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

THE DIRECTOR

October 11, 1994

(A) File for econ mtg (G)

MEMORANDUM FOR THE PRESIDENT

From: Alice M. Rivlin AMR

Subject: Big Choices

When we met in August, we noted that it was time for a serious discussion of the budget and economic agenda for 1995 and 1996. Decisions must be made soon about the policies to be articulated in the FY 1996 budget, the State of the Union, and our response to the Kerrey-Danforth Commission report. These policies and the message they contain are crucial to the record we will run on in 1996.

Since August two things have happened that make this discussion more urgent:

- First, without a health care bill, we are deprived, at least temporarily, of the "centerpiece" to our legislative agenda, and also of our answer to the question: what are we doing about entitlements (or about the projected rise in the deficit)?

- Second, we know that the Republican strategy -- at least for the 1994 election and probably longer -- features empty promises about deficit reduction and unspecified spending cuts coupled with attractive-sounding tax cuts.

Our attacks on the Republicans for evasiveness about how they would pay for their "contract" have been effective, but they make it imperative that we continue our established policy of explicit and paid-for proposals. The future-oriented campaign theme that you articulated at the Cabinet lunch on Friday -- major accomplishments, much to be done -- must be translated into policy decisions soon after the election.

All of us know what we would do to improve the long-run health of the economy and the average American's prospects if we had the resources. Although our priorities may differ somewhat, all of us want to:

- Increase public investment -- in technology, infrastructure, communities and the skills of the present and future labor force -- to raise productivity and raise living standards;

- Reduce the deficit to release saving for private investment and reduce long-term interest rates;

- Provide universal health security and reduce the rate of growth of health care costs;

- Insure retirement security and the future solvency of the social security system;

- Cut taxes, especially for middle class working families.

The big problem is that we cannot do ANY of these things without freeing resources that are now devoted to other things.

Where will the resources come from?

The experience of the last two years has reinforced what we already knew about the difficulties of finding resources for new initiatives. There are only three possibilities -- all of them tough:

- Discretionary spending cuts

  With enormous effort, this year and last, we shifted significant discretionary spending from on-going programs into our highest priority investments. But Congressional resistance is strong -- witness our limited success in cutting highway demos and LIHEAP -- and there is unlikely to be much more room here. Moreover, a more conservative Congress could lower the caps further and force cuts that would likely fall mostly on our investments.

- Tax increases.

  The anti-government mood probably precludes any general-purpose tax increase. However, revenue increases may be possible to fund specific initiatives, especially if the tax has a logical connection to the use -- as in a tobacco tax or a tax on high-cost health plans tied to health care reform. It might also be possible to gain support for a revenue-neutral restructuring of taxes -- such as reducing tax breaks for high-income people to fund a middle-class tax cut.

- Entitlement spending cuts.

  Since entitlement spending, unlike discretionary, is still growing and projected to grow more rapidly, everyone looking for budget savings points to entitlements. But the specifics are daunting. A package of benefit reductions for veterans, farmers, government retirees, etc. would meet heavy public and Congressional resistance. COLA cuts are indiscriminate, hitting the most as well as the least vulnerable. Concord-Coalition-type schemes to recapture benefits from the wealthy are possible and progressive, but will not generate big savings if they only effect the truly well-off, and may erode support for these programs among upper-income groups. Moreover, 90% of savings would come from Social Security and Medicare, and would probably be labeled by opponents as tax increases.

The difficulties of freeing resources, either on the tax or spending sides, suggests that it may be most fruitful to consider packages in which the means of financing is closely tied to the initiative or reform we want. One example is some variation on Rob Shapiro's "Cut and Invest" package in which growth-inhibiting subsidies would be cut in favor of pro-growth investments or even a tax cut. Another is health care reform, where we have the opportunity to work with the next Congress to craft a health care bill with dedicated financing that contributes to out-year deficit reduction.

A less obvious example would be to address the looming problems of Social Security in a way that both restores the long-run fiscal balance of the system and frees some resources in the nearer term for deficit reduction or even investment.

Pages A, B and C that follow briefly lay out some of the relevant magnitudes to give you a context for thinking about these choices. Page D then suggests a range of six illustrative packages that may serve to start our discussion. We may also want to address the question of the timing of any proposals -- i.e. in the budget, in the State of the Union, or thereafter -- as well as what approach we should take to the work of the Kerrey-Danforth Commission as it nears its December 15 reporting date.

