THE WHITE HOUSE

WASHINGTON

December 8, 1975

MEMORANDUM FOR: PHIL BUCHEN
JACK MARSH
MAX FRIEDERSDORF
ALAN GREENSPAN
ROBERT HARTMANN
JIM LYNN
BILL SEIDMAN

FROM: JIM CANNON Jim

SUBJECT: Social Security

Attached for your comments is a draft decision memorandum for the President on Social Security. The memorandum has been discussed extensively with many of you and your staffs. It presents to the President key substantive questions each of which have significant ramifications for workers and retired persons.

While the issues are complex, they have, as I mentioned, been reviewed before and we have attempted to reflect the suggestions and comments that have been submitted to us. In this final round, therefore, it is essential that you indicate specifically the changes that you believe are still necessary.

Given this background, I would appreciate having your comments by close of business on Wednesday, December 10, 1975.

Attachment

THE WHITE HOUSE

WASHINGTON

December 8, 1975

MEMORANDUM FOR

THE SECRETARY OF HEALTH, EDUCATION, AND WELFARE
THE SECRETARY OF LABOR
THE SECRETARY OF THE TREASURY

FROM: JAMES CANNON Jim

SUBJECT: Social Security

Attached for your comments is a draft decision memorandum for the President on Social Security. The memorandum has been discussed extensively with many of you and your staffs. It presents to the President key substantive questions each of which have significant ramifications for workers and retired persons.

While the issues are complex, they have, as I mentioned, been reviewed before and we have attempted to reflect the suggestions and comments that have been submitted to us. In this final round, therefore, it is essential that you indicate specifically the changes that you believe are still necessary.

Given this background, I would appreciate having your comments by close of business on Wednesday, December 10, 1975.

Attachment

THE WHITE HOUSE

WASHINGTON

December 17, 1975

MEMORANDUM FOR: THE PRESIDENT

FROM: JIM CANNON

SUBJECT: Social Security Financing

PURPOSE

The purpose of this memorandum is to present for your decision options for dealing with the serious short and long term financing problems facing the Social Security System. The timing of any legislative proposal is clearly a key element in your decision. Therefore, options must be examined in terms of the impact on the trust fund, the budget, and broad policy considerations.

It is our suggestion that before making a final decision, you meet with the three trustees: Secretaries Mathews, Simon and Dunlop, together with Jim Lynn and myself.

CURRENT SYSTEM

The Social Security System is composed of three separate trust funds: Old Age and Survivors' Insurance (OASI), Disability Insurance (DI), Health Insurance (HI) --- Medicare. The combined OASDI trust funds are the major concern in this memo, as they are expected to decline rapidly in the next few years.

In 1974, Social Security collected $58.9 billion for OASDI from 99 million workers in covered employment and paid $58.5 billion in OASDI benefits to some 31 million beneficiaries. The OASDI tax rate is 9.9% (4.95% each paid by employees and employers) on a maximum wage base of $14,100. The wage base will increase to $15,300 in 1976. The current tax rate for the HI (Medicare) trust fund is 1.8% (.9% each paid by employees and employers). Current law provides a tax increase of .2% in 1978 for HI only.

Social Security Tax Rates (Employer/Employee, each):

Present Law

Calendar Year	OASDI	HI	TOTAL
1975 - 77	4.95%	0.90%	5.85%
1978 - 80	4.95%	1.10%	6.05%
1981 - 85	4.95%	1.35%	6.30%
1986 - 98	4.95%	1.50%	6.45%

PROBLEMS

The OASDI trust funds are underfinanced in the short and long-term. Benefit outlays are expected to exceed payroll tax receipts in 1975 and every year thereafter. If no changes are made in current law, the projected deficit over the next 25 years (1975-1999) will average 1.3% (.65% each for employees and employers) of taxable earnings. In the following 25-year period (2000-2024) the deficit will rise to 4.1% (2.05% each for employees and employers) of taxable earnings.

Unless some action is taken, OASDI trust funds will fall from the current 66% of yearly outgo to 43% in 1977, 33% in 1978, 11% in 1981, 3% in 1982, and the trust funds will be exhausted by 1983.

The projected rapid decline in trust fund assets over the next few years can be attributed to:

-- Increased benefits resulting from wage growth and inflation.

-- Legislation since the late 1960's which raised benefits.

-- Absence of equivalent increases in payroll tax revenues. (In fact, payroll tax receipts have lagged due to high rates of unemployment and slowed wage growth).

The projected long-term deficit beyond 2000 can be attributed to:

-- Population trends which include a substantially increasing ratio of retired persons to the working population after the beginning of the 21st Century.

-- A flaw in the current system which over adjusts the benefits of future retirees to inflation. The current formula which determines future benefits for workers increases the weighting of earnings by the rate of inflation. Since wages normally grow with inflation, the result is an overcompensation -- commonly referred to as a "coupled" system. There is a general consensus in the Congress and among outside experts that the inflation adjustment in the formula should be eliminated, thus "decoupling" the system. Such a change would not affect the automatic CPI increases in benefits after retirement. It should be emphasized here that "decoupling" will have virtually no effect on the short-term deficit.

POLITICAL CONTEXT

A review of the political environment surrounding the Social Security System is useful as we sort out these very important issues. Social Security decisions have traditionally followed a pattern which has insulated the system from sudden and far reaching changes. Structural modifications take place usually after extensive public debate including exhaustive studies and visible commissions. Protection of the system is fostered by one of the strongest and largest consituencies in the public policy arena, including the elderly, organized labor and all of the wage earners who are contributing to the system and expect to benefit from it in the future.

Members of Congress and especially of the Finance and Ways and Means Committees have institutionalized this process of incremental reform. The Committees have jointly established an advisory group (the Hsiao Panel) to examine the long-term financing -- "decoupling" problem and to recommend policy changes to the Committees in the spring of 1976.

Although some hearings have been held on the short-term financing problem, no proposals have come out of the Committees. Secretary Weinberger testified before Ways and Means last May and took the position that the Administration would be pleased to cooperate in developing a proposal to alleviate the short-term deficit. You decided then not to propose any tax or wage base increase noting that the Congress had failed to act on the 5% cap on benefit increases proposed in the FY 1976 budget. The stand-off has continued since that time as the trust fund continues to decline.

Because of the financing problems, the public has begun to question the stability of Social Security. Although the subtleties and complexities are not widely understood, there exists general pressure to move toward stabilizing the trust fund with a minimum of change for those in the system.

DECISIONS

The discussion of alternatives for your decision are presented in three categories:

I. Options to deal with the short-term decline in trust fund assets.

II. "Decoupling" options which alleviate part or all of the long-term deficit.

III. Mechanism for analyzing the structure and role of Social Security.

I. SHORT-TERM FINANCING

Preventing the rapid decline of the trust fund requires difficult choices. Simply expressed, at some point before 1983, revenues must be increased or benefits must be reduced. The options take into account the effect on the trust funds, budgetary and broad policy consequences.

