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ECONOMIC POLICY BOARD MEETING
Friday, November 7, 1975
Roosevelt Room
8:30 a.m.

THE WHITE HOUSE
WASHINGTON

Nov. 7, 1975

JMC:

You are scheduled to discuss Social Security Financing at the EPB meeting tomorrow morning and are first on the agenda - 8:30 a.m.

Pat Gwaltney and Grady Means will be attending this particular session.

p

VERY IMPORTANT TO BE READ TONIGHT
ART QUERN.

THE WHITE HOUSE

WASHINGTON

November 4, 1975

MEMORANDUM FOR: ECONOMIC POLICY BOARD

FROM: JIM CANNON

SUBJECT: SOCIAL SECURITY FINANCING

PURPOSE

This memorandum is to bring to your attention some of the problems facing the Social Security System, to raise some fundamental issues regarding the role of social security and to describe within a context of their programmatic, economic and political implications several alternative approaches for dealing with

-- short and long term financing problems

-- broader fundamental and structural issues.

The advice and assistance of members of the Economic Policy Board is requested as we proceed with the development of specific options for the President to consider. The timing of various decisions and the subsequent announcement of legislative proposals is clearly an important strategic consideration and, again, we would appreciate your advice on this matter. We anticipate a decision memo being sent to the President by the end of November.

BACKGROUND

In 1974, the Social Security System collected $58.9 billion for OASDI from 99 million workers in covered employment and paid $58.5 billion in OASDI benefits to 31 million beneficiaries. The current OASDI tax rate is 9.9% (4.95% each paid by employers and employees) on a wage base of $14,100. The wage base will increase $15,300 in calendar year 1976.

Current projections showing substantial declines in the assets of the Social Security trust funds over the next few years and beyond the Year 2000 raise some very serious issues requiring immediate attention. Unless some action is taken, the OASDI trust funds will fall from the current 66% of yearly outgo to 42% in 1977, 32% in 1978, 9% in 1981, and the trust fund assets will be exhausted after 1981. Most experts seem to agree that it is irresponsible to allow the trust fund to decline below 33%.

Benefit outlays from the Old Age, Survivors and Disability Insurance (OASDI) trust funds are expected to exceed payroll tax receipts in 1975 and every year thereafter. In 1975 the shortfall in revenues will be $5.8 billion, which is approximately 0.8% of earnings subject to the payroll tax. Under current law, the projected deficit will average 1.3% of taxable earnings over the next 25 years (1975-1999) and will rise to 4.1% in the following 25-year period (2000-2024).

This projected rapid decline in trust fund assets is due in part to our current economic situation -- high rates of inflation and unemployment have increased benefits and reduced payroll tax receipts. These problems are exacerbated in the longer run by: 1) a flaw in the current system which <u>over adjusts</u> the benefits of future retirees to inflation, and 2) projected future population trends which include a substantially increased ratio of retired persons to the working population at the beginning of the 21st Century.

<u>FUNDAMENTAL ISSUES</u>

Thus, there are very serious short and long term financing problems which require us to take careful stock of the structure of social security, and to clarify some of the fundamental characteristics and objectives of the system and trade-offs among them. These include:

- -- Stability of the Social Security System, including benefit levels and tax rates which should be related to one another and predictable over time.

- -- Role of social security as a mechanism for wage replacement vs. its income redistribution (welfare) aspects.

- -- Adequacy of retirement benefits in terms of maintaining purchasing power vs. reflecting changes in wage patterns.

-- Equity in the treatment of various categories of contributors and beneficiaries over time.

-- Role of social security system in a macro-economic context of economic activity and growth.

-- Public confidence in a stable social insurance system.

SPECIFIC ISSUES

Within this framework of sometimes conflicting characteristics and objectives of the Social Security System, the key specific issues and problems include:

1. Coupled System -- The current method of indexing social security benefits to the cost of living contains a serious and apparently unintended flaw. The benefits of future retirees are over-adjusted for inflation. Not only will their benefits after retirement rise automatically with increases in the CPI, but the current formula also indexes the benefit base (percentage of average monthly earnings) to which CPI increases after retirement will apply, thus creating a "double indexing," situation. Depending on which "decoupling" proposal is selected to remedy this problem, approximately 50% of the long term deficit could be eliminated.

