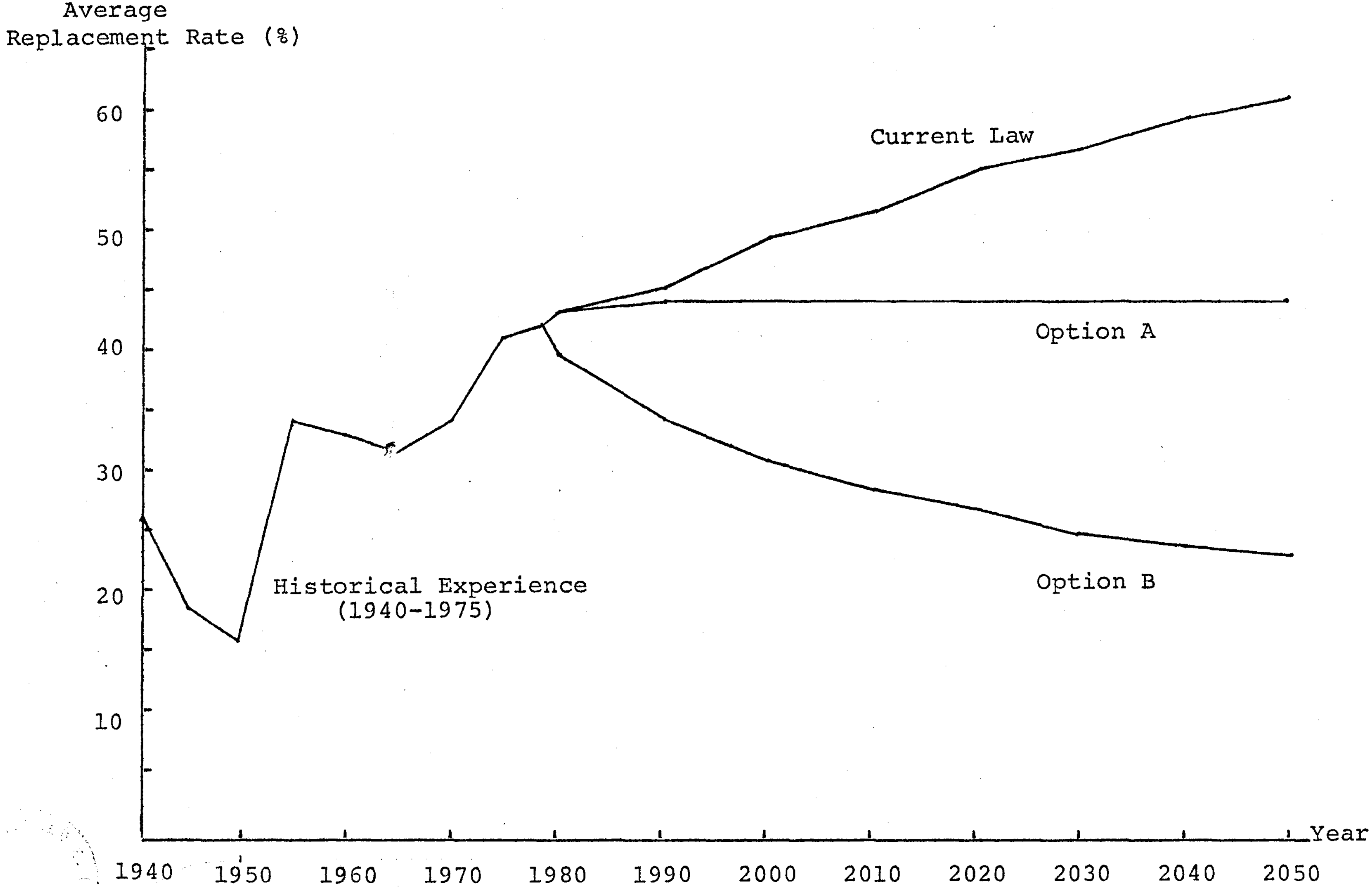


Note: Assumes long-range annual increases of 6% per year in wages and 4% per year in prices.

TAB D

COMPARISON OF PROJECTED REPLACEMENT RATES:

CURRENT SYSTEM, OPTION A, AND OPTION B (1975-2050)



TAB E