Estimated Trust Fund Assets under Current Law:

Calendar Year	Assets at Beginning of Year as Percent of Outgo during Year
1975	66%
1976	55%
1977	43%
1978	33%
1979	25%
1980	18%
1981	11%
1982	5%
1983	0%

These projections by the Social Security Administration are based on economic assumptions (Tab A) which are of course judgmental. In the light of recent changes in the economy, CEA advises that the assumptions appear slightly pessimistic for 1975 and 1976 and somewhat optimistic from 1977-1983. HEW believes that it would be unwise for the trust fund assets to fall below 33% in an unpredictable economic situation. This is in part a matter of public confidence. The 33% reserve would serve as a buffer if the economy worsens. In order to prevent the trust funds from falling below 33% during 1978, legislation to increase revenues or decrease benefits must be effective by January 1978.

If the economic assumptions are off the mark and/or if you feel that the trust funds should not fall so low, then the effective date should be early in 1977, which would require legislation in 1976. Of course raising taxes or decreasing benefits would be unpopular but, on the other hand, it may seem irresponsible not to take a position.

You should be aware that regardless of which short-term financing option you choose to stabilize the combined OASDI trust funds, legislation will be required to allow the transfer of funds from the OASI trust fund to the DI trust fund. Without such action, the DI trust fund will probably be exhausted before 1980.

Short-term financing options which prevent the OASDI trust fund assets from falling below one-third in 1978 include the following:

Option 1: Increase revenues by raising payroll taxes

It would be necessary to increase taxes by .3% (each for employees and employers) of payroll beginning in 1977 and to gradually increase that amount to .6% by 198[illegible].

PRO

The advantage of such a tax increase is that it would eliminate the entire short-term (1975-1990) deficit.

CON

Given your proposal for a permanent income tax reduction and the [illegible] increase in the [illegible], it would be difficult to justify an additional tax increase in the next year or so. Also, an increase in the payroll tax has a particularly harsh effect on low wage earners. The employer tax increases the cost of labor and may discourage additional hiring, particularly at the low wage level. There may be political repercussions from taxpayers generally and particularly from business and organized labor.

Option 2: Increase revenues by a combination of a more modest increase in taxes and raising the maximum wage base.

If the wage base were raised from the currently projected $16,800 for 1977 to $19,500, the necessary tax increases (for employee and employer each) would be .25% in 1978, rising to .45% by 1984.

PRO

As in Option 1, the entire short-term deficit would be eliminated Also, the more modest tax increase would be less hard on low wage earners than Option 1.

CON

Again, even these more modest tax increases would be difficult, given economic and political considerations. The base increase would cause high (above $16,800) wage earners and their employers to assume more of the tax increase. Because this group would then be entitled to higher future benefits, the trust fund expenditures and taxes would be enlarged in the long run.

Option 3: Reduce outlays by placing a cap on the 1976 and 1977 CPI benefit increases and decreasing certain other benefits.

OMB has proposed for the FY77 budget and you have tentatively agreed to, increasing benefits by only 60% of the CPI in 1976 and 1977 and several other program changes, including:

a. Eliminate payment of retroactive benefits for the months before an application is filed if such payment would require a permanent reduction in future monthly benefits.

b. Eliminate the monthly retirement test and base the retirement test on annual earnings.

c. Eliminate, over a 4-year period, benefits for for those aged 18 to 22 in school full time.

The two 60% caps on the CPI benefit increases would save \$3.1 billion in calendar 1977 and an increasing amount in subsequent years. The other program changes would save approximately \$1.2 billion in 1977 and up to \$3.2 billion in 1981. Such reduced expenditures would keep the trust fund levels above one-third of outgo through 1981. This postpones another decision on short-term financing for up to five years.

PRO

This benefit reduction "buys" time. Further economic recovery (lower unemployment and inflation) in the next five years may increase revenues and reduce benefits somewhat; and a tax or tax/wage base increase may be more feasible at that time. Also, in the present economic situation where social security recipients have been largely insulated from the depressing effects of the recession, they should perhaps shoulder some of the burdens, as opposed to wage earners.

CON

It eliminates only a small portion of the short-term deficit. A similar cap was proposed last year and was not considered in the Congress. Such a proposal has little chance of enactment and, if proposed, would probably be opposed by constituent groups, particularly the elderly.

Option 4: Do not propose legislation at this time

Since Congress has made no move on short term financing, you could simply wait or raise the issue and agree to work with the committees to arrive at a mutually agreeable solution.

PRO

In economic and political terms, it will be difficult to propose any of the above options, all of which have clear disadvantages. The Congress should share the burden of any proposal. Also, there probably exists some [illegible] on timing of any legislative proposal. Depending on your view of the economic assumptions and trust fund stability, you could postpone action for another year.

CON

Because of declining public confidence in the stability of social security, inaction on your part may be viewed as irresponsible. Aside from the issue of public confidence, if the economic assumptions are overly optimistic or the economy takes a downturn, the trust fund "buffer" may not be adequate.

RECOMMENDATIONS:

--- Secretary Mathews recommends Option 3, reducing benefit outlays, as being consistent with your overall budget strategy.

--- Secretary Simon has raised questions about the capability of the Domestic Council staff in this "very complex policy area." He urges a delay so that his staff can assist in producing "a more accurate, readable and compact decision instrument." Simon suggests that, instead of any of the above options, we should make social security benefits subject to the personal income tax. His staff has not yet analyzed the impact of such a proposal on the deficit.

--- Robert Hartman recommends deferring action, Option 4.

--- Max Friedersdorf recommends deferring action, Option 4.

--- Phil Buchen believes it would be economically and politically irresponsible not to adopt one of the action options. He opposes deferring action.

--- Domestic Council agrees with the OMB recommendation (Option 3) to reduce outlays. This is the most acceptable option as it is consistent with current budgetary and economic policy.

DECISION:

Option 1 (tax rate increase in 1977) __________

Option 2 (wage base increase in 1977 and tax increase in 1978) __________

Option 3 (60% cap on benefit increase and other reductions) __________

Option 4 (defer action) __________

COMMENTS:

II. DECOUPLING

Background

As described on Page 2, "decoupling" means the élimination of the double indexing for inflation in the benefit formula for future retirees. The cumulative effect of "double indexing" began in 1975 in the form of slightly higher benefits for people who retired that year. Decoupling is a long-term financing issue, as the "coupled" system will not impact significantly on the trust fund deficit until after the year 2000.

Replacement Rates

Social Security benefits after retirement replace a certain percentage of a retiree's previous earnings. This percentage is known as the replacement rate. Under the current law, retirement benefits are equal to:

--- approximately 62% of the recent gross wage 1/ of a low income worker.

--- approximately 42% of the recent gross wage of an average earner.

--- approximately 30% of the recent gross wage of a higher earner.

Due to the double indexing for inflation in the formula which determines the level of benefits at the time of retirement, replacement rates for each category of worker are rising from year to year. If this continues, eventually retirement benefits will replace more than 100% of a worker's recent gross wages.