2. Replacement Rates -- The current benefit formula provides various replacement rates (benefit amounts as a percentage of wages) for various wage groups. At the time of retirement, the wages of a Social Security beneficiary are replaced at a given percentage of his wages (replacement rate). After retirement this benefit level rises automatically with increases in the CPI. In the current coupled system, replacement rates for every category of wage earner are rising over time due to the double indexing of the benefit base. This is clearly undesirable and should be corrected.

chart - showing impact?

A central question regarding the benefit structure is whether replacement rates should remain constant or decline over time. If replacement rates are to remain constant, at what level should they be fixed or if they are to decline, at what rate should they be allowed to decline. The benefit formula can be adjusted to produce the desired constant or declining replacement rates.

(CPI)

Because wages normally grow faster than prices, constant replacement rates (holding at current levels, for example) result in real benefit levels which increase over time. Declining replacement rates would hold real benefit levels constant over time, therefore, simply maintaining purchasing power.

3. Minimum Benefit -- The current system includes a minimum benefit of $101.40 payable on the basis of average monthly earnings of $76 or less. The resulting income redistribution effect has been criticized because the minimum benefit is subsidizing some middle and high income people who were not primarily dependent on earnings from employment covered under Social Security. In addition, many low income wage earners could be covered by the supplemental security income (SSI) program which guarantees a minimum income to those eligible.

4. Equity Issues and Dependent's Benefits -- The treatment of working vs. non-working wives, singles vs. married couples and children (ages 18-21) who are in school vs. working must be examined in terms of equity and the relationship of benefits to contributions. The Social Security Administration is currently reassessing the system's policies toward women and of dependents to assure their equitable treatment. Court decisions have held that widows and widowers with children and that male and female spouses shall receive equal treatment.

5. Retirement Age -- The age of eligibility for social security (65 for full benefits) should be examined in the context of changes in longevity and of the effect on employment, savings and private pensions (which generally use the social security retirement age).

let them earn ? more or less ?

6. Earnings Test -- The current provision allows an individual to earn up to $2520 annually or $210 monthly without losing benefits. Above that level, earnings are taxed at a rate of 50%. This annual allowance is scheduled to increase to $2760 in 1976. Alternatives to eliminate or modify this requirement warrant consideration.

7. Impact on Capital Formation -- The effect of expected social security benefits on private savings and the effect of the trust fund on investment and capital formation are issues which require careful examination in a macro-economic context.

8. <u>Impact on Income Tax Progressivity and Employment</u> -- The effects of the regressive social security payroll tax in relation to an overall progressive tax system and as a possible work disincentive are issues requiring attention and analysis in terms of our overall economic policy.

9. <u>Relationship to Private Pensions, Income Transfer Programs</u> -- Although it is clear that a dynamic exists among social security, private pensions and income transfers, additional analysis of the existing and potential interfaces is needed to clarify the appropriate role of each.

10. <u>Definition of Disability</u> -- The disability insurance program has grown rapidly in the last ten years. There were 1,237,000 claims filed in FY 74, an increase of 158% from FY 65. Approximately 2,017,000 disabled worker beneficiaries received payments in FY 74, an increase of 126% over FY 65. And payments increased from $1.4 billion in FY 65 to $6.2 billion in FY 74, an increase of 342%. This growth and projections of sizable future increases raise the issue of whether the definition of disability and the eligibility determination process are adequate and effective.

<u>POLITICAL CONTEXT</u>

An awareness of the political environment surrounding the social security system is crucial as we sort out these very important issues. Decisions regarding social security have traditionally followed a unique 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 constituencies 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 a high level advisory working group, which will recommend policy changes to the Committees in the spring of 1976.

