**The original documents are located in Box C40, folder "Presidential Handwriting, 5/6/1976 (2)" of the Presidential Handwriting File at the Gerald R. Ford Presidential Library.**

THE WHITE HOUSE

WASHINGTON

May 6, 1976

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: JIM CANNON

FROM: JIM CONNOR JEC

SUBJECT: SOCIAL SECURITY: LONG-RANGE FINANCING

The President reviewed your memorandum of April 30 on the above subject and approved the following:

Option A: Decouple -- Index Future Initial Benefits To Growth In Prices and Real Wages (Average benefits grow in direct proportion to average earnings.)

The following notation was also made:

"I approve #A - as rationalized by Jim Lynn."

Please follow-up with appropriate action.

cc: Dick Cheney

# STATEMENT BY THE PRESIDENT

I have today directed the Secretary of Health, Education and Welfare to seek prompt Congressional action on my legislative proposal to maintain the fiscal integrity of our Social Security trust fund.

Simple arithmetic indicates that the Social Security trust fund is headed for trouble. Unless the Congress acts soon to ensure that the fund takes in as much as it pays out, there will not be adequate security for old or young.

In my State of the Union message in January, I proposed a payroll tax increase of .3% each for employees and employers to increase revenues into the trust fund to ensure that benefits will be available to all who have earned them.

My proposed increase would cost workers with a maximum taxable income less than a dollar a week. This increase will help stabilize trust funds so that current and future recipients can be assured the benefits that they have earned. I urge the Congress to take the earliest possible action on my proposal to preserve the integrity of the Social Security trust fund.

THE WHITE HOUSE
WASHINGTON

I approve
#A

as estimated
by Jim Lynn.

THE WHITE HOUSE

WASHINGTON

DECISION

April 30, 1976

MEMORANDUM FOR THE PRESIDENT

FROM: JIM CANNON Jim

SUBJECT: Attached Decision Memorandum on Social Security Long-Range Financing

I apologize for the sheer bulk of this document. However, it reflects the great complexity of the issue and the wide range of staff opinion on what should be done about it.

Attachment

THE WHITE HOUSE

WASHINGTON

DECISION

April 30, 1976

MEMORANDUM FOR THE PRESIDENT

FROM: JIM CANNON Jim

SUBJECT: Social Security: Long-Range Financing

PURPOSE

The purpose of this memorandum is to respond to new developments and significant new opinions regarding the issue of "decoupling" 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, the Trustees, OMB, and I recommend 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 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 both the House Ways and Means and Senate Finance Committees have indicated that they will not attempt to enact such an increase this year.

2. <u>The system's cost-of-living indexing provisions enacted in 1972 are now overadjusting 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 tied directly to CPI increases, and the other due to wage increases caused by inflation.

   (Technically, the current formula incorporates both an automatic adjustment for increases in the CPI <u>and</u> corrects for inflation a second time because growth in wages causes benefits to rise -- 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>.

   Cost estimates are customarily made on a long-term basis at least 75 years into the future, to estimate the impact of current provisions. Projections based on revised long-range assumptions (the revisions are currently under consideration by the Trustees) indicate huge deficits of about 8 percent of annual taxable payroll between now and 2050.

   This translates to an estimated actuarial deficit approaching $3 trillion. About half the projected deficit is attributable to the "coupling" problem, and the rest is largely due to revised economic and demographic (i.e., fertility rate) assumptions.

THE DECEMBER DECOUPLING DECISION

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

1. The belief held by some 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 four 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 (essentially equivalent to 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. To the best of our knowledge, neither committee has yet responded positively or negatively to the Hsiao report.

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 implicitly in your decoupling decision, but all of them require additional in-depth study and analysis. Several major 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 (e.g. 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 on unemployment and work incentives.
- The extent to which Social Security should redistribute income, and its interaction with income maintenance programs.
- The mandatory inclusion of all workers under Social Security (including Federal civil servants and employees of State and local governments who now have optional coverage).
- Other related issues (e.g. sex discrimination, the treatment of one vs. two worker families, 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 about the scope and role of the system.

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 basic alternative directions for the program to take over time. (A third alternative, to defer the decision, is also included for your consideration.)