There exists a general consensus in Congress, among interest groups representing the aged, and [illegible] experts, that the overadjustment for inflation in the formula should be eliminated, thus "decoupling" the system.

1/ These figures are expressed in terms of before tax gross wages and do not reflect wives' benefits. Analysts at the Treasury Department [illegible] that after tax replacement rates for an average earner ($8,400 gross wages) would be approximately [illegible]% without including dependent wives' benefits or approximately [illegible]% assuming a dependent wife.

Key Issues

The issue on which your decision is needed is whether the Administration should make a specific decoupling proposal in 1976 or whether that proposal should be delayed for at least another year. The answer to the question depends on the objectives to be sought through decoupling, your assessment of the reactions to possible proposals and the implications for possible future changes in the system.

Possible objectives of a decoupling proposal include:

1. Eliminate the overadjustment for inflation.

2. Use decoupling as a lever for further changes such as reducing the role of social security in overall retirement income, thus reducing the tax burden on workers, and reducing the redistributive (welfare) tilt of the benefit formula.

A consensus exists in agreement with the first objective. There may be wide disagreement on the second objective, which involves a philosophical question: What should be the future role of Social Security? What levels of benefits and tax rates would be appropriate in the context of overall taxes and other retirement income?

HEW advises that a "neutral" decoupling proposal which eliminates the overadjustment and maintains current replacement rates would be acceptable to constituent groups (labor and elderly) and the Congress. Others believe that such a neutral decoupling which ignores the second objective would foreclose the opportunity for major structural changes in the future.

In considering various approaches to "decoupling", this philosophical question translates into a judgment about what are appropriate replacement rates (percent of wages replaced by retirement benefits) now and in the future. Should we continue to replace the same percentage of wages for low, average, and high earners as we do now? If so, payroll taxes will have to be raised substantially in the long run (as much as [illegible] by [illegible]) to finance the system.

Or, should we allow replacement rates to decline over time? This would mean that unless they increase their personal savings, people who retire in later years would not be able to enjoy the same standard of living relative to their recent earnings as people who retire now do. But, a reduction of the role of Social Security would allow us to contain and perhaps even lower future tax rates. This is a difficult trade-off.

To illustrate the trade-offs, three models which "decouple" the system and provide alternative replacement rates over time will be compared to the current law coupled system. The key variables are the replacement rates (benefit levels and expenditures (taxes) required to finance the system.

Three charts illustrating the effect on replacement rates and expenditures of three alternative decoupling models as compared to the current law "coupled" system are attached (Tab B).

The alternative "decoupling" models are described as follows: (It should be noted that all models require a phased transition from the current system.)

Alternative I: Decouple, maintaining the current role of Social Security

Stop the increase in replacement rates and hold them constant over time at current levels. This means that the benefits of future retirees will reflect increases in the standard of living resulting from their real wage growth (since wages are expected to grow at an annual rate of 6% and prices are expected to rise at an annual rate of 4%, then the 2% real wage growth means that Americans will enjoy a steadily increasing standard of living over the years).

Approximately 5[illegible] of the long term deficit would be eliminated by this alternative. Therefore, additional [illegible] (as much as [illegible] more employer/employee combined by 2050) would be required to finance such a system.

[illegible]

[illegible] this proposed decoupling, with [illegible] of change in current replacement rates, [illegible] among constituent groups and in the Congress. In fact, aging groups and the AFL-CIO have supported this concept. It ensures that the benefits of future retirees will keep pace with our rising standard of living. You could propose to "decouple" in this manner now, and come back later after further analysis and consensus building, with a broader proposal to change the structure and role of Social Security over the long-term.

CON

It only eliminates 50% of the long-term deficit, therefore, additional tax increases or further restructuring will be required in the future (after 2000). Aslo, if you propose decoupling in this manner with minimum of change in the system, you may lose a useful lever for forcing the Congress to address the tough issue of the future role of Social Security as it affects taxpayers and beneficiaries.

Alternative 2: Decouple and reduce future role of Social Security

Allow benefit levels for future retirees to keep pace with inflation instead of real wage growth. This means that if such a proposal were enacted in 1976, the future benefits of workers who retire some years later will be based on the standard of living in 1976. Since wages will grow faster than prices, replacement rates will decline over time. A person who retires in the year 2000 would receive the same benefits as a similar worker who retires in 1976. But because the 2000 retiree would have experienced real wage growth during those 25 years, his Social Security benefits, unless supplemented by other retirement income or private savings, would result in a significant change in his lifestyle.

This proposal would eliminate the entire long-term deficit and would allow future tax reductions (as much as 3% employer employee combined) by 2050.

PRO

[illegible] rollbacks could be realized. Since the role of Social Security would be lessened over time, people may save more or buy supplemental pensions [illegible] capital formation.

CON

Such a far-reaching change in the system would prove very controversial politically. Replacement rates would fall as low as 7 - 14 percent by 2050. Although we have developed the concept of this model, additional staff work will be required over the next month or so before legislation could be submitted.

Alternative 3: Decouple and reduce future role of Social Security more moderately.

Allow future benefits to keep pace with approximately half of the growth in real wages (standard of living). This represents a middle ground between Alternative 1 and 2. Replacement rates never fall below 25% of a retiree's recent wages. This proposal would eliminate 80% of the long-term deficit. Therefore, some additional tax increases (1.2% by employer-employee combined by 2050) would be required in the long run.

PRO

- This Alternative would reduce the future role of Social Security (taxes and benefits), but less severely than Alternative 2. Capital formation may be stimulated somewhat.

CON

Future tax increases, although less than under current law or Alternative 1, would be required in the long run. Declining replacement rates (though less severe than those in Alternative 2) would prove politically controversial. Again, at least 1 or 2 months would be required to complete the necessary staff work for this proposal.

The existing consensus in opposition to the current coupled system provides a forum for consideration of decoupling proposals. Therefore, any of these three could be announced by itself or in conjunction with a short term financing proposal. (It is important to note again that decoupling will not solve the short-term deficit problems).

Alternatives 2 and 3, which include declining replacement rates, raise some fundamental questions about the role of Social Security which you [illegible] [illegible] [illegible]

Alternative 4: Defer Action on Decoupling

Section III of this memorandum recommends a comprehensive study of the Social Security system. Such a study could address the question of constant or declining replacement rates.

Unless you are comfortable with proposing Alternative 1 which decouples (eliminates double indexing for inflation) with a minimum of change from the current structure, you may wish to postpone action and avoid the controversy represented by Alternatives 2 and 3. More analysis is needed of these alternatives and the economic assumptions on which they are based. You could offer to work with the Committees on decoupling and present several models for consideration.

PRO

Further study of these issues and cooperation with the Congress would allow time for consideration by the public and in Congress of some fundamental questions about the future role of Social Security -- the appropriate tax rates and benefit levels.

CON

Because a consensus exists on eliminating the double indexing in the formula (Congress may take action this spring) and the adverse effects are accumulating over time (replacement rates are rising), it may seem irresponsible to postpone action or not to take a position.

