MEETING ON CONGRESSIONAL AND THINK-TANK SOCIAL SECURITY REFORM APPROACHES

PART II

Cabinet Room
November 24, 1998
2:50 p.m.

AGENDA

III. PLANS THAT USE SURPLUSES BOTH TO STRENGTHEN THE TRUST FUND AND ESTABLISH INDIVIDUAL ACCOUNTS
(We anticipate our discussion tomorrow beginning on page 16.)

Discussed Last Time:

I. PLANS THAT TRANSFER SURPLUSES TO TRUST FUND

II. PLANS THAT USE SURPLUSES TO FUND INDIVIDUAL ACCOUNTS

A Basic Typology of Plans

We will be discussing six forms of Social Security plans. All of these plans use the surplus in one way or another, and all could be designed to do so to a greater or lesser extent.

Title	Description
A. Plans That Use the Surplus to Shore up the Trust Fund	
1. Bond-only plans	Maintain current policy of holding only Treasury securities.
2. Equities in the Trust Fund	Introduce equities into the system, but hold them collectively.
B. Plans That Use the Surplus in Creating Individual Accounts	
3. Add-on individual accounts	Continue to use all of the current 12.4 percent payroll tax to fund traditional Social Security benefits; make sufficient adjustments to the system (benefit cuts, revenue increases) to bring it into balance. Establish individual accounts in addition to the current system.
4. Carve-out individual accounts	Divert some of the current 12.4 percent payroll tax into individual accounts. Individual accounts *replace* part of the current system, and could potentially be described as a tax cut. Relatively large surplus transfers and/or cuts to the traditional Social Security benefit would be necessary to restore solvency. So far, most carve-out plans have been "fiscally conservative" with significant cuts through such provisions as raising the retirement age. With more use of the surplus, the cuts could be softened.
C. Plans That Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts	
5. Integrative plans	Use surplus to establish individual accounts. At retirement, part of the proceeds of the accounts are used to finance traditional benefits, while part provide an add-on individual account.
6. Hybrid plans	Contribute part of the surplus directly into the Trust Fund, as under (1) or (2), and part into individual accounts as under (3) or (4).

THREE BASIC REFORMS

At this point, we want our discussion to focus on fundamental issues of plan design that could impact our short-term strategy for achieving reform, and to avoid spending too much time on details that can be worked out at a later date.

- **Many of our plans contain three basic provisions that are meant as place holders for benefit cuts and/or revenue increases to be determined later.** The three provisions we happen to have chosen close 44 percent of the 75-year actuarial imbalance. There would be many other ways to achieve similar solvency effects.

  -- **Raise the taxable maximum for the OASDI payroll tax so that 90 percent of earnings are taxed by 2010:** This would return the percentage of earnings that are covered to where it was in 1982 and 1983. In 1998 dollars, it would be equivalent to raising the taxable maximum from $68,400 to $95,100. It would raise taxes by up to $1,655 (each for workers and employers) for the six percent of workers with earnings above $68,400. We are exploring ways to raise revenues without having such a large effect.

  -- **Cover state and local government new hires beginning in 2011.**

  -- **Increase the number of years used in calculating Social Security benefits from 35 to 38.**

- **These proposals could be replaced with an across-the-board benefit cut of 10 percent.** While all three of these proposals are likely to run into serious political opposition, it is important to note that only one of these three provisions results in a reduction in Social Security benefits for future retirees, and that the reduction equals only 3 percent of current-law benefits. Replacing these provisions with an across-the-board benefit cut would require a 10-percent cut in benefits for 2015 and later (or 20 percent by 2040 if the cuts were phased in more slowly). Such benefit cuts may be even less palatable than these three basic provisions.

I. Plans that Transfer Surplus to the Trust Fund

TRANSFER UNIFIED BUDGET SURPLUSES TO SOCIAL SECURITY TRUST FUND AND INVEST IN BONDS ONLY

- Transfer **91 percent** of the *currently projected* unified budget surpluses to the Trust Fund for as long as they last (2033), and continue to invest the Trust Fund in government bonds only.

- Do not include common set of reforms.

KEY ATTRACTIONS OF THIS APPROACH

- Continues the program on a completely defined benefit basis, avoiding potentially costly and risky alternative approaches.

- Preserves benefits at current law levels.

