The original documents are located in Box 54, folder "1975/12/21 - Social Security Meeting" of the James M. Cannon Files at the Gerald R. Ford Presidential Library.

THE WHITE HOUSE

WASHINGTON

SOCIAL SECURITY MEETING

Sunday, December 21, 1975
4:15 p.m. (45 minutes)
Cabinet Room

From: Jim Cannon

I. PURPOSE

To resolve key questions regarding the short-term financing of Social Security.

II. BACKGROUND, PARTICIPANTS, PRESS PLAN

A. Background: FY 77 Budget deadlines require some key decisions on the short-term deficit facing the Social Security system. The alternatives of limiting benefit increases and/or raising payroll taxes affect:

a. The FY 77 budget

b. The short-term (1975-83) trust fund deficit

In addition, these decisions have implications for the long-term problem facing the system. This affects the issue of "decoupling" which deals with the double benefit for inflation built into the current system. Secretaries Mathews and Simon have very strong and different opinions in this regard.

Attached at Tab A is a two-page paper from Jim Lynn which highlights the issues. At Tab B is a more extensive discussion of the issues with recommendations from your senior advisers. At TAB C is a memorandum from Secretary Matthews.

B. Participants: Secretaries Simon, Dunlop and Mathews, Jim Lynn, Jim Cannon, Paul O'Neill, Art Quern.

C. Press Plan: To be announced.

III. TALKING POINTS

A. Our FY 77 Budget requires us to take a hard look at what actions we should take this year in regard to Social Security.

B. The short-term financing issues and the questions of the current system's overcompensation for inflation will be affected by our budget decisions.

C. These issues are of concern to all of us, and I believe we need to look at the steps we are taking in our FY 77 Budget in relation to both the short and long-term financing issues.

A

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

ACTION

MEMORANDUM FOR: THE PRESIDENT

FROM: James T. Lynn

SUBJECT: Social Security Financing

Annual outgo is exceeding annual income in the Social Security Trust Funds. If present trends continue, the trust funds will be exhausted by 1983.

This problem has been discussed by your staff, and a memorandum will be coming from Jim Cannon which describes several financing alternatives. These alternatives include a tax rate increase (possibly tied to a wage base increase), reducing benefit costs, and decoupling (removing the present double indexing for inflation in the benefit formula).

In preparing the 1977 budget, you have approved a plan to phase in the next two Social Security cost-of-living increases by providing 1/3 of the increase in July, 1/3 in November, and 1/3 in March, in order to significantly reduce 1977 budget outlays.

In reviewing the Domestic Council paper on this issue, you may wish to consider the following approach which would place the Social Security Trust Funds back on a sound actuarial and financial basis through the year 2000.

1. Decouple the system at current replacement rates.
2. Phase in the next two Social Security cost-of-living increases, as we now plan in the budget.
3. Increase the tax rate by .6% (.3% more for employer and employee) in January 1977, gradually moving to 1.2% above current levels by 1984 (.6% more for employer and employee).

Decoupling would remove a costly and unintended feature of the 1972 Social Security amendments, and remove half of the trust fund deficit over the next 75 years. Phasing in the next two cost-of-living increases is an important part of meeting your budget outlay goals between now and FY 1979. The tax rate increase will bring in about $100 more annually for each worker earning the maximum subject to the tax ($50 by employer; $50 by employee). The increased revenues will reduce the overall FY 1977 budget deficit by $2.5 billion, and eliminate all of the trust fund deficit for the next 25 years--to the year 2000.

B

THE WHITE HOUSE

WASHINGTON

December 17, 1975

MEMORANDUM FOR: THE PRESIDENT

FROM: JIM CANNON Jim

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 subleties 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	3%
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:

<u>Option 1</u>: <u>Increase revenues by raising payroll taxes</u>

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 1984.

<u>PRO</u>

The advantage of such a tax increase is that it would eliminate the entire short-term (1975-1999) deficit.

<u>CON</u>

Given your proposal for a permanent income tax reduction and the recent increase in Unemployment Insurance tax rates, 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 leeway 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 elimination 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 existed a general consensus in Congress, among interest groups representing the aged, and among outside 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 estimate that after tax replacement rates for an average earner ($8,400 gross wages) would be approximately 56% without including dependent wives'benefits or approximately 84% 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 3% by 2050) 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 1: 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 50% of the long-term deficit would be eliminated by this alternative. Therefore, additional tax increases (as much as 3% more employer/employee combined by 2050) would be required to finance such a system.

PRO

Because this proposal decouples with a minimum of change in current replacement rates, it would prove the least controversial 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

Future payroll taxes could be reduced. Since the role of Social Security would be lessened over time, people may save more or buy supplementary pensions, thus stimulating 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 discussion of decoupling proposals. Therefore, one of these three models could be proposed 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 may not wish to address at this point. A fourth alternative would be to defer any initiative on decoupling.