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

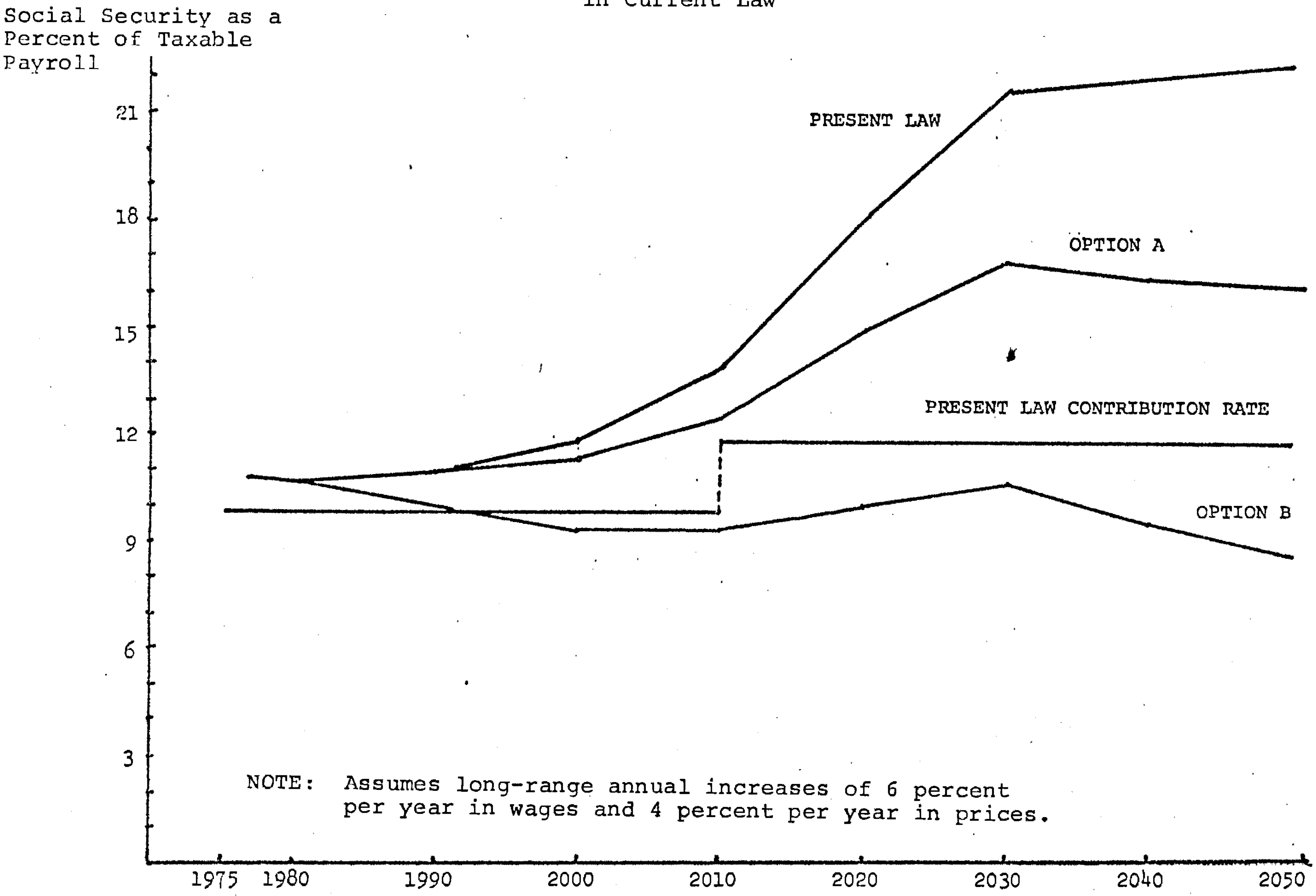
> Option A: This plan (your December decision) would index future initial benefits to growth in prices and real wages. It guarantees that average initial benefits grow with average earnings in the economy. It would eliminate approximately half of the long-term deficit and therefore should be viewed as a major step toward solving the total problem, but not the complete solution.

> Option B: This plan (essentially equivalent to the Hsiao panel recommendation) would correct future initial benefits for inflation, and reflect real wage growth to a much lesser degree than Option A. Average initial benefits grow somewhat faster than prices, but not as fast as average earnings in the economy. It would eliminate essentially all of the long-range deficit.

> Option C: Postpone action on decoupling until a more sophisticated analysis of the alternatives (Options A, B, and others) can be completed -- possibly in conjunction with analysis of other, related Social Security issues.

A better indication of the projected long-range cost requirements of the current system and Options A and B is provided in the chart on the following page. It illustrates the percent of annual taxable payroll that the various options are expected to require.

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



DISCUSSION

## 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 in terms of the percentage of a retiree's previous earnings they replace. This percentage, known as the replacement rate, averages 43 percent in 1976 for single wage earners and about 65 percent for those retiring with a dependent spouse.* For various earnings' levels, the replacement rate is the following:

- Approximately 63 percent of the wages of a single worker earning $3600 (a relatively "low" wage worker).
- Approximately 42 percent of the wages of a single worker earning $8600 (a "middle" wage worker).
- Approximately 30 percent of the wages of a single worker earning the covered maximum (in 1975) of $14,100 (a relatively "high" wage worker).

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 major difference between Options A and B is how they would have replacement rates behave in the future. (Benefit formulas for Options A and B are at Tab D.)

Option A would treat a person <u>on the basis of his relative status among all wage earners</u>, by indexing future initial benefits to wage 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 continue to replace the same portion of pre-retirement wages for persons similarly placed in the earnings spectrum.

Option B, on the other hand, would treat a person <u>on the basis of his real level of earnings</u>, by indexing future initial benefits to price increases. Under Option B,

* Since Social Security benefits are tax free, these rates understate the relationship to after tax (net) income.

replacement rates would remain the same over time for constant 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 21 percent by 2050 due to the progressivity in the formula. Option B assumes that as living standards rise average workers will 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 C is a chart which plots the behavior of average replacement rates under current law and Options A and B.)

Comparative Benefits and Replacement Rates

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 fourfold increase in real wages).

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

Today's "low" wage worker earns about $3600. Because of real wage growth, a comparable earner in 2050 is expected to earn $15,000. 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" and "high" wage worker (and, of course, all other wage earners experiencing real wage growth) 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 whose current replacement rate approximates 100%). 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 Tab B.

COMPARISON OF OPTIONS A AND B FOR "LOW," "MIDDLE," "HIGH," 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 |
| "High" | | | | | |
| 1976 | 14,100 | 4,800 | 4,800 | 34 | 34 |
| 2050 | 63,800 | 22,500 | 11,000 | 34 | 17 |
| "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 Tab B). 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 Costs

Long-term cost is also an extremely important consideration. Under the 1975 actuarial assumptions, Option A was expected to require 16.2 percent of taxable payroll in 2050. The current law's tax rate is 9.9 percent with a scheduled increase to 11.7 percent in 2011. (These costs and rates do not include Medicare.) Option B was estimated to require 8.8 percent. As stated earlier, the proposed 1976 assumptions would result in significantly larger deficits. Tab B has additional comparative cost data.

A strong cautionary note with regard to actuarial assumptions should be made at this point because 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 fertility rate. 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 (2 percent real wage growth, 4 percent inflation, and a fertility rate of 2.1), the system was projected to have an actuarial deficit of 5.3 percent of taxable payroll -- this resulted in an actuarial deficit of approximately $2 trillion and generated widespread public reaction.