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

We find ourselves in a situation where postponing action ~~too~~ much longer may seem irresponsible in the face of a rapidly declining trust fund, and where an attempt to provide a remedy for every possible wrong with social security may seem extreme and may render a longer range proposal to restructure the system irrelevant to the Congressional and public debate. Instead, it is our judgment that the most useful course would be to proceed with the immediate development of decoupling and short-term financing options for the President while at the same time initiating a process and forum for analysis of the fundamental structural questions over the coming year.

for more than 3 mos,

DOMESTIC COUNCIL APPROACH

The Domestic Council is currently developing and examining in conjunction with the Social Security Administration several alternative decoupling and short term financing measures which would stabilize the trust fund until 2000 at least. In addition, it is our sense that some of the fundamental structural questions and longer term financing issues require further analysis and time to educate the public to these issues and to develop a consensus about responsible longer term solutions.

ALTERNATIVES FOR IMMEDIATE ACTION

Alternatives for immediate action which are being considered include decoupling proposals (which eliminate at least 50% of the long term deficit) in combination with short term financing measures, which would stabilize the trust fund until after the year 2000.

A. Decoupling Alternatives

The term "decoupling" refers to proposals that would provide a new method of determining social security cash benefits for future retirees which would eliminate the double indexing, but which would not affect the automatic cost of living increases that are provided after a person retires. A decoupled system will eliminate approximately 50% of the long term deficit, but have little effect on the declining trust fund before 2000. The decoupling models are described as follows:

1. The "high 20" model bases benefits on actual dollar earnings averaged over 20 years; this is the averaging period under law for people retiring at age 62 in 1976.*/ A weighted benefit formula has been devised by SSA which closely approximates replacement rates under present law at the time of implementation, thus facilitating a smooth transition to the new system. Replacement rates would remain stable over time at approximately the current levels.

2. The second model includes a computation period which lengthens each year until it ultimately reaches 35 years, as under current law.*/ A worker's actual earnings would be indexed in relation to average earnings in the economy. The present non-indexed formula, which uses actual dollar wages, gives undue weight to recent earnings. As in the first model, initial benefits would be adjusted for increases in the cost of living after retirement and replacement rates would be stable over time.

3. The third model, like the second, includes a 35 year computation period but indexes actual wages to changes in prices rather than average wage growth, thus expressing wages in constant dollars. Rather than stable replacement rates, this model allows benefits as a percentage of wages to decline over time.

These three models will allow assessment of the tradeoffs between:

-- 20 vs. 35 year averaging

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*/ The retired person's monthly benefit is currently calculated as a percentage of his average monthly earnings which were subject to the payroll tax. For workers retiring in 1976, earnings are averaged over 20 years. After 1976, the averaging periods lengthens until 1991, when earnings will be averaged over a 35 year period.

-- stable vs. declining replacement rates

-- actual wages vs. indexed wages

-- indexing wages to prices vs. wage growth.

B. Short Term Financing Alternatives

To deal with the short term (1975-1999) deficit, several alternatives are being considered to offset the projected deficit over the next 25 years, which will average 1.3% of taxable earnings. These alternatives include the following:

1. Increase payroll tax for employees and employers by .65%.

2. Increase the payroll tax .5% and increase the wage base from the currently projected $16,800 to $19,500 in 1977.

3. Shift funds from the HI trust fund, (medicare) for which a .2% increase (for both employees and employers) is scheduled in 1978, to the OASDI trust fund.

4. General revenue financing for medicare.

C. Other Possible Adjustments

In addition to decoupling and short term financing measures, other alternatives to generate additional revenues and to reduce outlays immediately, but which would have little effect on the long term deficit include:

-- eliminating the minimum benefit;

-- taxing benefits; and

-- prohibiting any cost of living increases in benefits for one year.

A set of options, including decoupling and other short term financing measures which will be prepared by the end of the month, will present for Presidential decisions proposals which would eliminate at least 50% of the long term deficit and stabilize the trust fund until at least 2000.

FURTHER STUDY OF FUNDAMENTAL ISSUES

To allow time for the necessary data collection, for analysis of the broader structural issues and for education of the public and consensus building, it is our judgment that a comprehensive study is needed. The approach that we are considering involves asking Domestic Council members to assist in developing a framework for the study which clearly identifies the appropriate issues, and to 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 either the Domestic Council or in the Office of the Secretary of HEW.

To assist in clarifying the role of the Social Security System, the study should focus on such issues as:

-- wage replacement and income redistribution aspects of social security;

-- relationship of social security to private pensions and income transfer programs;

-- treatment of various categories of contributions and beneficiaries over time.