RECOMMENDATIONS

---- Secretary Mathews advises proposing a decoupling plan as soon as possible that is as neutral as possible on the matter of future fundamental changes. He believes that if we do not, Congress will, [illegible] or unconcerned about the [illegible] fault in the system. He therefore recommends Alternative 1, which [illegible] the current role of Social Security.

---- Alan Greenspan believes [illegible] that it is [illegible] the President to [illegible] in the [illegible] which [illegible] all their ramifications [illegible].

--- Bill Seidman recommends Alternative 2 which reduces the role of Social Security, "in view of the large number of additional pension programs available to Americans."

--- Robert Hartmann recommends Alternative 4, postponing action.

--- Phil Buchen recommends Alternative 2.

--- Domestic Council recommends Alternative 1, to decouple now with a minimum of change in the current structure. We believe that you should take the initiative now on this important long-term issue. After further analysis of the role and structure of the Social Security System, you could go forth with proposals for broad program reform.

DECISION

--- Propose decoupling along the lines of:

Alternative 1 ---	Decouple, holding current replacement rates constant	______
Alternative 2 ---	Decouple, allowing replacement rates to decline rapidly	______
Alternative 3 ---	Decouple, allowing replacement rates to decline more slowly.	______

--- Defer a proposal on decoupling by choosing:

Alternative 4 ---	Postpone action.	______

COMMENTS

III. Study of Social Security System

To allow time for analysis and the development of recommendations on broader structural issues and for education of the public and consensus building, it is our judgment that a comprehensive study is needed.

If you decide to defer legislative action on a short-term financing proposal and/or decoupling, then the study group could address these issues over the next year.

Clarification of the role of Social Security in our society is necessary to ensure its stability and continued public confidence. Some of the fundamental questions include the following:

--- What should be the role of Social Security in terms of wage replacement vs. income redistribution (welfare)?

--- What should be the role of Social Security in the context of the overall pension system?

--- What should be the role of Social Security in the overall tax system?

--- What should be the role of Social Security in the context of economic growth?

It is our judgment that Domestic Council and Economic Policy Board members should assist in developing a framework for the study which clearly identifies the appropriate issues, and should assist in the selection of a group of outside experts. The experts would provide needed analysis and facilitate increased public awareness of the issues. Responsibility for overseeing the study could be housed in the Domestic Council.

RECOMMENDATIONS

--- Secretary Simon recommends a study but believes that the Domestic Council does not have the economic expertise to study these issues. Therefore, the Economic Policy Board or [illegible] would be better qualified.

--- Alan Greenspan recommends a study and feels that the study group should be appointed jointly by the Domestic Council and the Economic Policy Board.

--- Bill Seidman agrees with a Domestic Council/EPB study.

--- Robert Hartmann agrees with a study.

--- Domestic Council recommends a year-long "in house" study designed by the Domestic Council with the assistance of the Economic Policy Board, with resources to draw on outside experts. We feel that an appointed Commission would be less productive and more time consuming.

DECISION

Propose study of Social Security.

Agree:____________________ Disagree:____________________

COMMENTS:

TAB B

THE WHITE HOUSE

WASHINGTON

April 7, 1976

MEMORANDUM FOR: THE HONORABLE W. J. USERY, JR.
SECRETARY OF LABOR

FROM: JIM CANNON Jim

SUBJECT: Social Security Long-Range Financing

Attached for your comments and recommendations is a draft decision memorandum for the President on the long-range Social Security financing problem. It describes the two major options for carrying out the President's December decision to "decouple" the system.

There are broad differences of opinion over how best to present this issue. Therefore, we welcome specific suggestions for any changes you consider necessary.

I would appreciate receiving your comments by close of business, Monday, April 12, 1976.

Attachment

THE WHITE HOUSE

WASHINGTON

April 7, 1976

MEMORANDUM FOR: THE HONORABLE DAVID MATHEWS
SECRETARY OF HEALTH, EDUCATION, AND WELFARE

FROM: JIM CANNON Jim

SUBJECT: Social Security Long-Range Financing

Attached for your comments and recommendations is a draft decision memorandum for the President on the long-range Social Security financing problem. It describes the two major options for carrying out the President's December decision to "decouple" the system.

There are broad differences of opinion over how best to present this issue. Therefore, we welcome specific suggestions for any changes you consider necessary.

I would appreciate receiving your comments by close of business, Monday, April 12, 1976.

Attachment

THE WHITE HOUSE

WASHINGTON

April 7, 1976

MEMORANDUM FOR: THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY

FROM: JIM CANNON

SUBJECT: Social Security Long-Range Financing

Attached for your comments and recommendations is a draft decision memorandum for the President on the long-range Social Security financing problem. It describes the two major options for carrying out the President's December decision to "decouple" the system.

There are broad differences of opinion over how best to present this issue. Therefore, we welcome specific suggestions for any changes you consider necessary.

I would appreciate receiving your comments by close of business, Monday, April 12, 1976.

Attachment

THE WHITE HOUSE

WASHINGTON

April 7, 1976

MEMORANDUM FOR: PHIL BUCHEN
ROBERT T. HARTMANN
JACK MARSH
MAX FRIEDERSDORF
ALAN GREENSPAN
JIM LYNN
BILL SEIDMAN

FROM: JIM CANNON Jim

SUBJECT: Social Security Long-Range Financing

Attached for your comments and recommendations is a draft decision memorandum for the President on the long-range Social Security financing problem. It describes the two major options for carrying out the President's December decision to "decouple" the system.

There are broad differences of opinion over how best to present this issue. Therefore, we welcome specific suggestions for any changes you consider necessary.

I would appreciate receiving your comments by close of business, Monday, April 12, 1976.

Attachment

Social Security

THE WHITE HOUSE

WASHINGTON

April 13, 1976

MEMORANDUM FOR: JIM CANNON

THROUGH: PHIL BUCHEN P.

FROM: KEN LAZARUS KL

SUBJECT: Social Security: Long-Range Financing

Counsel's Office has reviewed your draft memorandum to the President on the subject noted above, and offers two comments.

First, the memorandum would appear to be more technical and detailed than necessary to present the basic concepts under consideration.

Second, we would support a third option, delaying announcement of any decision in this area until such time as a complete plan is designed. Alternatively, we would support Option A as preferable to Option B.

THE WHITE HOUSE

WASHINGTON

April 20, 1976

MEMORANDUM FOR: JIM CANNON

FROM: ART QUERN

SUBJECT: Public Employee Pension Funds

Attached is a summary provided by Steve McConahey of a 20th Century Fund Report on public pension funds. It is a very interesting report and Steve's summary is well worth your time.

Art Q

Attachment

cc: Art Fletcher
Pat Delaney
Lynn May
Allen Moore

Where is full Report

THE WHITE HOUSE

WASHINGTON

April 19, 1976

MEMORANDUM FOR: ART QUERN

FROM: STEVE McCONAHEY SGM

SUBJECT: Review of the 20th Century Fund Report on Public Employee Pension Funds

This report provides a very comprehensive review not only of the basic elements of pension fund policy but of some specific programs. This memorandum provides you with the highlights of the major recommendations reached by the author.