In this year's draft Trustee's Report now under review, further revisions in the actuarial assumptions are under consideration (specifically 1.75 percent real wage growth, 4 percent inflation, and a fertility rate of 1.9). In conjunction with other changes, the revised assumptions result in deficits averaging 8 percent of taxable payroll and an actuarial deficit closer to $3 trillion. This is not to say that conditions are significantly different this year from last, but reflects the multiplier effect of even small changes in assumptions when projected over time.

At this point, the new assumptions have not yet been ratified by the trustees, and some disagreement exists among them on whether the new assumptions should be adopted. Most economists caution against relying on a single set of assumptions and prefer that a range be used. (The draft Trustee's Report uses an "optimistic," "intermediate," and "pessimistic" set but refers often to the results caused by the "intermediate" set).

SUMMARY TABLE -- "INTERMEDIATE" ACTUARIAL ASSUMPTIONS

| Assumptions | Inflation | Real Wage Growth | Fertility | Average Annual Deficit (% Payroll) |
|---|---|---|---|---|
| 1975 | 4% | 2.0% | 2.1 | 5.3% |
| 1976* | 4% | 1.75% | 1.9 | 8.0% |

*Under consideration for inclusion in 1976 Trustee's Report.

No one seems to believe that the decoupling question should be decided by the results of the revised assumptions because they are so inherently speculative. However, you do need to be aware of their existence and their vulnerability to public misunderstanding. You also need to know that under the revised assumptions, Option A is expected to reduce the 8 percent annual deficit to 4.3 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 still expected to eliminate most of the long-term deficit.

PROS AND CONS

## PROS AND CONS

OPTION A: Decouple -- Index Future Initial Benefits To Growth In Prices and Real Wages (Average benefits grow in direct proportion to average earnings.)

Pros:

- Option A eliminates the overadjustment for inflation and reflects the recommendation of the independent 1975 Social Security Advisory Council. 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 and Economic Report. 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 from the announced position 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 remaining long-run financing problem. This permits consideration of various changes falling between the 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 total solution to the problem. You could simultaneously announce the establishment of a study team to develop more far-reaching, long-term recommendations.

<u>Cons</u> (Option A):

- Option A solves only 50 percent of the long-term financing problem. Under the proposed assumptions in the 1976 draft <u>Trustee's Report</u>, Option A translates to a long-term average annual deficit of 4.7 percent of covered payroll -- well in excess of $1 trillion. This could be publicly compared unfavorably with last year's estimated 5.3 percent average deficit for the <u>coupled</u> system.

- By itself, Option A 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 to deal with other issues not directly linked to that problem. As time passes, the system may become increasingly difficult to change. Cost pressures may also make it impossible to give benefit increases to the retired population whose benefits increase only with the CPI.

- The remaining long-term projected deficits may further erode public confidence in the system -- especially in light of the proposed revised assumptions in the draft <u>Trustee's Report</u>.

OPTION B: <u>Decouple -- Index Future Initial Benefits Proportionately to Price Growth and Less Than Proportionately to Real Wage Growth</u> (Average benefits grow somewhat faster than prices, but significantly slower than average earnings.)

<u>Pros</u>:

- Option B would eliminate most of the long-range deficit, thus putting the Administration on the side of prudent fiscal management in a way that would preserve the financial integrity of the system without further tax increases.

- It is in keeping with the independent findings of the non-partisan Hsiao study panel.

- 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 appeal because it returns to Congress more financial latitude for making discretionary increases or other popular reforms that could add to costs.

<u>Cons</u> (Option B):

- Option B will 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 and Economic Report 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.

- It invites criticism for making major changes in the system without detailed analysis and public debate of the underlying role, economic implications, and philosophy of Social Security. (Option A is subject to the same criticism, but to a far smaller degree.)

OPTION C: Postpone Action On Decoupling

Option C would postpone any initiative on decoupling until a more thorough analysis of the implications of the various options could be undertaken. This would involve the development of a much more sophisticated model for forecasting changes in the system. At the same time, there would be time to study related 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 support of your own non-partisan position.

Pros:

- Option C would provide an opportunity for extensive analytic effort geared toward the preparation of a well-founded decoupling option (and, possibly, a comprehensive Social Security reform package). It would permit the development of a more sophisticated data base for making projections and comparisons among a wider variety of decoupling options.

- 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 also may preserve the opportunity to link comprehensive structural reform to correction of the "coupling" problem.

Cons:

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

- There is no guarantee that a more sophisticated computer model (or a comprehensive study of issues) will lead automatically to a consensus position on major questions which are inherently difficult to answer, require important value judgments, and invite controversy.

RECOMMENDATIONS

STAFF RECOMMENDATIONS

Those Favoring Option A:

Jack Marsh

Max Friedersdorf

Bill Seidman

Robert Hartmann

He stipulates, however, "after November."

Secretary Mathews (Tab E)

He views Option A as the proper way to stabilize and significantly reduce long-range costs of the system "without fundamentally changing its nature." He believes it sets the stage for further analysis of options for additional reforms. He believes Option B would "reflect adversely" on your political credibility and would put you in the position of supporting "an unachievable fundamental deliberalization" and "major restructuring" of the system.

He believes your earlier support of Option A earned you credit from labor and other Social Security watchers, and that a change now would catch them by surprise. He believes the "issues implicit in Option B merit further study," but believes a commitment to such study is all that is appropriate at this time.

Secretary Usery (Tab F)

He believes that to propose any other decoupling model would be "disastrous," and, in light of the 1977 Budget and Economic Report language, he believes a change now would cause "considerable embarrassment and uproar." He cites organized labor's current strong support for Option A as important to achieving any decoupling.

Secretary Richardson (Tab G)

He "strongly recommends" that you hold "to your December decision" of Option A. He believes that "to go further at this time -- as in

Option B -- would unnecessarily entail serious political risk, for a long-term solution that is less than optimal, in a manner that could well prove self-defeating." He believes "a skillful Democratic opponent would have no trouble converting (Option B) into a major negative issue" and sees Option C as raising "unnecessary uncertainties."