- Prevents nearly all of the surplus from being used for other purposes.

- Very consistent with our message of the past year that surpluses have been reserved pending Social Security reform.

KEY DISADVANTAGES OF THIS APPROACH

- See box on next page.

IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

Common set of reforms	NA
General revenue transfer to Trust Fund	+2.22
Remaining Actuarial Balance	+0.03

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Total	+0.0	+0.0	+0.0

ALTERNATIVE VERSION WITH 3 COMMON REFORMS:

- Transfer **55 percent** of the *currently projected* UB surplus to Trust Fund for as long as they last (2031), and continue to invest the Trust Fund only in government bonds.

- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).

KEY CHALLENGES ASSOCIATED WITH BONDS ONLY PLANS

- **Will Transfers of the Surplus Help Us Prepare for the Future?** Transfers of the budget surplus to the Trust Fund do not reduce the mismatch between annual tax revenues and benefit obligations in the out years. However, to the extent that transfers allow us to use the surplus to pay off debt (or purchase private securities), they will leave us in a stronger financial position when the demographic challenges arrive.

- **Will Transfers Succeed in Removing Surpluses from the Books?** Under current budget scoring rules, transfers used to purchase government bonds would not remove any unified budget surplus from the books, and therefore would not prevent the surplus from being used for tax cuts or new spending. However, allocating the surpluses for Social Security could lead to a change in scoring rules.

- **The Double Counting Problem.** The Trust Fund has already been credited with the excess of Social Security taxes over benefits. The current unified budget surplus is entirely due to the Social Security surplus. Under OMB projections, 89 percent of unified budget surpluses over the next 10 years are due to Social Security (under CBO projections, 98 percent are due to SS). If we were to transfer the surplus to Social Security, some might complain that we were crediting the Trust Fund twice. Indeed, some people already argue that the Trust Fund is not "real" and that we are "raiding" the Social Security Trust Fund to mask non-Social Security deficits.

- **Maintains and Expands Social Security Trust Fund Structure.** Many Democrats and Republicans do not support the trust fund structure, saying that it does not truly set aside money for Social Security and does not prevent the funds from being spent. By transferring additional funds to the trust fund, this type of plan would expand Social Security's reliance on the trust fund structure.

- **Sustaining Transfers If Surpluses Do Not Materialize.** If the full projected surpluses do not materialize and transfers are scored as outlays, then the transfers could result in budget deficits. To the extent that these deficits are financed by issuing debt, then we will not have done anything to improve the long run fiscal situation. In addition, it the future it may appear strange to be transferring amounts based on projections of surpluses from many years before.

TRANSFER SURPLUS TO TRUST FUND AND INVEST IN EQUITIES

- Transfer **68 percent** of the *currently projected* unified budget surpluses to the Trust Fund for **1999-2032** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.

KEY ATTRACTIONS OF THIS APPROACH

- Continues the program on a completely defined benefit basis.
- Achieves higher returns with low administrative costs while spreading risk across the population and over time.
- Preserves benefits at current law levels.

KEY DISADVANTAGES OF THIS APPROACH

- The government would own between 5 and 11 percent of the stock market depending on the methodology used. See the box on the next page for details

IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

Common set of reforms	NA
General revenue transfer to Trust Fund	+2.20
Across the board cuts to achieve solvency	NA
Remaining Actuarial Balance	+0.01

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Total	+0.0	+0.0	+0.0

ALTERNATIVE VERSION WITH COMMON SET OF REFORMS:

- Transfer **50 percent** of the currently projected UB surpluses to the Trust Fund for **1999-2008** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make across the board benefit cuts of 6 percent to achieve solvency.

SUBOPTION:

SAVE SOCIAL SECURITY WITH SOCIAL SECURITY PLUS ACCOUNT

- It would be possible to use the surplus remaining after achieving actuarial balance to fund individual accounts that are truly in addition to the traditional benefit. The equities in the trust fund would be preserving the traditional structure, and the individual accounts would be on top of the full traditional benefit. Therefore, doubts about sustainability and risk of the individual accounts would not threaten the traditional Social Security program. However, the plan would rely on essentially all of the currently projected surpluses for 30 years. Thereafter, this plan could create demands for deficit funding of the individual accounts.