1. The most significant policy question for public pension systems is the degree to which they are coordinated with social security. The author feels that if a state did not somehow coordinate its system with social security, it will have no control over its employee retirement benefits.

2. For the most part, public employee pension funds have a higher benefit level than private funds; however, this is a combination of a higher payout ratio as well as a greater contribution rate on the part of the employee.

3. The author feels that anything that provides a benefit beyond "continuance of net income" raises questions about the equity of the fund and certainly raises risk of public rejection. Moreover, he documents the phenomena of early retirement when benefits are provided immediately upon retirement as opposed to a point when the age of 60 or 65 is reached. Not only does this force early retirement, but it adds additional burdens to the pension system.

4. Because social security tends to be focused on assistance to the poorer parts of the American public, local governments have to be careful to coordinate their plans of social security to avoid payment of more than net income before retirement when the two systems are combined.

5. He specifically recommends amendments to the law to include all public employees hired in the future. He further suggests that the elements of the social security law that permit withdrawal ought to be changed to prevent employees who elect to terminate from receiving future increases in benefits.

6. He feels that it is inappropriate, on general principles, for the larger system of social security to accomodate the peculiarities of many federal, state and local plans. He feels that that responsibility of coordination and development of a reasonable retirement program should be left to the states.

7. He emphasizes the need for public employment retirement systems to be funded on actuarial basis. He feels that pay as you go arrangements encourage irresponsibility, grant benefits without recognition of the cost, and expose employees to the hazards and disappointment of the jurisdictions inability to pay.

8. He feels that jurisdictions should be able to reach portability agreements amongst them, whereby one does not lose benefits when transferring to another.

9. Policemen and firemen pensions have been too high in many places, and have encouraged early retirement. Again, this causes a high turnover in employment ranks and causes an increased financial burden on the pension system.

10. Many pension systems should update their investment programs. He feels that investment policies have been too conservative without the flexibility to react quickly and without using the expertise of people totally familiar with the investment market.

11. Consolidation of individual public pension systems at the state levels is worth considering. This would avoid benefit competition among various jurisdictions and would yield more efficient administration and perhaps better investment policies.

12. He expresses concern about the inclusion of pension benefits in collective bargaining process. In such situations where it is bargained for there is always the risk that the legislature will refuse to accept what an employee union has negotiated.

13. There is a need for some type of firm commitment for the delivery of the benefits promised. However, he recommends avoiding situations where the state is left with no opportunity to adjust plans if particular problems arise.

14. In improving pension legislation, there is no magic formula. He feels that it is " a combination of statesmen art of combining, with judgment and integrity, the ideal with the possible."

15. The author concludes "on the whole, benefits paid by public systems have been a major contribution to the security of several generations.... New circumstances, rising levels of wages and benefits, and a new social security system confront employee pension plans with a need for redifinition of purpose and for a new approach for the accomplishment of their goals."

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.

<u>RELATED LONG-TERM ISSUES</u>

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 quitedramatic after that.

Option A: This plan (your December decision) is designed to replace on the average a constant proportion (approximately 43 percent) of preretirement 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.

TAB A

PUBLISHED DESCRIPTIONS OF PRESIDENT'S DECOUPLING DECISION

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	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	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	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	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	11,700	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	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	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	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	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

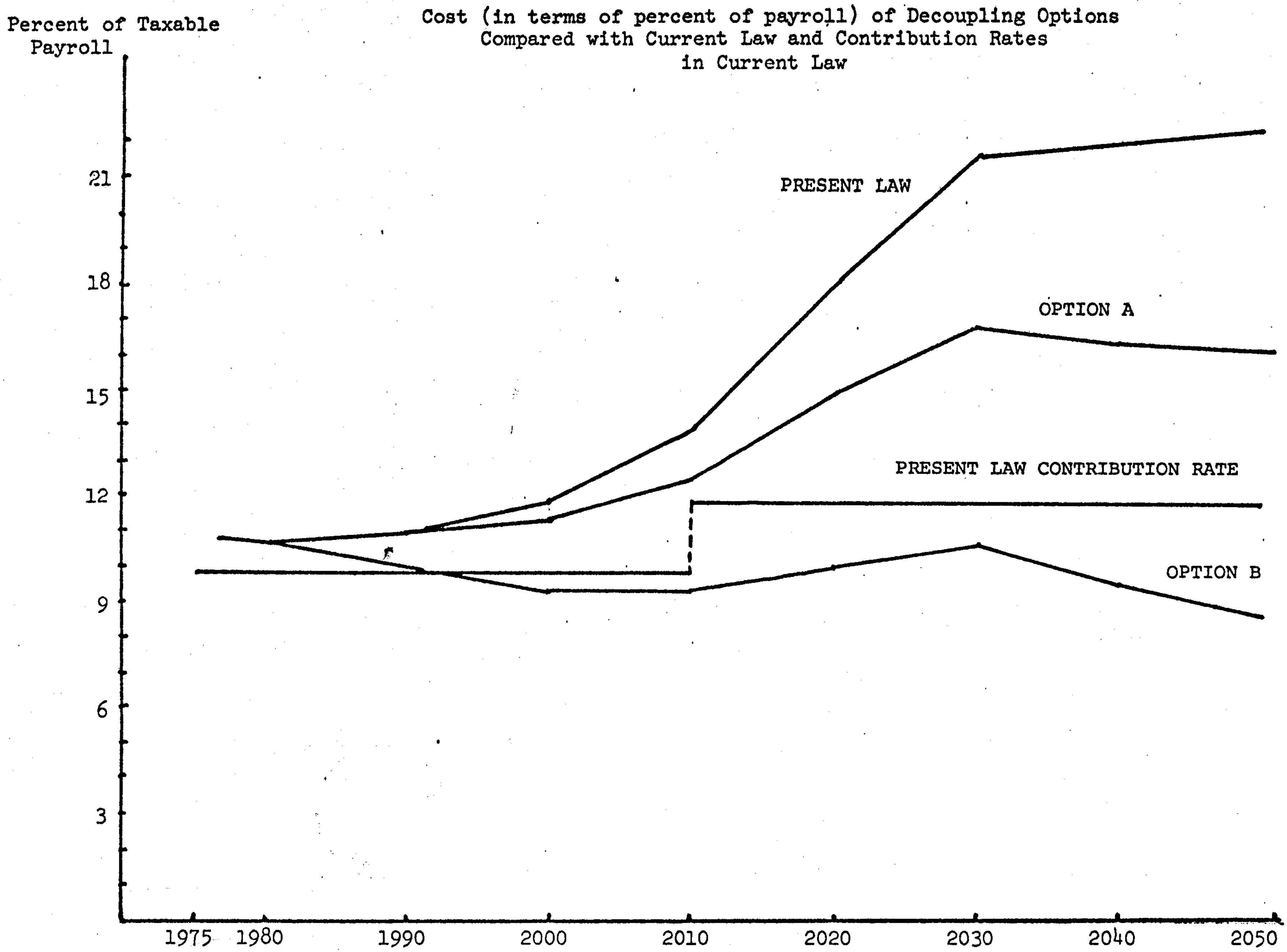
1/ Primary insurance amount at age 62 as a percent of earnings in the preceding year.