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, and label us indecisive or unconcerned about this obvious fault in the system. He therefore recommends Alternative 1, which maintains the current role of Social Security.

--- Alan Greenspan believes that it is premature to ask the President to "choose among the few extremes presented in the memo which have not really been worked out in all their ramifications."

--- 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 one of its agencies 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:

C

14

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

DEC 12 1975

MEMORANDUM FOR THE PRESIDENT

The purpose of this memorandum is to comment on two important social security issues that need to be decided as a part of your 1976/77 budget and legislative program: what to do about the short-term deficit and about "decoupling."

Both of these issues are the subject of a comprehensive memorandum that has either been sent to you or is on its way to you from the Director of the Domestic Council. HEW and others at interest have had a full and fair opportunity to participate in the preparation of this memorandum. However, as the Cabinet Officer responsible for managing the social security program and as a principal Administration spokesman about the program, I thought it important to express my views about these two issues, as follows:

RL

Short-Term Financing

The memorandum lays out several options for dealing with the short-term financing problem. Without debating the merits of any of them, it seems to me that, given the overall budget strategy that you have already adopted, the only consistent choice would be to assume that the short-term deficit will be met through the budgetary device constraining social security benefit payments during the 1976-77 fiscal years. The 60 percent cap, plus other constraints that are being included in the budget, would be sufficient to keep trust fund reserves at an adequate level through at least 1981. We should emphasize, of course, that these devices will not avoid the long-term deficit that is clearly facing the system.

"Decoupling"

I would start out by saying that I am a strong believer in decoupling the system as soon as possible. I would like to see the Administration take the initiative on decoupling as a part of its 1976 legislative program. It is my belief that if we do not do so, the Congress will and, in the process, label us as being either indecisive about or unconcerned with this obvious fault in the system.

I would recommend that you go forward with a social security legislative strategy that incorporates the budgetary policy discussed above with decoupling in the name of "fiscal responsibility."

We would be saying, "We are not going to make the same mistake with this pension system that New York made with its system. The present coupled system results in unpredictable future costs and requires unnecessarily high taxes. We are taking steps to correct it now rather than later."

I am aware that Secretary Simon (and perhaps others within the Administration) would prefer to use decoupling as a device for fundamental change in the overall social security system--change that goes well beyond decoupling per se. The options contained in the Domestic Council memorandum that call for declining future social security "replacement rates" are, in my opinion, options that represent fundamental change. They would employ decoupling as a vehicle for reducing the role of social security relative to the private pension system in providing retirement income.

Because these options have the practical effect of reducing the scope and coverage of social security--reducing benefit levels relative to preretirement earnings--they are certain to be controversial and are certain to attract a great deal of opposition from the labor movement and others interested in promoting the cause of social security.

While I cannot argue against examination of the system in terms of its impact on capital formation, the private pension system and tax and income maintenance policy, I do argue that we lack the time to make such an examination in sufficient depth and be able to present a well-rounded proposal to the next session of Congress--something that I think we would be well-advised to do. As I have already indicated, if we are not on the side of early action, just about everybody else will be, and we will appear to be less than concerned about the system's financial stability.

In short, I recommend that the Administration adopt a decoupling plan that is as neutral as possible on the matter of future fundamental changes in the system and that the plan be included in the Administration's 1976 legislative program.