-- effect of future population trends, wage and price growth on social security;

-- relationship between income and outgo in the system;

-- effect of social security on employment;

-- effect of social security on private savings and capital formation;

-- examination of the payroll tax and other financing alternatives.

CONCLUSION

The current status, therefore, of the Domestic Council's examination of Social Security issues is:

1. Specific, detailed analysis of "decoupling" and short term financing options is nearly complete and will be ready for the President's consideration by the end of November.

2. Since decoupling and short term financing can be characterized as a "benefit decrease" or "tax increase," we include in our analysis alternatives which put off this limited choice for the time being such as eliminating the minimum benefit or the CPI increase. Choosing this course of action would mean that decoupling and short term financing would be included in the fundamental analysis of the system over the next year. Since this delay would mean that the trust fund would fall below 33 1/3% of outgo by 1978 this course of action would be susceptible to charges of irresponsibility and would significantly increase the amount by which taxes will have to be raised once action is taken.

3. Preparation is underway for a comprehensive and fundamental analysis of the entire structure of the social security system. An option on whether to proceed with this sort of study during the coming year will be included in the decision paper going to the President this month.

This then is our sense of the issues involved and our current thinking on the various approaches for dealing with them. We would welcome the advice and assistance of the Economic Policy Board as we prepare the Presidential decision paper.

## Current Benefit Formul

- Benefit schedule weighted in favor of low e less margin for reduction in their incomes.

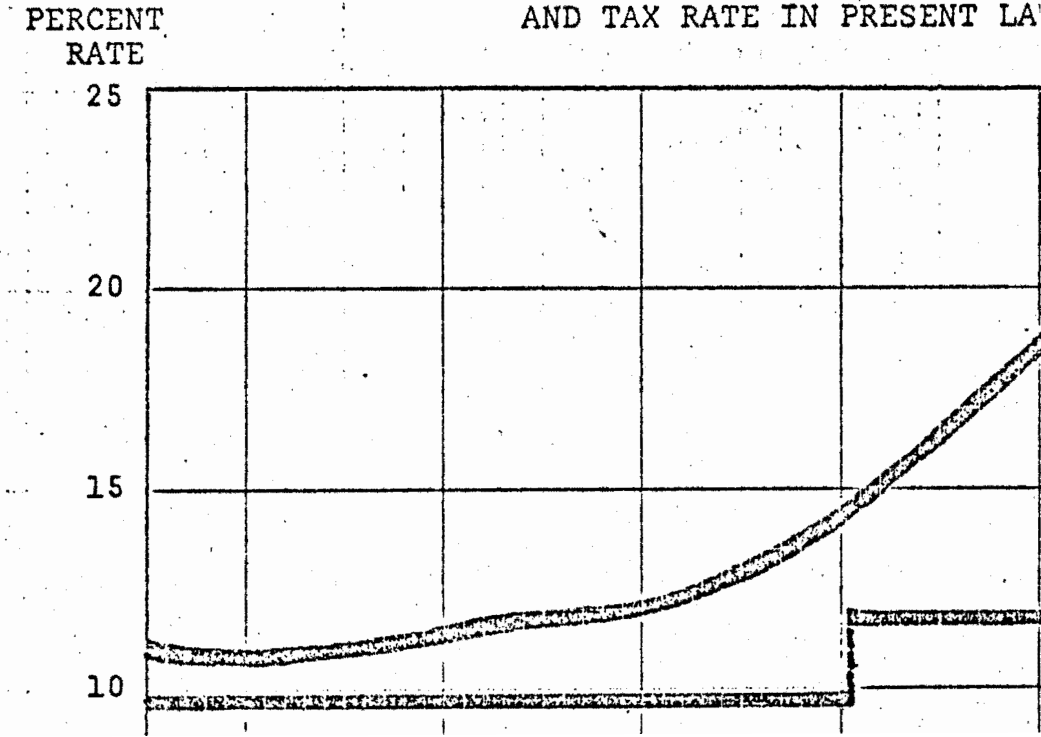
- The following formula closely approximates in the law:

| AME Ranges | Weighting Percent | AI |
|---|---|---|
| first $110 | 129.48 | $ 1 |
| next 290 | 47.10 | 4 |
| next 150 | 44.01 | 5 |
| next 100 | 51.73 | 6 |
| next 100 | 28.77 | 7 |
| next 250 | 23.98 | 10 |
| next 175 | 21.60 | 11 |