He believes the proposed revised actuarial assumptions in the <u>Trustee's Report</u> coupled with Option B invite a charge of an "overall 'plot' to 'reverse' or 'undo' the recent Social Security gains, if not the whole system itself." Substantively, he believes the system may properly belong somewhere between Options A and B, but believes the best strategy for reaching that point is to go ahead with your December decision to eliminate the "technical flaw" in the system, and direct that we continue "to pursue analysis of the broader long-term issues."

<u>Those Favoring Option B:</u>

Jim Lynn (Tab H)

He believes Option A is much too expensive, would have "negative implications for employment, businessmen's costs, and capital formation," and would lead to "significantly higher payroll taxes or general revenue financing in the future." He believes Option A, as a "highly generous program," would be difficult to reform in the future.

He believes Option B is politically viable because of widespread understanding of the need to correct the coupling problem, and because Option B would not reduce anyone's benefits relative to today -- but rather increase them more slowly than Option A. He believes the Budget and Economic Report announcements could be countered by citing the Hsiao recommendations and the cost impact of the proposed assumptions in the draft <u>Trustee's Report</u>.

Secretary Simon (Tab I)

He believes it is "the only responsible decision economically or politically," and that Option A and C "would be rightly criticized outside the Administration as a failure to face up to the problem." He emphasizes that Option B does not affect current beneficiaries in any way and still provides growing benefits for future retirees. He believes projected aggregate expenditures should be an important element of the decision.

Those Favoring Option C:

Phil Buchen

He believes we should delay "announcement of a decision in this area until such time as a complete plan is designed." He would, however, "support Option A as preferable to Option B."

Council of Economic Advisers (Burt Malkiel) (Tab J)

The CEA believes much more sophisticated study is required of the impact of various decoupling options (including, but not limited to, A and B) before a decision can be made. They believe current analysis is based on "very limited technical data," so they would create a more sophisticated computer model to replace what they view as "primitive equipment" used by the Social Security Administration.

They find Option A "completely unacceptable" because of excessive cost considerations. They also believe Option A will be "extraordinarily difficult" to modify in the future once it is in place. Although the general outline of Option B "appear(s) to be satisfactory," they are hesitant to endorse it because of the data limitations already cited.

RECOMMENDATION

I recommend Option A. When the legislation is ready to be sent up, I think you should make a strong statement reaffirming your various efforts to maintain the financial integrity of the Social Security system. Namely,

(1) Your proposed .6 percent payroll tax increase last December.

(2) Your proposal to eliminate the "technical flaw" in the current law that overadjusts for inflation.

(3) A special directive to the Trustees to develop a plan for analyzing alternative means to eliminate the remaining long-term projected deficits.

My reasons for favoring this course of action are the following:

- Option A represents a major step in maintaining the integrity of the system;
- Option A is the only initiative warranted at this time in the absence of more analysis;
- Option A is a re-affirmation of your December decision, and therefore represents minimal political risk; and
- Option A can be announced with full acknowledgment of the remaining long-term financial problem requiring further study.

DECISION

Option A. Decouple -- Average future initial benefits grow in direct proportion to average earnings. GRF ______

Option B. Decouple -- Average future initial benefits grow somewhat faster than prices, but significantly slower than average earnings. ______

Option C. Postpone the Decision. ______

TAB A-December
Decoupling
Decision

## ADMINISTRATION'S PUBLIC STATEMENTS ON THE 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

> "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)

TAB B
Comparison of
Options A and B

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 |

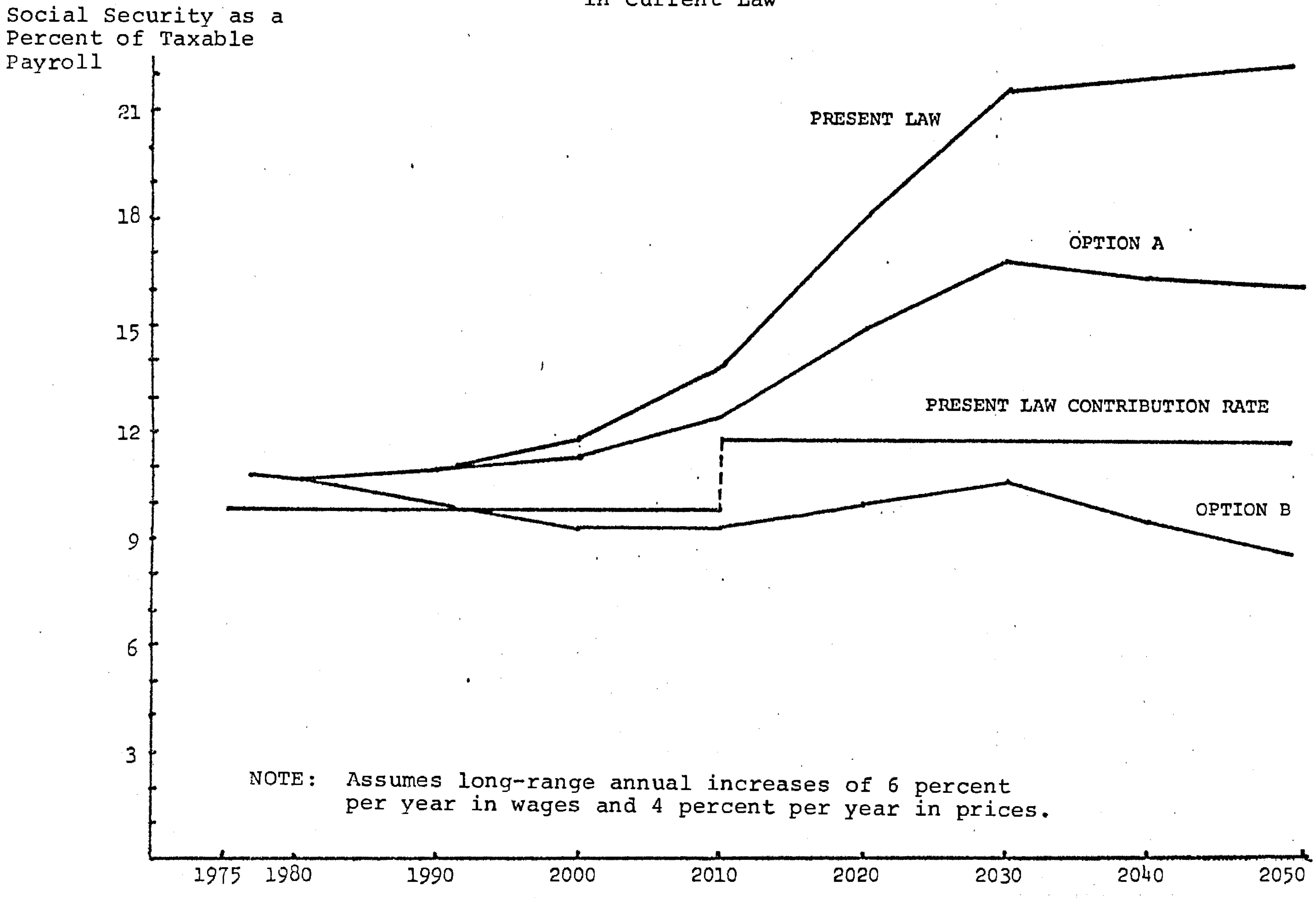
1/ Primary insurance amount at age 62 as a percent of earnings in the preceding year.