The appendix charts offer further detail on possible components of investment and tax cut options and the means for financing them.

Attachments -- pages A through D, plus appendix

STAFF DRAFT

ORDERS OF MAGNITUDE
Illustrative deficit, investment, and tax cut options

Option	Path ($ billions, FY) 95	96	97	98	99	00	5-yr aggregate spending cut/tax increase required ($ billions)	National savings rate FY00*	Change in deficit as a % of GDP (95 to 00)
Deficits									
Baseline	168	184	194	192	219	235	0	3.7%	2.4% to 2.5%†
Path to 2.0% of GDP	168	184	194	192	190	180	84	4.3%	2.4% to 1.9%
Hold at $168 B	168	168	168	168	168	168	184	4.3%	2.4% to 1.8%
Continue modest deficit reduction	168	160	155	150	145	140	274	4.6%	2.4% to 1.5%
Steeper downward path	168	155	140	125	110	95	399	5.1%	2.4% to 1.0%
Path to balance	168	135	100	65	35	0	689	6.1%	2.4% to 0%
Investments/Tax Cuts									
Modest investment package	--	10	10	10	10	10	50		
Bigger investment package	--	20	20	20	20	20	100		
Modest tax cut (PPI)	--	5	11	11	11	12	50		
Deeper tax cut (Rockefeller Comm)	--	26	46	48	49	51	220		
Packages									
Continue modest deficit reduction plus modest investment plus modest tax cut	--	39	60	63	95	117	374		
Steeper downward path plus bigger investment plus deeper tax cut	--	75	120	135	178	211	719		

**Assumes no change in private savings behavior. For comparison, 1947-1980 savings rate was 8.4%.*
†CBO projects change in deficit as a percent of GDP from 2.3% to 2.9% over FY95-00.

Kerrey-Danforth Commission background, 10/5/94

(A)

LONGER-TERM BUDGET TRENDS RELATIVE TO THE ECONOMY

CBO's baseline deficits are significantly higher than OMB's in the outyears, and rise as a share of GDP even in the five year budget window. In the much longer-term, OMB's projections (CBO is expected to issue its own in January) show the deficit rising very sharply as "the baby boom hits its rocking chairs" and associated medical and pension costs increase dramatically.

Baseline deficit projections

	95	96	97	98	99	00	01	02	03	04	10	20	30
$ in billions													
OMB	168	184	194	192	219	235	251	264	274	285	456	1,479	4,125
CBO	162	176	193	197	231	257	287	319	355	397	na	na	na
Share of GDP													
OMB	2.4	2.5	2.5	2.3	2.5	2.5	2.6	2.6	2.5	2.5	2.9	5.9	10.4
CBO	2.3	2.4	2.5	2.4	2.7	2.9	3.0	3.2	3.4	3.6	na	na	na
Debt as a share of GDP													
OMB	51.6	51.5	51.4	51.2	51.3	51.3	51.4	51.5	51.5	51.4	52.2	69.8	113.6
CBO	51.1	51.2	51.4	51.7	52.2	52.7	53.4	54.1	55.0	56.1	na	na	na

Though we have reduced deficits as a share of GDP markedly from their highs of the Reagan-Bush era, national savings remain very low versus our history and that of other nations. This explains why -- absent changes in private savings behavior -- deficits at current levels still pose serious risks to long-run growth and prospects for the average American's living standards.

Deficits vs. size of the economy

Deficits	Share of GDP
1982-1990	4.4%
1991	4.8%
1992	4.9%
1998 (estimate)	2.3%

Savings vs. size of the economy

Net national savings	Share of GDP
1947-82, U.S.	8.2%
1983-1992	
U.S.	3.3%
EC	8.4%
Germany	10.7%
Japan	18.9%
1994-00, U.S. (estimate)	3.2%

SOCIAL SECURITY

THE PROBLEM

- The 75 year OASDI imbalance is now estimated at 2.13% of covered payroll -- *a present value deficit of over $2.5 trillion.*

- The Social Security Trust Funds now have a sizeable surplus. This surplus will be exhausted in 2029.