David Mathews

Secretary

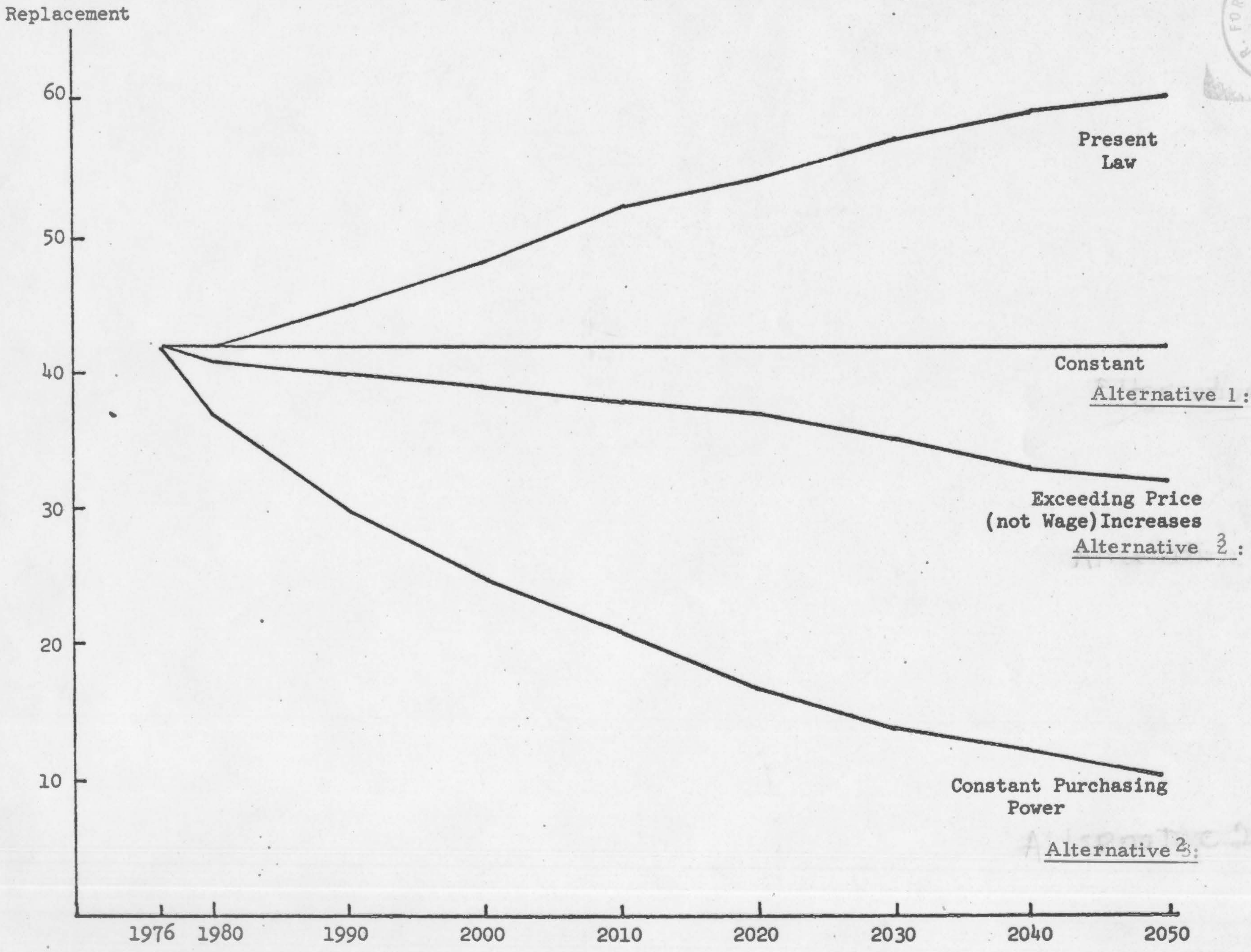
TAB A

Economic Assumptions and Automatic Increases Based on 1975 Social Security Trustees Report Through Calendar Year 1981

Calendar Year	Percent Increase in --- Average Annual Wages	Average Anual CPI	Real Wages	Percent Unemployment Rate	Contribution and Benefit Base	Percent Benefit Increase
1975	6.2%	9.0%	-2.6%	8.8%	$14,100	8.0%
1976	9.0	6.6	2.3	8.0	15,300	6.6
1977	11.0	6.5	4.2	7.0	16,800	6.4
1978	8.8	5.7	2.9	6.2	18,600	6.3
1979	7.7	4.6	3.0	5.4	20,100	4.8
1980	7.0	4.0	2.9	4.8	21,600	4.0
1981	6.0	4.0	1.9	4.8	23,100	4.0