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.

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 percent per year in wages and 4 percent per year in prices.

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 1/ Rate 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 1/ Rate 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.

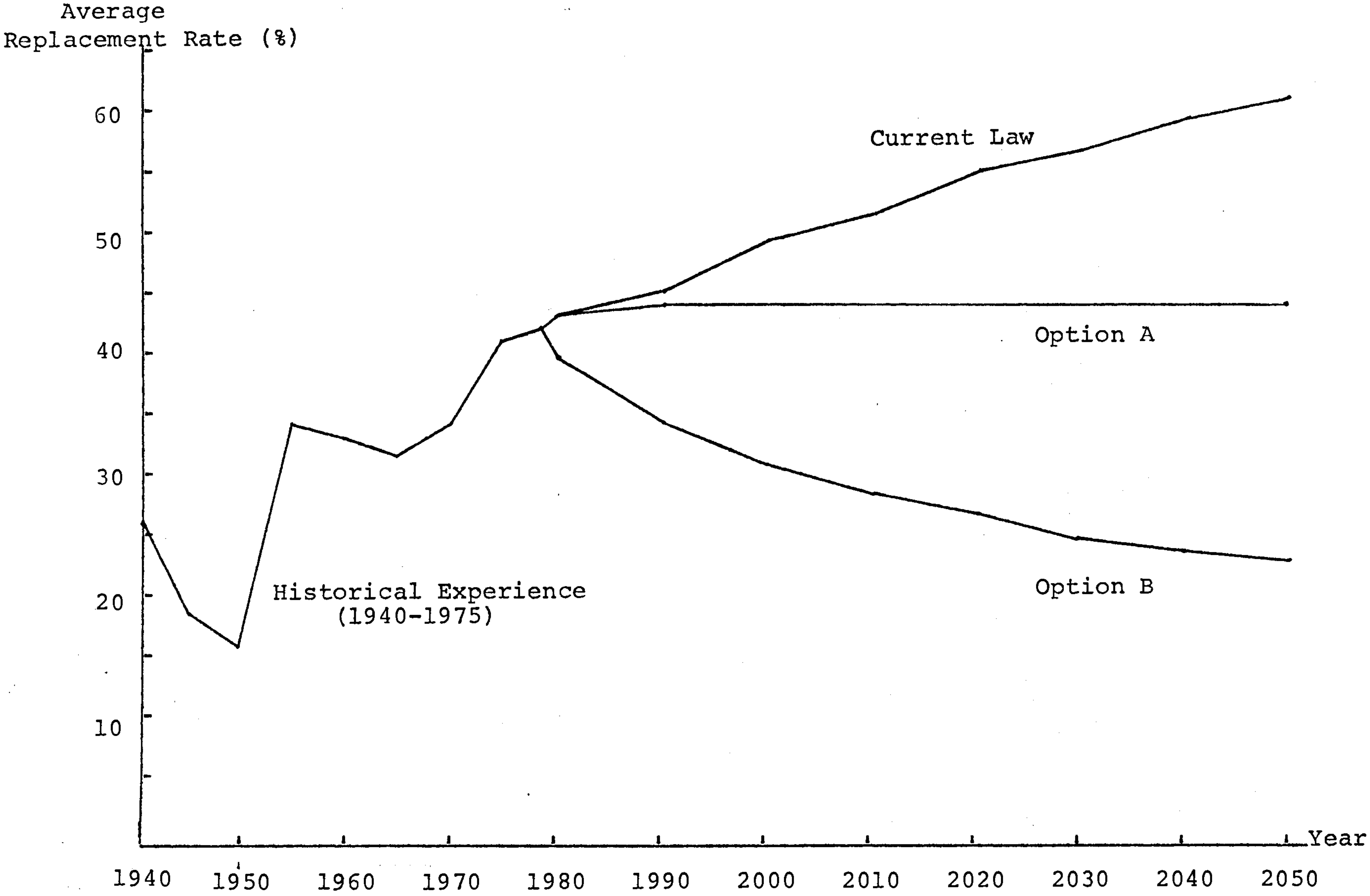
3/ Married couples refer to couples where the wife has no social security benefit in her own right.