- Much more important than the trust fund balance is the cash flow balance, since once annual spending on benefits exceeds annual revenue from payroll taxes, the unified deficit will increase unless taxes are raised or benefits reduced. *Social Security will face such a cash deficit in 2013.*

- The cash flow deficit grows quickly and could come even earlier (1999) under pessimistic economic assumptions (two recessions between now and the end of the decade).

ILLUSTRATIVE SOLUTION

Possibly under review by the Kerrey-Danforth Commission

Major provisions	5 yr deficit reduction ($ B) †	Impact on 75 yr actuarial balance (need 2.13%) †
• CPI-1 for 5 years (see Note 1 below)	$43.0	--
• Increase normal retirement age to 70 by 2023 (see Note 2 below)	--	1.06%
• Lower the 3 "bend points" in the benefit formula from 90%, 32%, and 15% to 87.3%, 31%, and 14.6% for a uniform 3% reduction in benefits for newly retired workers (starting in 10 years)	--	0.37%
• Increase earnings subject to tax by $10,000 and index (starting in 5 yrs)	--	0.19%
• Tax 85% of benefits at income and benefits of $25K for individuals and $32K for couples	$5.9	0.01%
• Include children's Social Security benefits in parents taxable income	$10.0	--
• Include all State and local employees hired after 12/31/95 in OASDI	$8.5	0.23%
• Increase payroll taxes by 0.32 (starting in 5 years)	--	0.30%
TOTAL	**$67.4**	**2.16%**

Note 1: Could include SSI supplement, but cost of supplement not included.
Note 2: Includes elimination of the 11 year "pause" in current law increase to 67.

†Pricing is illustrative and not final; interaction of options could alter total. Pricing of options differs among HHS, Treasury, CBO, OMB staff.

ILLUSTRATIVE RANGE OF PACKAGES

- **Current path -- consolidate and communicate.** This option would build on our success in reducing the deficit and investing in lifelong learning, technology, and infrastructure. With no new dollars required, we would focus our efforts on a renewed (deficit-neutral) health care proposal, welfare reform, REA, and other initiatives not yet enacted, and continue to fight for our investments in the appropriations process. Choosing not to add to this plate lets us more effectively implement and communicate about our accomplishments. Option could add (at no cost) a renewed or more formalized phase II of REGO, and a deregulatory initiative.

- **"Cut and invest."** This option would build on our commitment to make life better for the average citizen in New Democrat style by taking on the special interests and eliminating tax loopholes and spending giveaways that favor the few while hurting growth. It would save up to $100 billion over the next five years and use the proceeds for new investments that promote growth for all Americans by upgrading skills and training, technology and infrastructure. (The savings could come from subsidies to energy, agribusiness, transportation, aerospace, and other industries).

- **Restructure the tax system to provide a middle-class tax cut.** This option would build on our commitment to make life better for the average family through an $800 refundable child tax credit. It would be paid for by curbing tax expenditures that mainly benefit the affluent. (For example, limiting mortgage deductions, stepping up capital gains basis at death, or limiting all deductions to the 15% bracket.)

- **Reform health care.** This option would entail working with Congress to produce a new health care package that contained significant deficit reduction in both the short and long run. The package might contain a slower phase-in of benefits and greater emphasis on system-wide cost control with short-term savings from higher tobacco taxes, cuts in Medicare/Medicaid, and a tax cap on benefits. In this way, it should be possible to reduce the deficit by $50 billion to $75 billion over the next 5 years and by growing amounts in the outyears.

- **Restore confidence in Social Security.** This option would restore the soundness of Social Security, currently projected to run out of money in 2013. A combination of COLA adjustments, phased-in benefit reductions (including retirement age increases), and higher payroll taxes would balance income and outgo over the next 75 years. The package could both reassure seniors and baby boomers that the system is sound, and produce $25 billion to $75 billion in deficit reduction over the next 5 years, plus much larger amounts in the next two decades.

- **Balance the budget and increase public investment.** This option wagers that the goal of balance by 2000 (or 2005) plus major new funding for popular causes (e.g. skills/training) can galvanize public to follow Presidential leadership and take long-term view to raise living standards. Would require large but highly progressive options in tax expenditure and entitlement reform; one year "freezes" on many items as part of a call to "to put the problem behind us"; other steps to assure that all sectors participate in the restraint, save the neediest. An agency might be abolished to dramatize call for change. Creative enforcement provisions (confiscating congressional pay if targets not met?) might be populist way to convince dubious public that any short-term sacrifice will bring results.