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.

Cost (in terms of percent of payroll) of Decoupling Options
Compared with Current Law and Contribution Rates
in Current Law

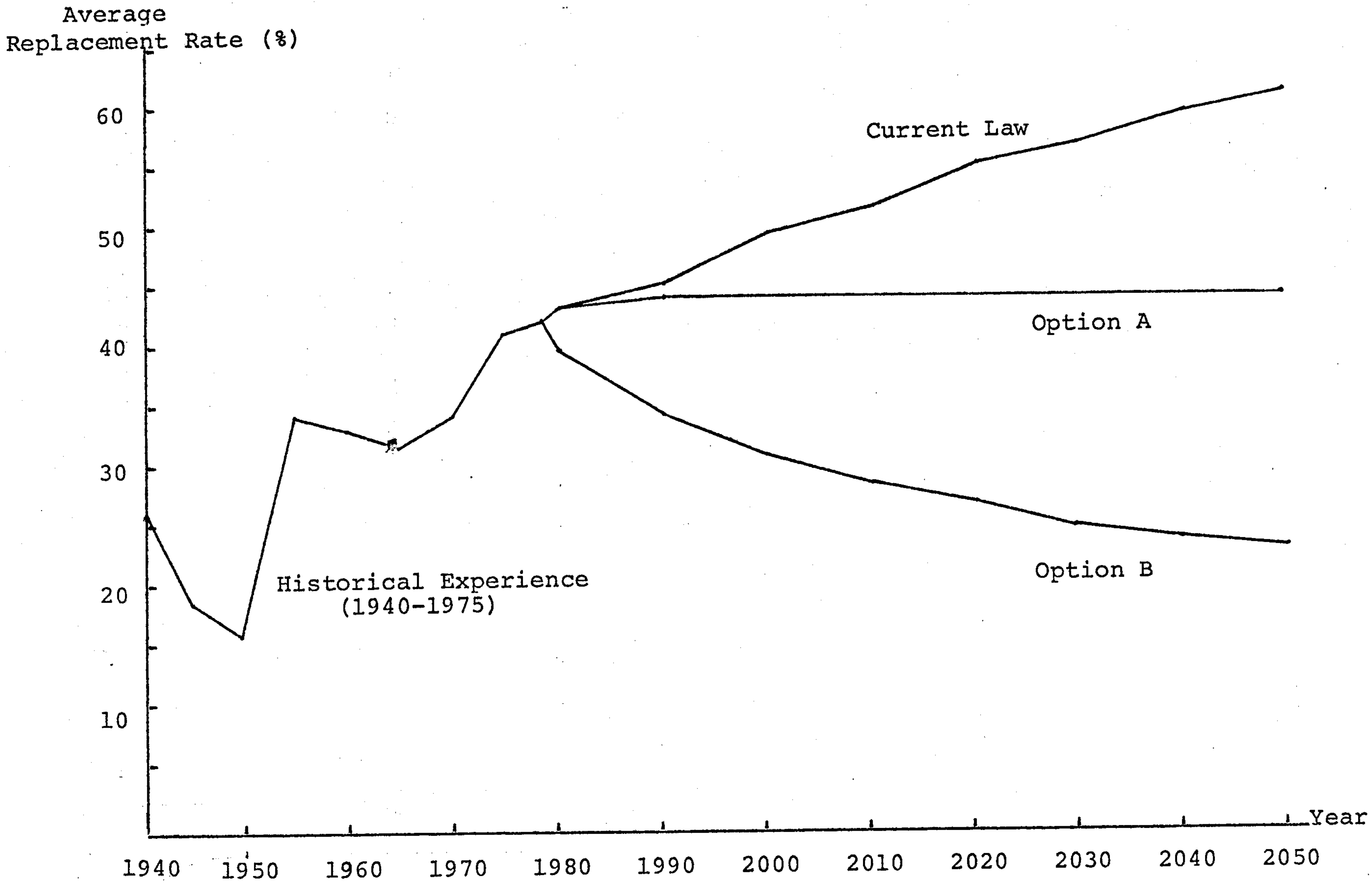


Note: Assumes long-range annual increases of 6% per year in wages and 4% per year in prices.

TAB D

COMPARISON OF PROJECTED REPLACEMENT RATES:

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



TAB E

THE WHITE HOUSE

WASHINGTON

Goes w/ Social Security papers

April 27, 1976

TO: JIM CANNON

FROM: ALLEN MOORE AM

SUBJECT: Bob Goldwin's proposal to eliminate the retirement test from Social Security. (See his memoranda, attached)

This memo indicates my belief for ~~why~~ no public initiative should be taken on the issue at this time.

ISSUE: Should the Social Security Retirement Test be eliminated?

BACKGROUND

The "retirement test" under current Social Security law measures the earned (as opposed to unearned) income of a beneficiary between the ages of 65 and 72. To the extent earnings exceed $2,250, benefits are reduced one dollar for every two dollars earned. Therefore, a family entitled to benefits of $300/month ($3,600/year) would lose benefits up to the point at which earnings reached $9,450 [i.e. 2,250 + 2(3600)]. Once earnings passed $9,450, no social security benefits would be paid. The "retirement test" is eliminated when the retiree reaches age 72. Also, the $2,250 figure is adjusted upward annually at the rate of average wage growth in the economy.

The question of whether or not to preserve the retirement test hinges on economic theory, cost, and employment considerations, as well as on public perceptions about Social Security.

Treasury has written a memo laying out the rationale in favor of eliminating the test. OMB wrote one in favor of retaining the test until we better understand its impact. No one else inside is on the record with a position, but the Hsiao study on social security recommends no change now, but rather a research study to examine the economic and employment effects of a variety of retirement tests. It appears that Bob Goldwin is pursuing the issue on his own initiative (with Treasury's support). He tried to put the issue on the EPB agenda with decoupling.

In my digging on this issue, I discovered that Reagan had called for the elimination of the retirement test in his nationwide speech (note language attached). I further discovered that a brief statement citing a $2 billion cost figure was circulated in a speech kit by the PFC (attached). No one seems to know whether or not this issue has received any subsequent coverage. (Neither OMB nor Goldwin had been aware of this political development.)

My thoughts on the merits of the issue are laid out in a brief memo sent to Rudy Penner (attached). Consistent with my informal recommendation to him, I suggest that you respond to the Goldwin memos with the attached memo making the following points:

(1) We do not know enough about the economic impact and costs, but the costs appear to be significant;

(2) We should look at alternatives other than outright elimination; and

(3) The issue fits logically into the analytic agenda on Social Security which may be initiated soon.

I think one other point might be made verbally, i.e. a new position on this issue may look like a political move to Reagan's corner and conflicts with the implied tone of the PFC material.