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

TAB C - Replacement Rates

COMPARISON OF PROJECTED REPLACEMENT RATES:

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



TAB D - Benefit Calculations

BENEFIT CALCULATION FORMULAS

OPTION A: Provides benefits based on earnings indexed to increases in average wages through age 60. Benefit in 1978 computed using the formula 90% of the first $180 of average indexed monthly earnings (AIME), 33% of the next $875 of AIME, and 16% of all AIME over $1055. For future years the formula would be adjusted to increases in average wages.

OPTION B: Provides benefits based on earnings indexed to increases in the CPI through age 61. Benefit in 1978 computed using the formula 93% of the first $175 of average price indexed montly earnings (APIME), 33% of the next $860 of APIME and 17% of all APIME over $1035. For future years the formula would be adjusted to increases in the CPI.

TAB E - HEW
Comments

THE SECRETARY OF HEALTH, EDUCATION, AND WELFARE
WASHINGTON, D.C. 20201

APR 13 1976

MEMORANDUM FOR HONORABLE JAMES M. CANNON

I am writing to set forth the Department's comments on your draft memorandum on social security long-range financing, as requested in your memorandum of April 7.

As a general proposition, we see the memorandum as doing a credible job of presenting a complex issue.

We would, of course, like to see the Recommendation section of the memorandum state clearly our support of Option A and our opposition to Option B. I would cite, in general terms, three reasons for our position:

1. We see Administration advocacy of Option B as reflecting adversely on the President's political credibility. As a practical matter, it would place the President in the position of supporting an unachievable fundamental deliberalization of the social security program. We see just about everyone as opposing it.

2. Electing Option B at this time and in this fashion would be to elect a major restructuring of the social security system without having considered all of the choices, all of the options, and all of the implications. We do not think this is a good way to shape public policy, nor do we think it would reflect well on the Administration. Election of Option A, on the other hand, accomplishes the major objective of stabilizing and significantly reducing the long-range costs of the social security system without fundamentally changing its nature and sets the stage for a thorough and comprehensive analysis of the options for and implications of further reforms in social security.

3. Adoption of Option B will represent a departure from an earlier Presidential position for which the labor movement and other social security watchers were giving him credit. A change of this

kind at this time will not only draw their natural opposition, but will surely catch them by surprise. On this point, although no specific details have ever been shared outside the Executive Branch, everyone must understand that an expectation has been developed to the effect that when the details of the President's proposal were finally made public, they would follow the principles of Option A. The issues implicit in Option B do merit further study, but since this option would fundamentally alter (reduce) the social security system (a system the President has pledged to defend), a commitment to such study seems to us all that is indicated at this time.

Enclosed are more detailed comments about the style and substance of the draft memorandum.

David Mathews

Secretary

Enclosure

TAB F - Labor Comments

U. S. DEPARTMENT OF LABOR

OFFICE OF THE SECRETARY

WASHINGTON

April 27, 1976

MEMORANDUM FOR JIM CANNON
BILL SEIDMAN

FROM: W.J. USERY, JR.

SUBJECT: Views to be Incorporated in Social Security Decoupling Memorandum to the President

(1) I think it would be disastrous to propose any alternative other than Option A as the decoupling model. However, I do not mind combining such a decoupling plan with a set of proposals addressing the question of how best to deal with remaining long term financing problems.

(2) Organized labor strongly supported Option A when it was announced earlier as the President's position. This support is important in achieving any decoupling.

(3) The President clearly and specifically proposed Option A in the 1977 Budget and the Economic Report. It would cause considerable embarrassment and uproar to back off now.

TAB G - Commerce Comments

THE SECRETARY OF COMMERCE

WASHINGTON, D.C. 20230

April 30, 1976

MEMORANDUM FOR THE PRESIDENT

SUBJECT: SOCIAL SECURITY "DECOUPLING"

This is to provide my recommendation with respect to the alternatives presented in Jim Cannon's memo on social security decoupling. Among the options presented, I would strongly recommend Option A--i.e., holding to your December decision to "decouple", while assuring that, as stated in your Budget, "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." A summary of my reasons is as follows:

(1) The other options--especially option B--would bear a high political cost. As you know well, the aged constituency is very large and extremely sensitive to social security issues. Further, the aged represent a highly organized constituency which votes in disproportionately high numbers. Although option B could undoubtedly be articulated in terms of "concern for the long-term integrity of the social security system," a skillful Democratic opponent would have no trouble converting this into a major negative issue. And option C, while less troublesome politically, would nonetheless raise unnecessary uncertainties.

(2) When linked with the anticipated Trustees Report--with revised actuarial assumptions and a dramatically increased projected deficit--these political problems would be compounded. If option B were chosen, the charge would undoubtedly be made that the actuarial assumptions had been "suddenly" modified as part of an overall "plot" to "reverse" or "undo" the recent social security gains, if not the whole system itself. Further, the linkage of option B with the anticipated Trustees Report--and the associated reduction in the likely credibility of the Report itself--could conceivably reduce the opportunity for necessary and desirable reforms. That is, the ultimate cost could be substantive as well as political.

(3) <u>There are better ways to solve the long-term financing problem than option B</u>. On substantive grounds one can well argue that, for the long term, the average wage-replacement rate ought to be lower than that of option A. But it need not necessarily be as low as option B. There are, of course, many intermediate alternatives. And the remaining financing problems associated with these could be addressed through the tax side of the equation--e.g., holding to your proposed 0.6% tax increase for the near term with a greater tax increase in the more distant term--or through a combination of a moderate tax increase and other necessary reforms (e.g., a tightening of the rapidly expanding disability insurance portion of the social security system).