ISSUES ARISING FROM INVESTING THE TRUST FUND IN EQUITIES

- **Government Ownership of Private Securities.** In the plans shown on the previous page, the government would eventually hold between 5 and 11 percent of the overall stock market. This raises three important concerns:

  1. **Largest Shareholder.** If the Trust Fund owned 10 percent of the stock market, the government would be the largest shareholder in at least 70 percent of U.S. publicly traded corporations.

  2. **Political Influence on Investment Choices.** Congress could legislate restrictions on what the funds could invest in (e.g. no tobacco stocks).

  3. **Corporate Governance Issues.** For example, how would government-owned shares be voted at stockholder meetings?

There are different methodologies for projecting the future size of the stock market. Depending on the methodology chosen, one obtains different estimates of the share of the total stock market held by the trust fund. The chart below shows the share of the stock market held by the trust fund for two different reform plans under two different assumptions about the future growth rate of the stock market.

THE PERVASIVENESS OF CORPORATE GOVERNANCE ISSUES

- While issues of government ownership of private securities do not arise in the case of individual accounts, issues of political influence over investment choices and of corporate governance could still be large, especially if investment choices were limited to a few government-authorized index funds.

WHAT HAPPENS IF THE STOCK MARKET PERFORMS POORLY?

- If the stock market performs worse than is projected, the balance in the trust fund will be lower than projected, creating pressure for additional revenue sources or benefit cuts. This is a common feature of plans that depend on stock market returns to fund traditional Social Security benefits.

II. Plans That Use the Surplus to Fund Individual Accounts

Five Key Issues Concerning Individual Accounts

Key Issue #1: Perceptions of Benefit Levels

- People might perceive that the individual account is part of the total Social Security benefit, and has more than made up for the reduction in the traditional benefit.
- Alternatively, people might think of their individual account as risky and uncertain, and perceive that they received a 16-percent reduction in their Social Security benefit.
- Plans which guarantee benefit levels or which integrate the individual account and the defined benefit may be more successful in getting people to look at their total benefit.

Example: Impact on Benefits (Percentage of current law benefits)

Change in traditional benefit	-16.3 percent
Annuity from individual account	+20.8 percent
Total	+4.5 percent

Key Issue #2: Benefit Guarantees

Because individual accounts expose individuals to more risk, it might be desirable to shift some of that risk to society as a whole.

- **Providing a Safe Investment Option.** One way to do this would be to offer a safe investment option -- for example, Treasury Inflation Protected Securities -- and to design a reform package to ensure that workers who chose this safe investment option have a reasonable level of benefits.
  - -- The downside of this approach is that it might encourage individuals -- particularly low-income individuals -- to take too little risk.
- **Guaranteeing Current-law Benefits.** Another option would be to let people invest however they choose, but to guarantee that the combined benefit from traditional Social Security and the individual account would at least equal the current-law traditional Social Security benefit (Sen. Gramm's plan adopts this approach).
  - -- A guaranteed benefit might encourage workers to take too much risk, since they would receive the upside gains, while the government would protect them on the downside. However, some argue that many investors do not take on enough risk. Moreover, if the portfolio choices were limited to basic index funds, the extent of this "moral hazard" problem would probably be minimal.
  - -- A guarantee shifts risk away from individuals and onto the unified budget. We are currently trying to quantify the extent of this risk.

KEY ISSUE #3: FISCAL SUSTAINABILITY

For How Long Can We Afford to Fund Individual Accounts Out of the Surplus?

- If remaining surpluses are spent, 2 percent individual accounts can be afforded until around 2023.

- Once the surpluses have run out we could continue to fund the individual accounts out of general revenues (this would cost around 0.8 percent of GDP), or we could trigger in traditional reforms to pay for the individual accounts.

- It might also be possible to set aside some of the extra surpluses in the early years to prefund individual account contributions in later years. We present a plan like this later in the packet.

KEY ISSUE #4: DESIGNING A PACKAGE WITH "WINS" FOR BOTH PARTIES

- **Individual accounts can be provided in a way that is more progressive than the current defined benefit Social Security system.** We could propose a negotiating principle that the traditional benefit must remain as progressive as it currently is, and that any individual accounts must be *more* progressive.