This final point raises a larger question about procedure. It was only accidental that I discovered the Reagan statement and the PFC response. No one on the Domestic Council was asked to respond from a policy viewpoint on issues raised by Reagan. Even worse, once an implied policy response was drafted, no one here had any systematic way of learning about it. I don't have a solution to this problem, but I think we should look for one.

Attachments

cc: Art Quern
Jim Cavanaugh

THE WHITE HOUSE

WASHINGTON

MEMORANDUM FOR: BOB GOLDWIN

FROM: JIM CANNON

SUBJECT: Proposal to Eliminate the Social Security Retirement Test

I believe it would be a mistake to eliminate the Social Security retirement test at this time for the following reasons:

(1) We simply do not know enough information about the budgetary, employment, and economic consequences of this action.

Both the OMB and Treasury memos reflect the uncertainty about the net cost and distributive effects of this proposal. The theory itself is appealing, but given the expectation that the proposal could cost $2-3 billion annually, we should first consider whether this is the best public purpose for which to spend such amounts. This problem is particularly sensitive given the current financial pressures on the social security system.

(2) The issue as currently presented ignores consideration of more moderate action alternatives directed at similar objectives.

Since total elimination of the test may prove so costly and may focus benefits on persons with relatively moderate need, incremental steps toward this objective should be considered. Changes such as increasing exempted earnings, reducing the marginal tax rate, providing additional benefit incentives for continued employment, etc. should be analyzed before a final recommendation is made.

(3) The question fits logically into the issue agenda on Social Security which is currently under discussion.

The "retirement test" is only one of a number of Social Security issues which has been mentioned in internal memoranda as requiring major analytic attention. The specific mechanism for studying these issues has not been decided upon, but given the uncertain impact of the retirement test, it is an appropriate issue to include in any broad range study.

I do agree with you that this is an important issue which deserves our careful consideration, and hope that we can avoid unnecessary delay in analyzing it properly.

THE WHITE HOUSE

WASHINGTON

March 31, 1976

MEMORANDUM TO: RICHARD CHENEY
JAMES CANNON
JAMES LYNN
ALAN GREENSPAN
JAMES CAVANAUGH
WILLIAM SEIDMAN
R. G. PENNER

FROM: ROBERT GOLDWIN RAG

SUBJECT: Secretary Simon's Comments on Irving Kristol's Proposal to End the Earnings Restriction on Social Security

I think you will be interested in Secretary Simon's comments agreeing with Kristol's proposal that this Administration act to end the earnings restrictions on Social Security recipients between the ages of 65 and 72. He disagrees with the OMB analysis.

It seems clear to me that this should be done and could be done rather promptly. It would be eminently fair, would be immediately intelligible to everyone, and would be seen as a very direct and humane act of "de-regulation."

Encl.

THE WHITE HOUSE

WASHINGTON

April 14, 1976

Bob Orben

MEMORANDUM TO: WILLIAM SEIDMAN

FROM: ROBERT GOLDWIN RAG

SUBJECT: Kristol's Proposal to End the Earnings Restriction on Social Security

You remember that Irving Kristol has written to me proposing that this Administration act to end the earnings restriction on Social Security recipients between the ages of 65 and 72. He argues that the restriction is irksome and unfair, since it results in a 50 per cent marginal rate of taxation on the income of persons who are our natural constituency and should not be taxed so unfairly.

An analysis was done by someone in OMB which argued against Kristol's proposal, but you, Secretary Simon, Kristol and I all agree that the restriction should be ended.

You are the one in the best position to initiate consideration of a possible recommendation to the President. Action now, in my opinion, would be appropriate and timely. Is there any reason why this proposal should not be brought up promptly for consideration and action?

I have attached copies of all the correspondence and memoranda I have on this matter, starting with Kristol's first letter.

Attachments

cc: Mr. Richard Cheney
Mr. James Cavanaugh
Mr. David Gergan

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

MAR 26 1976

Memorandum to: Mr. Robert A. Goldwin
Special Consultant to the President

Subject: Irving Kristol's proposal to end the retirement test for social security beneficiaries

On economic grounds I agree with Irving Kristol that the retirement test ought to be ended. The test penalizes many older persons who wish to augment their incomes by working. It thereby increases the isolation of these people, hastens debilitation, and ultimately raises the social burden of caring for them. The test also deprives the economy of the fruits of the skills which older people possess.

The OMB critique does not address the economic benefits of ending the retirement tests, but evaluates the proposal on two grounds only:

-- Relative treatment of the aged poor vs. the aged well-to-do.

-- Budgetary "costs."

The critique seems to assume that the proposal is merely a way "to transfer $6 billion in Government Funds to the public with the objective of helping the elderly poor." If this were indeed the objective, OMB might be right to see Mr. Kristol's proposal as inefficient. But if the objective is to remove governmental strictures which hurt the economy, as I believe it should be, then the OMB criticisms are of secondary importance.

Budgetary Impact

In any event, OMB's $6-$7 billion figure for the "cost" of ending the retirement test may greatly over-state the likely negative impact on the Budget. While the basic data (prepared by SSA actuaries) are presumably correct, they are incomplete. And the OMB critique does not tell the full story. Without a full analysis, it is unclear whether the budgetary impact would be negative, positive, or approximately neutral.

First, OMB leaves an important "plus" out of the calculation. Ending the retirement test would bring old people back into the labor force from the ranks of the retired. Others who already work in spite of the test would expand their earnings and work effort. These shifts, the magnitude of which is uncertain, would bring additional revenues into the system.

Moreover, it should not be assumed that the cost of ending the retirement test would be financed by higher payroll taxes. If that assumption were correct, we would merely be redistributing taxes from retired people to workers, and much of the benefit to the overall economy would be foregone. If, on the other hand, we kept total benefits paid about the same, while making them unconditional on earnings, the "cost" to the Budget would be converted into a gain and full economic benefits would be obtained.

Second, OMB states that the "cost" of ending the test includes a one-time amount of $3-$4 billion due to early retirement. (SSA actuaries refer to this figure as a "guess.") It arises because many people in the 62-64 age group may opt to claim their benefits before age 65, if they no longer face a retirement test. The critique is unclear on this point. The effect is not a one-time "cost" to the Budget, but is repeated every year as a new cohort reaches age 62. The OMB critique observes that the increased "cost" attributable to each participant would be precisely offset by an actuarial reduction in benefits throughout his retirement period. It fails to make it clear that, as a result, a shift to early retirement would leave the discounted present value of budget outlays unchanged. The $3-$4 billion would be fully recouped over the long haul.

Benefits to the Aged Poor

OMB concludes that Mr. Kristol did not "correctly identify the people who would benefit" from eliminating the test. Perhaps the critique is right, but the figures presented by no means justify that conclusion. The fact that it is relatively well-to-do people who suffer total loss of benefits due to the retirement test is beside the point. A more relevant question is how much the lower income aged would have earned if the retirement test had not put those earnings beyond their reach. And we can't begin to answer that question with present knowledge.