(4) <u>It is not necessary for you to change your position now--a comprehensive approach to the general financing problem can await further study</u>. This, of course, is the position you took in December. It was not then contemplated that decoupling would solve the whole financing problem. Decoupling was intended simply to remedy an "inadvertent feature of the 1972 social security amendments." The broader long-term financing problem--soon to be highlighted by the Trustees Report--legitimately suggests the need for a broader look at social security financing. It does not, however, require any immediate action beyond option A and a directive to continue to pursue analysis of the broader long-term issues.

In sum, it seems to me that option A is a responsible approach to the narrow decoupling problem. The longer term financing problem requires additional review. To go further <u>at this time</u>--as in option B--would unnecessarily entail serious <u>political risk</u>, for a long-term solution that is less-than-optimal, in a manner that could well prove self-defeating.

Elliot L. Richardson

TAB H - OMB
Comments

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

APR 29 1976

MEMORANDUM FOR THE PRESIDENT

FROM : James T. Lynn

SUBJECT : Social Security Decoupling

A. Recommendation - OMB recommends Option B.

B. Arguments for Option B

- Although Option B is often portrayed as representing a reduction in the role of social security, it is important to emphasize that it treats people retiring in the future at specific income levels slightly more generously than they are treated now. For example, the couple retiring in the year 2000 with recent incomes of $8,600 in 1976 purchasing power will receive the equivalent of $6,000 in 1976 dollars. They currently receive $5,400.

- The average replacement rate for the whole population of new retirees will decline through time and this inspires the charge that Option B represents a reduction in social security. The average replacement rate falls solely because the society becomes richer on average and the present system provides a lower replacement rate for higher income retirees.

- Option A must counteract the tendency for the average replacement rate to fall and does so by continually raising the replacement rate for individuals retiring at a given level of income. For example, the couple retiring at $8,600 would receive a benefit of $8,400 in the year 2000 under Option A as opposed to the $6,000 received under Option B.

- This constant increase in the replacement rate plus the large future increase in the ratio of the retired to working population makes Option A very expensive in the long run.

- Option A results in a payroll tax over the long run that is roughly 35 percent higher than that implied by Option B. Option B can be financed with current tax rates under the economic and demographic assumptions used in the last Trustee's report.

- The high tax rates implied by Option A have obvious negative implications for employment, businessmen's costs, and capital formation, in addition to the high burden imposed on the worker.

- Option A implies that retirees at a given level of income will rely less and less on private pensions as time goes on and more and more on social security. Option A's maximum benefit for a couple would rise to over $35,000 in present day purchasing power by the year 2050.

- Since we obviously cannot afford such generosity, advocates of Option A argue that it will necessitate reform and cutbacks in the future. We would argue that it is much easier to reform a less expensive system than it is to cutback and reform a highly generous system. Moreover, if we want to avoid the need for significantly higher payroll taxes or general revenue financing in the future, we shall eventually have to adopt some variant of Option B.

C. Countering the Political Arguments Against Option B

1. Option B represents a reduction in the role of social security.

   Everyone agrees that the rate of growth of social security implied by the present double-indexed system must be cut back. No one believes that social security should be reduced absolutely to less than it provides today. With Option B no one loses in comparison to the benefits received this year. Benefits grow through time both on average and in the first few years for individuals retiring at a given level of real income. They simply do not grow as fast as the average standard of living, and therefore, average replacement rates fall.

2. Option B represents a retreat from the proposals made in the January Budget.

   True. The issue was re-examined in the light of the recommendations of the bipartisan Hsiao panel report and in the light of the higher deficits now forecast by the Trustee's report.

TAB I - Treasury
Comments

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

APR 28 1976

MEMORANDUM FOR JIM CANNON

FROM: William E. Simon WES

Subject: April 22 Draft Memo to the President on Social Security Decoupling

The new draft of the memo is a further improvement in clarity from the last one. However, we do still have a few problems with it, and I have asked David Ranson to communicate these to you directly.

The Treasury Department strongly favors Option B. However unpopular, it is the only responsible decision economically or politically. Option A or Option C would be rightly criticized outside the Administration as a failure to face up to the problem. It should be emphasized to the President that Option B would in no way affect the payments received by the 30 million or so who are already retired. And, in terms of dollars of constant purchasing power, it would still provide for continually higher per capita benefits for successive retiring generations in the future.

One remaining concern of mine is that the details of Options A and B are not spelled out in the memo. Only an outline of the logic behind them is provided. As a result, the Social Security actuaries say they are unable to make definitive calculations on the financial consequences of the options. I think it would be desirable to have definitive figures for the President. The figures should also be fully up-to-date.

Finally, I urge you once more to present the projected aggregate expenditures of OASDI under current law and under Options A and B. These figures can readily be obtained from the actuaries' computer program. There is nothing like seeing the consequences of one policy or another in terms of hard dollars.

TAB J - CEA
Comments

COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

ALAN GREENSPAN, CHAIRMAN
PAUL W. MACAVOY
BURTON G. MALKIEL

April 28, 1976

MEMORANDUM FOR JIM CANNON

Subject: Social Security Financing

We have been giving considerable thought to the decoupling issue and have become increasingly convinced that Option A would be an irresponsible course to follow. Under Option A, an automatic mechanism is set in place that continually raises the benefits that individuals with comparable levels of earnings will obtain as time goes on. The amount by which benefits are raised at each level of earnings is related by formula under Option A to increases in average annual payroll covered by social security.* Under any reasonable forecast average annual covered payroll will rise by about 1 to 2 percent (adjusted for inflation) and as workers become wealthier, benefits under Option A will rise sharply for workers coming up for retirement. For example, under Option A, by the year 2050, assuming a 2 percent a year growth in real average payroll (deflated by a price index), a worker earning $8,600 in the year 2049 (in 1976 dollars) would be awarded the full $8,600 a year in benefits at retirement if single and $12,900 if married with a dependent spouse. At present a worker earning $8,600 receives benefits of $3,600 if single and $5,400 if married. Thus under Option A, as indicated below, benefits at a given earnings level steadily increase and, similarly, replacement rates increase.

| Year of Retirement | Retirement earnings in constant 1976 dollars | Option A benefits | | Option A Replacement Rates | |
|---|---|---|---|---|---|
| | | Single worker | Married worker | Single worker | Married worker |
| 1976 | $8,600 | $3,612 | $5,418 | 42% | 63% |
| 2050 | 8,600 | 8,600 | 12,900 | 100 | 150 |

*This hybrid statistic is heavily influenced not only by changes in wage rates but also by changes in hours and weeks worked. Thus, if the mix of workers shifts to longer hours and more weeks worked, benefits would automatically rise.