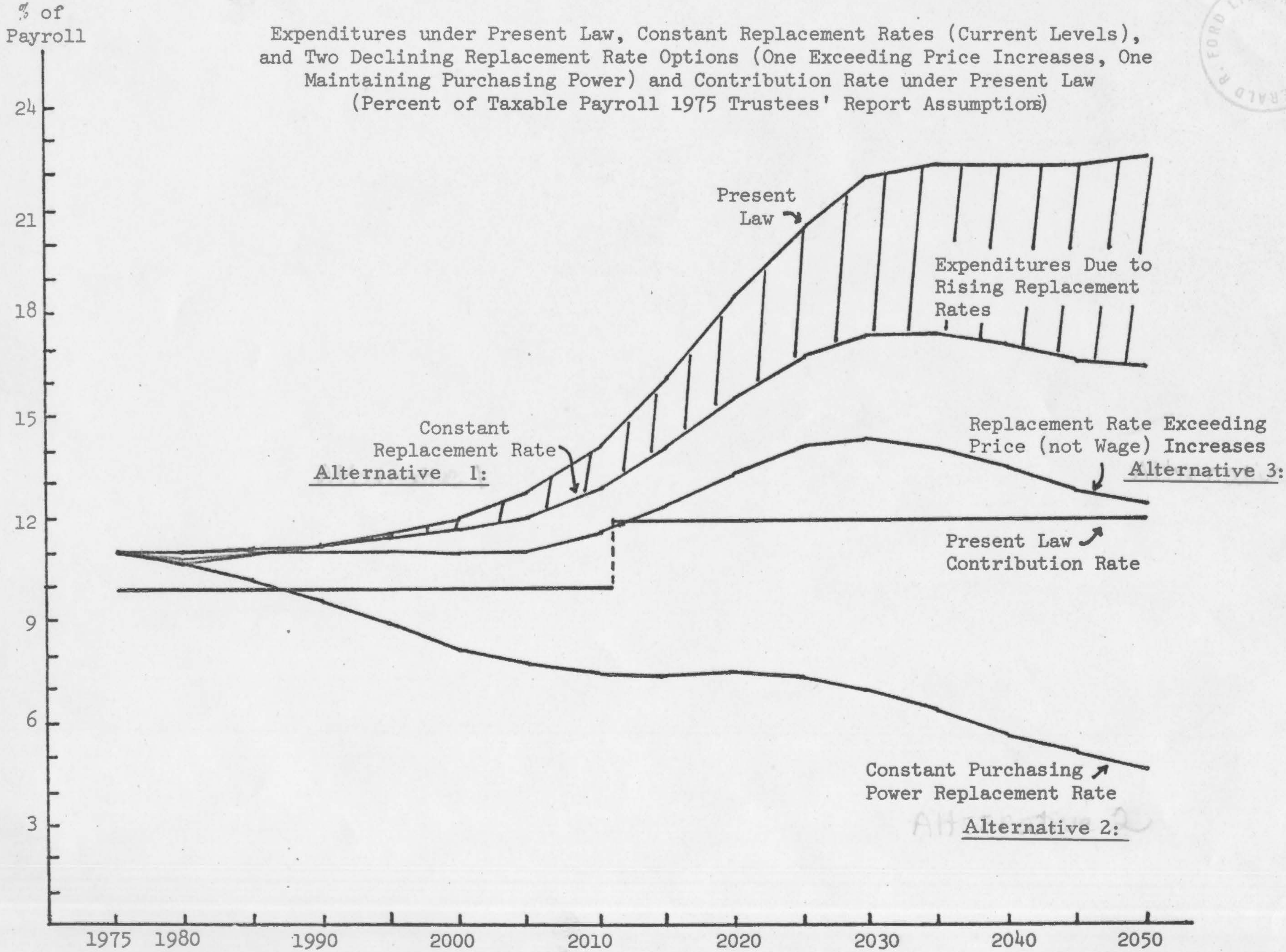
TAB B

Replacement Rates for Regular Workers with Average Wages under Present Law, under a Constant Replacement Rate Proposal and Two Declining Rate Alternatives



Tab B -1

Expenditures under Present Law, Constant Replacement Rates (Current Levels), and Two Declining Replacement Rate Options (One Exceeding Price Increases, One Maintaining Purchasing Power) and Contribution Rate under Present Law (Percent of Taxable Payroll 1975 Trustees' Report Assumptions)



Tab B - 2

LONG-RANGE ESTIMATES OF COSTS AND REPLACEMENT RATES UNDER PRESENT LAW AND UNDER DECOUPLING ALTERNATIVES

Long-Range Costs and Deficit or Surplus as Percent of Taxable Payroll
(employer and employee rates combined)

Item	Average 75 years (1975-2050)	First 25 years (1975-1999)	Second 25 years (2000-2024)	Third 25 years (2025-2049)
Present Law Taxes	10.94%	9.90%	11.02%	11.90%
Long-Range Cost				
Present law	16.26	11.16	15.12	22.09
Constant replacement rates	13.80	11.12	13.35	16.66
Slow decline in replacement rates with increases below wages but above CPI	12.13	10.92	11.96	13.39
Fast decline in replacement rates with increases keeping purchasing power	7.64	9.77	7.41	5.85
Long-range deficit (-) or surplus (+)				
Present law	-5.32	-1.26	-4.10	-10.19
Constant replacement rates	-2.86	-1.22	-2.33	- 4.76
Slow decline in replacement rates with increases below wages but above CPI	-1.19	-1.02	-0.94	- 1.49
Fast decline in replacement rates with increases keeping purchasing power	+3.30	+ .13	+3.61	+ 6.05

Replacement Rates (based on gross pre-retirement earnings)

	1976	2000	2025	2050
Low Earner				
Present Law	62%	75%	96%	107%
Constant	61	61	61	61
Slow Decline	61	55	49	45
Fast Decline	61	37	23	14
Average Earner				
Present Law	42	58	56	60
Constant	42	42	42	42
Slow Decline	42	39	36	32
Fast Decline	42	25	16	10
Maximum Earner				
Present Law	30	36	41	43
Constant	30	34	35	35
Slow Decline	30	30	27	25
Fast Decline	30	18	11	7