- **Our reform package could include initiatives to reduce elderly poverty, particularly among widows, and to help other needy populations.** We are developing a list of policy options in this area. For example, if progressive individual accounts were at least partially bequeathable, low-income families with short life expectancies could potentially benefit more from the progressivity of the individual accounts than they do from the progressivity of the current system.

KEY ISSUE #5: FEASIBILITY AND COST OF INDIVIDUAL ACCOUNTS

- **Individual accounts in foreign countries have proven very costly.** In both the U.K. and Chile, administrative costs absorb 20 percent or more of account accumulations under their systems of individual accounts.

- **Lower costs might be achievable by limiting choice.** At the cost of severely limiting choices, it may be possible to keep costs down significantly. Our benefit numbers assume a very low administrative cost of 10 basis points per year. This would correspond to a reduction in account accumulation of only 2 percent.

- **Low-cost plans would also be low-service plans.** The level of services associated with a plan this cheap would be very low, and in particular would compare unfavorably with the level of services offered through most 401(k) plans. Specifically, a bare-bones plan might offer annual reporting rather than monthly or even daily reporting, a much narrower range of asset choice, and a far lesser ability to switch among available assets.

- **Contributions would lag earnings.** For individual account funding approaches that are tied to past earnings, the delays in making contributions into accounts could be perceived to be very long. Under current procedures, workers' earnings for the prior year are not verified until November in the current year. Thus, if a system of this type were in force currently, workers' last recorded contribution as of today might be for 1996; or workers might just have received their contributions for 1997.

- **Funding out of the surplus might alleviate the perception problem.** It might be argued that since the funding of these accounts was coming from the surplus, individuals would not perceive the contributions to be tied to their earnings, and therefore not see it as arriving late.

- **Other approaches might be possible.** It is also possible, though not yet fully verified, that some acceleration of contributions could be achieved through a change in procedures.

Flat-Dollar Add-on Individual Account with Across the Board Benefit Cuts to Restore Solvency

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

Key Attractions of This Approach

- Gives individuals control over their retirement savings. Could be described as building wealth.
- Achieves higher returns while avoiding government ownership of private securities.

Key Disadvantages of This Approach

- Surpluses are not sufficient to fund individual accounts forever.

Impact on 75-Year Actuarial Balance (current balance is -2.19)

Common set of reforms	+0.97
Across the board cuts to achieve solvency	+1.22
Remaining Actuarial Balance	+0.01

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+34.4	+20.8	+15.8
Total	+18.1	+4.5	-0.5

PARTIALLY VOLUNTARY INDIVIDUAL ACCOUNTS

- Fund $290 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds. ***Allow workers to voluntarily contribute an additional 1 percent of earnings to their accounts.***

- Make common set of reforms.

- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

KEY ATTRACTIONS OF THIS APPROACH

- Cuts in half the long-term fiscal obligation of the government to finance individual accounts.

- Preserves benefit levels for low-income workers even if they do not make voluntary contributions.

KEY DISADVANTAGES OF THIS APPROACH

- Some may feel they are being asked to add an additional one percent of payroll taxes simply to maintain their existing Social Security benefit level.

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total without voluntary contribution	**+0.9**	**-5.9**	**-8.4**
Maximum annuity provided by voluntary Individual Account	+8.1	+10.8	+13.1
Total	**+9.0**	**+4.9**	**+4.7**

Under current law, annual benefit levels are $6010 for the low earner, $9925 for the average earner, and $13,112 for the high earner.

III. Plans that Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts

HYBRID PLANS:
INDIVIDUAL ACCOUNTS AND TRUST FUND EQUITY INVESTMENTS

- Create $290 per worker individual accounts funded out of general revenue.
- Invest Trust Fund assets worth 1 percent of payroll in stocks. Limit the share of the Trust Fund invested in stocks to 25 percent.
- Make common set of reforms.
- Make additional across the board cut in benefits to achieve solvency.

KEY ATTRACTIONS OF THIS APPROACH

- Provides wins for both sides. Shores up traditional Social Security and establishes individual accounts.
- Because individual accounts are small, sustaining them in the out years will not create much pressure on other programs.
- Because transfers to the trust fund are modest, the peak share of the stock market owned by the trust fund will be between 3.7 and 5.7 percent.

KEY DISADVANTAGES OF THIS APPROACH

- Has the downsides of both individual accounts and trust fund investments: the high administrative costs of small individual accounts and the problems of government ownership of private securities.

IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

Common set of reforms	+0.97
Tax indiv. accounts like OASDI	+0.06
Redeem TF assets to buy stocks	+0.58
Across the board cuts to achieve solvency	+0.73
Remaining Actuarial Balance	+0.00

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-8.0	-8.0	-8.0
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total	+6.2	-0.6	-3.1

ARE THERE WAYS TO REDUCE GOVERNMENT OWNERSHIP CONCERNS?

- **<u>Trust Fund investments could be allocated according to investment choices of individuals in their individual accounts.</u>** In plans that combine Trust Fund investments with individual accounts, it might be possible to have the Trust Fund allocate its investments according to the aggregate investment behavior of individuals in their individual accounts. This idea -- and other ideas like it -- could allow defenders of government investment to say that it was millions of individual choices and not a government board that was allocating funds.

Add-on Individual Account with Escrow Account to Sustain Individual Accounts

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- After funding individual accounts, place 70 percent of remaining surpluses in an escrow account invested 50-50 in stocks and bonds. Use the escrow account to fund individual account contributions after the unified budget surplus runs out.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

Key Attractions of This Approach

- Sustains individual accounts even after surpluses run out, thereby avoiding pressure to cut other programs to fund the new individual account "entitlement."

Key Disadvantages of This Approach

- Has same disadvantages as other plans that combine individual accounts and government investment in private securities.
- Some may find this proposal unusual and therefore not sound because it uses the escrow account to prefund individual account contributions rather than retirement benefits. People are used to the idea of prefunding pension benefits, but it would be novel to prefund pension contributions.

Impact on 75-Year Actuarial Balance (current balance is -2.19)

Common set of reforms	+0.97
Across the board cuts to achieve solvency	+1.22
Remaining Actuarial Balance	+0.01

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+34.4	+20.8	+15.8
Total	+18.1	+4.5	-0.5

Flat-Dollar Add-on IA with 50 percent Integration

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 stocks and bonds.
- Use 50 percent of individual accounts to fund traditional Social Security benefit. Tax other half of retirement income from individual accounts like Social Security
- Make common set of reforms.
- Make additional adjustments to traditional Social Security program to restore solvency.

Key Attractions of This Approach

- Revised benefits are guaranteed regardless of how the market performs.
- Creates individual accounts and strengthens traditional Social Security without government ownership of private securities.
- Integration of the benefit may make people more likely to perceive that their individual account is added together to their traditional benefit in providing their overall benefit.

Key Disadvantages of This Approach

- When the government uses 50 percent of the individual account to fund the traditional benefit, people may feel that they are losing half of their account rather than understanding all along that the account has two parts -- one part which funds the traditional benefit and another part that provides additional retirement income.
- May be perceived as complicated.

Impact on 75-Year Actuarial Balance (current balance is -2.19)

Common set of reforms	+0.97
Tax individual accounts like OASDI	+0.06
50 percent clawback of indiv. accounts	+0.90
Across the board cuts to achieve solvency	+0.26
Remaining Actuarial Balance	+0.00

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-3.2	-3.2	-3.2
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total	+11.0	+4.2	+1.7

Plans That Fund Individual Accounts Out of the Existing 12.4 Percent Social Security Payroll Tax

Breaux-Gregg-Kolbe-Stenholm Plan

- Use 2 percent of the existing 12.4 percent Social Security payroll tax to fund 2 percent of payroll individual accounts.
- Make reforms to traditional Social Security program:
  - -- Reduce second and third bend points by 2 percent per year for 20 years.
  - -- Reduce COLA by 0.5 percentage points.
  - -- Increase normal retirement age by 2 months per year until it reaches 70, then index.
  - -- Cover new state and local workers.
  - -- Reduce spouse benefits from 50 to 33 percent of PIA.
  - -- Increase computation period to 40 years, but count all earnings.
  - -- Eliminate earnings test.
  - -- Credit all taxation of Social Security benefits to OASDI.
  - -- Create new minimum benefit.

Key Attractions of This Approach

- Plan is fiscally responsible.

Key Disadvantages of This Approach

- Reduces benefits compared to present law (though not compared to the 72 percent of benefits that are affordable in 2032 if no changes are made).