In this sense, Option A does not fully decouple since it goes beyond simply removing the effect of inflation and changes the benefit formula each year to counteract the progressive features in the current social security system.

Option A is not consistent, moreover, since those who are already retired have their benefits adjusted each year only for the rise in the cost of living. They do not receive the extra increment for the increase in average covered payroll which will typically exceed the increase in cost of living by 1 to 2 percent. Such a provision would of course add a considerable cost to the already enormous price tag of Option A.

The cost of Option A is of course another objection. Under the economic assumptions of the 1975 Trustees Report, Option A would require a social security tax of 17 percent of covered payroll by the year 2030. Under the new assumptions the tax required would be 20 percent of payroll or more. Once Option A is in place it would, however, be extraordinarily difficult to lower benefits. Option A would impose on the future economy of this country a social security bill that would be a heavy burden to future wage earners and a socially divisive issue to the nation.

Although we find Option A completely unacceptable, we hesitate to endorse Option B although in general outline Option B would appear to be satisfactory. Our hesitancy stems from the very limited technical data which are now available to formulate and analyze social security options. To forecast changes in social security benefits under different options would require a sophisticated computerized model which can simulate changes in lifetime earnings profiles and in the mix of men and women (by marital status and skill level), changes in birthrates and mortality experience of these groups along with changes in economic conditions. With such a model we could readily test the effect of different assumptions and the sensitivity of different indexing schemes to these assumptions. One reason why the Amendments of 1972 which gave us double-indexing were passed without notice was that a mechanism for looking at a variety of assumptions was not in place. Nor is it now. So we are proceeding with only the most primitive equipment to tackle a very difficult problem.

We therefore are in favor of Option C which would insure that the technical apparatus be put in place for formulating and evaluating options. With the assistance of outside consultants to advise on the formulation of some of the basic relationships (such as the sensitivity of work patterns to economic conditions) a group of econometricians could put together a model in a year. The Hsiao group has already made a start in that direction and some work has also been done in HEW that could be incorporated in a model although it has not yet been utilized.

Comments on the April 23 memo

With respect to the memo for the President, we still find that Options A and B are not fairly or correctly described in the short summary (p. 4 and 5). We are of course pleased to see Option C reappear. However, the reasons in favor of Option C are not clearly given. The issue of long run problems with the basic social security system is quite different from the issue of the lack of an adequate model for evaluating options. The latter reason is the primary one for delay of a year since the more profound questions are not likely to be settled so soon.

In detail the following changes are requested:
p. 4 and p. 5 - Starting with the last paragraph on p. 4 and continuing to p. 5 the description of the Options should be reworded:

"Option A: This plan (favored by Social Security) is designed to counteract the progressive feature in the social security system which provides for benefits that replace a smaller proportion of past earnings as the income of the worker rises. Wages are expected over time to rise faster than the CPI. Option A adjusts the benefit formula each year so that, as workers grow richer through time, benefits to new retirees on average will continue to grow as fast as income no matter how high or how fast income grows. However, to achieve this result, workers with the same earnings over time will get an increasing benefit on retirement, replacing an increasing amount of their past earnings. This option is projected to cost about 50 to 55 percent as much as the present system using the coupled formula. However, it is still projected to place increasing financial burdens on the system, requiring a tax of about 20 percent of covered payroll by the year 2030."

"Option B: This plan (similar to the Hsiao proposal) is designed to correct only for inflation. Through time a worker with a particular level of purchasing power (say $10,000 a year in 1976 dollars) would always receive the same benefit (adjusted for inflation) at retirement. However, because more workers shift into higher real earnings brackets as time goes on as a result of economic growth, more workers will move into the ranges of the progressive social security fromula which provides for benefits that replace a smaller proportion of past earnings as earnings rise. Thus the average real benefit will grow as workers become richer, but the average benefit will not grow as fast as average income. This option is projected to require no increase or only a modest increase in taxes over time."

"Option C : Postpone the presentation of a specific decoupling option until a computerized model can be put in place that can fully test the sensitivity of Options A and B to different assumptions and until a wider range of specific decoupling options can be analyzed."

p.7 - The 1975 assumptions cannot be defended as better than the 1976 assumptions and indeed the majority vote was for the 1976 assumptions. In view of the fact that the Trustees Report is imminent, all of the calculations should be redone and presented based on the 1976 assumptions. Moreover, the paragraph on "disagreement among the trustees" is clearly unnecessary in view of the majority decision. The point should of course be made that different assumptions produce different results.

Pros and Cons - p. 9 through 13.

Under Option A it is misleading to mix up the historical pattern of replacement rates with the projected trend under a coupled system. It is reasonable to suppose that, in the absence of the coupling Amendments, replacement rates would have declined as financial pressures increased. The actual historical pattern shown in Tab E does not indicate an inexorable upwards movement in the pre-coupled era.

It is also misleading to describe the Hsiao proposal as a major restructuring since it merely corrects the system for inflation and nothing else. No change is made in the relationship between earnings and benefits.

Under Option B it is incorrect to say that benefits would be indexed to prices -- at least not average benefits. Benefits would rise faster on average than prices, but just not as fast as wages.

Specifically, we request the following changes as marked in the original text attached.

Attachment

Burton Malkiel

Burton G. Malkiel