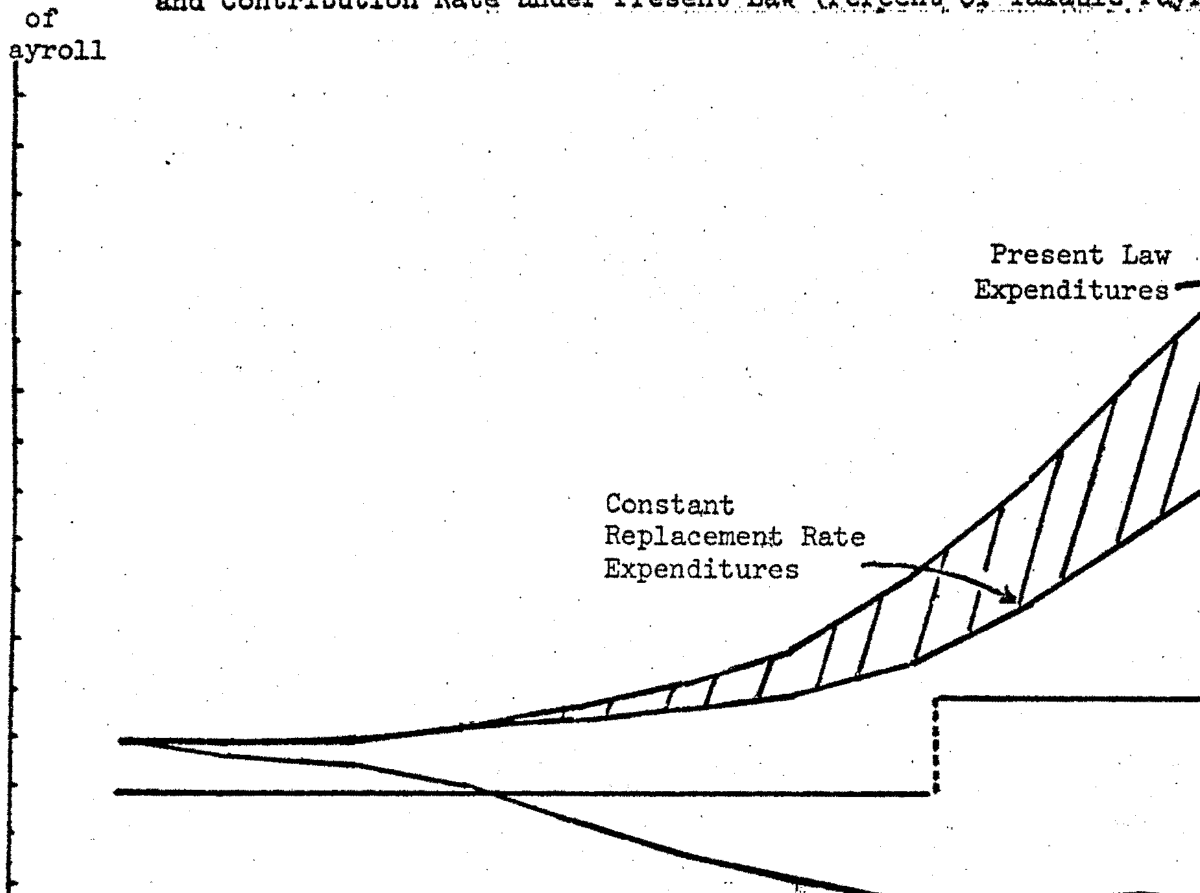
- When automatic cost-of-living benefit increa percentages are increased to reflect the in

PROJECTED OASDI PERCENT OF

AND TAX RATE IN PRESENT LA



Expenditures under Present Law, Constant Replacemen
and Declining Replacement Rates (Maintenance o
and Contribution Rate under Present Law (Percent of Taxable Payr



PROJECTED OASDI BENEFICIARIES PER HUND

1975-2050