D

APPENDIX

ILLUSTRATIVE $50 BILLION INVESTMENT PACKAGE

Investment item	5 yr $ B	Impact
Infrastructure Bank	5	Network of State "banks" to leverage to $13 billion for transportation, environment, etc.
National Information Infrastructure (NII)	1	Jumpstart advanced deployment of network and applications through NTIA, FCC, and ARPA.
Clean/Safe Water	4	
NIH/Ryan White	2	Ryan White: $0.2 billion -- Fund est. 14 new cities in FY96, plus 38-42 cities in FY95, plus increments to prevention, early intervention and pediatrics. NIH: $1.8 billion -- Fund 640 more research project grants annually (c. 10% over FY95, raising portion of grant applications funded from 23% to 26%); plus fund most or all Clinical Center replacement and renovation.
Head Start	6	Full funding by FY 2000 (instead of FY 2005).
GOALS 2000	1	Reform of every school in America (instead of 83%).
National Service	2.3	100,000 (President's goal; instead of 75,000) National Service Corps members.
School-to-Work and other training	2	One million additional trainees.
Welfare Reform	10	Funds entire program.
Urban initiative	4	Funds 24 new Metro Empowerment Zones; reinvention, accountability framework with locally designed benchmarks.
R&E tax credit	10	Funds making credit permanent.
Accelerate clean car program	1.5	Accelerate clean car initiative through increased technology partnerships, infrastructure grants and purchase incentives for first vehicles; gets 100,000 alternative fuel vehicles on the road by 2000.
TOTAL	**48.8**	

Kerrey-Danforth Commission background, 10/4/94

STAFF DRAFT

ILLUSTRATIVE TAX BASED POLICY OPTIONS FOR FAMILIES

Major options	5-year cost*
• $800 Refundable Credit for Young Children **Progressive Policy Institute "Mandate for Change"** Provides $800 credit to families with children. The refundable credit phases out from age 4 to age 11. Cost net of dependent exemption reduction.	$50 billion
• Allow Taxpayers Choice between Tax Credit and Increased Exemption **Clinton Campaign Documents "Putting People First"** Gives taxpayers choice between $300 refundable child credit or increased personal exemption.	$70 billion
• Double Tax Exemption for Children **Senate Republican "Agenda for the Republican Senate Majority in the 104th Congress"** Doubles tax exemption from $2,500 to $5,000 over 5 years.	$75 billion
• House Republican $500 Tax Credit for Children	$107 billion
• $800 Refundable Child Credit **Gore-Downey "Working Family Tax Relief Act"** Provide $800 tax credit for families with children. Credit is refundable and is not a function of the child's age. Dependent exemption would be repealed.	$175 billion
• $1,000 Refundable Child Credit **National Commission on Children** Provides $1,000 tax credit for families with children. Credit is refundable and is not a function of the child's age. Dependent exemption would be repealed.	$220 billion

**Pricing is illustrative, not yet evaluated in light of EITC expansions and welfare reform.*

Inventory of published proposals is illustrative; Treasury analysis required.

ILLUSTRATIVE ENTITLEMENT OPTIONS

Options	5-yr savings ($ B)
COLA reduction	
• CPI minus 0.5 "technical" reform (CPI may be overstated by 0.4% to 1.5%)	33
• Eliminate COLAs for one year	55
• CPI minus 2 for five years	109
Entitlement cap	
• Stenholm -- allows growth in beneficiaries plus inflation plus "extra" percentage factor of 1/1/1/0/0 over five years; programs growing slower than this formula can be netted against those exceeding it to calculate net "excess" that must be sequestered; Social Security is not exempt from sequester *Social Security is cut $26 billion over five years, or 1.4% of baseline outlays; Medicare is cut $17 billion over five years, or 1.7% of baseline outlays*	72*
• Nunn-Domenici -- allows growth in beneficiaries plus inflation plus "extra" percentage factor of 2/1/0/0/0 over five years; no offset is allowed for programs that grow slower than the cap formula *No impact on Social Security since that program is exempt from the sequester; Medicare is cut $94 billion over five years, or 8.5% of baseline outlays (including 13.7% in year five).*	270*
"Income-relating" of entitlements	
• Deny entitlements to top 5% of earners (singles above $100K and marrieds above $120K)	46
• Modified Concord "affluence test" (starting phase-in of benefit reduction at $60K, leaving 80% of Americans unaffected; savings is an estimate pending new CBO model analysis)	c. 100
• Concord-proposed "affluence test" (starts phase-in at $40K, leaving 58% of Americans unaffected)	250
• Tax all entitlement benefits	250
Selected specific cuts	
• Medicare (with reform not enacted, selected policies included in HSA and other proposals could reasonably be advanced), e.g.,	c. 50 - 60
-- Require competitive bidding for clinical lab and Part B items	2
-- Reduce physician fee increase	3
-- Extend and slightly increase OBRA 93 reduction in hospital payments	6
-- Implement an income-related Part B premium	c. 6 to 10
• End low-rated and unrelated veterans' disability compensation; include these monies in calculation of DI benefits	5
• Reduce administrative matching rates for Medicaid	5
• Charge in-school interest for Stafford loans	10
• Defer COLAs for Federal retirees to age 62 ($5 B) and raise CSRS contributions to 9% from 7% ($4 B)	9
• Reduce agricultural target prices by 3% per year ($12 B) and increase "triple base" acreage to 25% ($4 B)	16