Summary

Budgetary "costs" should not be hastily identified with true economic costs. The retirement test is responsible for costs to the economy which call for its elimination. We should not ignore these costs. Nor should we ignore the costs upon people who would have been willing and able to work in the absence of the retirement test.

Finally, as a matter of principle, people who have contributed throughout their working lifetime, should be permitted without harrassment to collect the benefits they have earned.

myth

William E. Simon

William E. Simon

against. Particularly, working wives. And, people who reach Social Security age and want to continue working, should be allowed to do so and without losing their benefits. I believe a Presidential commission of experts should be appointed to study and present a plan to strengthen and improve Social Security while there's still time--so that no person who has contributed to Social Security will ever lose a dime.

Before leaving this subject of our economic problems let's talk about unemployment.

Ending inflation is the only long range and lasting answer to the problem of unemployment. The Washington Establishment is not the answer. It's the problem. Its tax policies, its harassing regulations, its confiscation of investment capital to pay for its deficits keeps business and industry from expanding to meet your needs and to provide the jobs we all need.

No one who lived through the Great Depression can ever look upon an unemployed person with anything but compassion. To me, there is no greater tragedy than a breadwinner willing to work, with a job skill but unable to find a market for that job skill. Back in those dark depression days I saw my father on a Christmas Eve open what he thought was a Christmas greeting from his boss. Instead it was a blue slip telling him he no longer had a job. The memory of him sitting there holding that slip of paper and then saying in a half whisper "That's quite a Christmas present"--it will stay with me as long as I live.

REAGAN NATIONWIDE SPEECH (Excerpt)

REAGAN STATEMENT:

"...And people who reach Social Security age and want to continue working, should be allowed to do so, and without losing their benefits..."

FACT:

This change would add $2 billion more to the cost of Social Security.

THE WHITE HOUSE

WASHINGTON

April 23, 1976

MEMORANDUM FOR: RUDY PENNER

FROM: ALLEN MOORE AM

SUBJECT: Brief Thoughts on the Retirement Test Question

A. Reasons to Retain Retirement Test

1. Budgetary demands (particularly troublesome with system already under severe pressure).

2. Lack of knowledge on employment impact -- and therefore on tax receipts and budget.

3. Consistency with "earnings replacement" underlying philosophy of the system.

4. Progressive benefit structure reflects a "needs-related" posture for the system, and retirement test is consistent with this.

5. Elimination would help foster the contributory "myth" of the system (i.e. that benefits are closely tied to contributions).

6. People who would benefit have less relative need than many other beneficiaries.

7. Hsiao report says data poor and suggests study using different retirement tests for different worker groups.

8. This is a logical issue to look at in concert with the range of Social Security issues needing study (a la Decoupling memo).

B. Reasons to Eliminate Retirement Test

1. Political expediency -- something for elderly.

2. Improve work incentives.

3. Increase tax revenues.

4. Improve public understanding of system by treating earned and unearned income identically.

C. Optional Courses of Action

1. Initiate in-depth study.

2. Increase wage disregard.

3. Reduce marginal tax rate.

4. Change retirement test to earnings test, and bring in unearned income. Simultaneously, increase wage disregard significantly and/or reduce marginal tax rate.

5. Adjust benefits upward actuarially after age 72 for persons who had retirement test reduction.

Recommendation

1. Spend more time studying economic (i.e. employment, tax, and budget) implications of the issue.

2. Examine more than the one alternative.

3. Include, if possible, as part of study which hopefully will evolve from Decoupling decision.

4. If desirable, make Presidential announcement that issue is under study.

Social Security

NATIONAL GOVERNORS' CONFERENCE
NATIONAL CONFERENCE OF STATE LEGISLATURES

MEMORANDUM TO: Stephen McConahey

April 29, 1976

FROM: Stephen Farber & Jerry Sohns SBF JS

SUBJECT: State Social Security Termination

We have completed a quick survey of the states on the status of requests to terminate social security coverage for their employees.

This is a complex issue because there are varying degrees of coverage. In some states "regular" employees are subject to one arrangement, while employees of special authorities, teachers, etc., are covered differently.

This survey addresses the status of state termination actions with regard to regular employees of the state government only. The brief questionnaire (copy attached) was sent to the budget director in each state. In some cases we followed up by telephone to clarify survey responses. The results are as follows:

1. Four states (Massachusetts, Maine, Ohio and Nevada) have never been covered.

2. One state (Alaska) has requested termination.

3. One state (California) is seeking termination on an incremental basis for certain classes of employees.

4. Seven states (Hawaii, Idaho, Maryland, New Mexico, Oregon, Wisconsin and Wyoming) are actively studying the issue either by executive or legislative initiative.

5. Eight states (Arizona, Kansas, Missouri, Montana, New Jersey, Texas, Vermont, and Virginia) have begun to raise the issue in staff discussions. These states report varying levels of consideration, but are all at the preliminary stages of looking at the question.

6. The remaining twenty-nine states are not now considering requesting termination.

Several reasons have been given by state and local governments for decisions to terminate social security coverage. The most common reason given is the rising costs of the program to employer and employee. Other reasons offered included a dissatisfaction with benefits under social security compared to benefits available from other state programs; projected cost increases under social security; the condition of the Social Security Trust Fund; poor returns on employee contributions; and the heavy burden of payroll deductions on middle-income employees.

The National Conference of State Legislatures and the National Governors' Conference have no policy positions on this issue. Both organizations and the Academy for Contemporary Problems are studying the broader topic of public pension systems, and coverage of employees by social security will be a topic for further inquiry.

Attachment

National Governors' Conference
1150 Seventeenth Street N.W. Suite 600
Washington, D.C. 20036
(202)785-5600

Robert D. Ray
Governor of Iowa
Chairman

April 13, 1976

MEMORANDUM

TO: State Budget Officers

FROM: Terry Smith TS.

SUBJECT: Social Security Termination

State and local government requests for termination of social security coverage for their employees are occuring at a sufficient rate to make this a major issue in Washington.

The House Ways and Means Subcommittee on Social Security will hold hearings on April 26-27 to investigate the high rate of termination requests. In order to begin assembling some background on State views regarding this issue, the NGC has prepared the attached brief questionnaire. Would you please fill it out and return it to me as soon as possible.

If you desire to provide more detailed responses, please feel free to do so. This brief survey represents only an initial attempt to determine what the States are thinking about this issue.

Please return the questionnaire to:

Terry Smith, Special Assistant
National Governors' Conference
1150 - 17th Street, N.W., Suite 600
Washington, D.C. 20036

LETTER AND ATTACHMENT SENT TO ALL STATES NOT

CHECKED WITH RED "X".

BDH.

NGC QUESTIONNAIRE

ON

SOCIAL SECURITY TERMINATION

HAS YOUR STATE INITIATED TERMINATION OF SOCIAL SECURITY COVERAGE?

IS YOUR STATE ACTIVELY CONSIDERING TERMINATING COVERAGE?

WHAT FACTORS HAVE LED YOU TO INITIATE OR CONSIDER INITIATING TERMINATION?

STATE__________________ NAME___________________________

TITLE__________________________