Savings are rough preliminary estimates for order of magnitude illustration.

STAFF DRAFT

ILLUSTRATIVE TAX-RELATED OPTIONS

Options	5-yr savings ($ B)
Limit mortgage deductions for second homes	3
Limit mortgage interest deductions to $12,000 per return (single) or $20,000 (joint) 6% of claimers affected	32
Enact carryover basis for inherited capital assets	9
Include capital gains in last income tax return of deceased	35
Tax employer-provided health benefits above average plan	100
Eliminate deduction of State and local taxes	191
Limit value of itemized deductions to 15% Affects less than 10% of filers; might be partially offset by rate reductions in top brackets, and/or used in combination with middle-class tax cut as part of broader progressive restructuring.	274
Repeal or amend bracket indexing*	
• Indefinitely	c. 130
• Suspend for one year	46
• Correct for mismeasurement of inflation	TBD
2.5% VAT	160

**Except for EITC; could be done in full or in part (e.g., "CPI-2").*

CBO tax options shown for order of magnitude purposes only; Treasury analysis required.

Kerrey-Danforth Commission background, 10/4/94

By global standards, the United States today has extremely low rates of savings and investment -- even when compared with countries with far lower incomes than ours (who might understandably save far *less*). This raises questions about the prospects for future U.S. productivity growth, and our ability to raise living standards for average Americans.

SELECTED SAVINGS AND INVESTMENT COMPARISONS

Gross savings and investment as share of GDP, 1991

SAVINGS		INVESTMENT	
Country	% of GDP	Country	% of GDP
China	38.8	Korea	39.1
Korea	36.5	Thailand	38.9
Japan	34.0	Malaysia	35.9
Thailand	31.7	China	35.8
Malaysia	30.4	Japan	32.2
Chile	24.0	Papua New Guinea	28.6
Venezuela	23.4	Mauritius	27.5
Colombia	23.3	India	24.1
India	23.3	Honduras	23.8
Mauritius	23.1	Costa Rica	23.1
Nigeria	22.7	Sri Lanka	22.7
Costa Rica	22.4	**OECD average**	**21.0**
OECD average	**22.0**	Kenya	20.7
Jamaica	20.3	Egypt	20.4
Honduras	19.8	Jamaica	19.8
Kenya	19.3	Barbados	18.9
Barbados	16.4	Chile	18.8
Cote d'Ivoire	15.1	Venezuela	18.7
Cameroon	14.9	Nigeria	16.3
Argentina	14.8	**Sub-Saharan Africa average**	**15.8**
United States	**14.7**	Colombia	15.3
Papua New Guinea	12.9	**United States**	**15.2**
Sri Lanka	12.6	Cameroon	15.0
Sub-Saharan Africa average	**12.2**	Bolivia	13.8
Zambia	12.1	Zambia	13.5
Bolivia	8.7	Argentina	12.5
Egypt	7.0	Rwanda	12.5
Bangladesh	3.2	Cote d'Ivoire	10.9
Rwanda	1.4	Haiti	10.9
Haiti	1.1	Bangladesh	10.4

Source: World Bank, World Tables, 1993 (1991 is most recent data included)

Kerrey-Danforth Commission background, 10/4/94