Impact on 75-Year Actuarial Balance (current balance is -2.19)

Remaining Actuarial Balance	+0.00

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Change in Traditional Benefits	-25.1%	-39.5%	-42.2%
Annuity provided by Individual Account	16.2	21.6	26.2
Total	-8.9	-17.9	-16.0

A Kinder and Gentler Carve-out Plan

- A carve-out plan does not have to result in large benefit cuts. If general revenues are used to the same extent as in the add-on individual account (but are transferred to the trust fund rather than used to fund individual accounts), the benefit levels would be the same. It may be harder to sustain general fund transfers to Social Security once surpluses run out than it would be to sustain general fund financing of individual accounts.

2 Percent Carve-out for 2 Percent Individual Accounts with Transfer of Remaining Surplus for Bonds

- Redirect 2 percent of OASDI payroll tax beginning in 2000 to fund 2 percent of payroll individual accounts. Assume these funds are invested 50-50 in stocks and bonds. Transfer remaining *currently projected* surpluses to the trust fund and invest them in bonds.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board cuts by revising the benefit formula.

Key Attractions of This Approach

- Plan is fiscally responsible and would reduce long-term budget deficits and increase national savings even compared with the baseline that uses the surplus to pay off debt.
- The combined retirement income from individual accounts and traditional benefit would be close to currently promised benefit levels.

Key Disadvantages of This Approach

- In the long run, the individual account would be providing roughly 40 percent of the total benefit. Benefit levels would depend heavily on stock market performance.
- Because it uses some of the current payroll tax to fund individual accounts, this plan could be perceived as the first step toward total privatization.

Impact on 75-Year Actuarial Balance (current balance is -2.19)

Common set of reforms	+0.97
Two percent carve-out	-1.92
Transfer of remaining surpluses to OASDI	+1.45
Across the board cuts to achieve solvency	+1.71
Remaining Actuarial Balance	+0.03

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-18.7	-18.7	-18.7
Annuity provided by Individual Account	+16.2	+21.6	+26.2
Total	-5.5	-0.1	+4.5

STRATEGIC DISCUSSION OF A PLAN THAT INVESTS EQUITIES IN THE TRUST FUND

Many of the fundamental decisions related to Social Security reform can be framed by examining a plan that relies exclusively on prefunding and equity investment.

BASE PLAN

- Transfer **60 percent** of the *currently projected* unified budget surpluses to the Trust Fund for **1999-2032** to purchase equities. Limit the share of the Trust Fund invested in equities to 33 percent.
- Roughly $500 billion would be available over 10 years for some combination of debt reduction, Medicare, readiness, or specific priority proposals.

ALTERNATIVE A: SOCIAL SECURITY PLUS ACCOUNT

- Spend three-quarters of remaining surpluses on individual accounts and one quarter on discretionary spending. Account could be flat dollar or it could provide matches for voluntary contributions. Could afford approximately $200 per worker contributions for about 20 years (there would be shortfalls in early years).

ALTERNATIVE B: DO TRADITIONAL REFORMS OR ACROSS THE BOARD CUTS AS WELL

- Include 3 basic provisions (increase computation years, cover state and local workers, increase taxable maximum). Do additional 3 percent across the board cut in benefits.
- Transfer 50 percent of the currently projected surpluses to trust fund to purchase equities for only ten years (1999-2008). Limit trust fund to 25 percent equities. Alternatively, could transfer 35 percent of the surplus for as long as it lasts.

FISCAL DISCIPLINE

Critiques of this approach:

- **Allocates additional resources to the elderly.** For those who feel that society is spending too much on the elderly already, this approach directs additional resources to the elderly in order to maintain all of currently promised benefits.

- **Depending on surpluses and stock returns is risky.** This plan relies completely on 30 years of budget surpluses and on equity returns. Both components are uncertain. If budget surpluses do not materialize, then continuing general fund transfers to OASDI may result in pressure to cut other spending programs. If equity returns are lower than projected, then we will need to do Social Security reform again at a later date.

- **Does not directly address long-run funding gap.** This plan does not close any of the gap between current year tax revenue and benefit payments, and it has a trust fund that is declining at the end of the 75-year window.

- **Denies surplus for other needs.** Because the plan relies on substantial general revenue transfers, it precludes the use of these funds for other purposes (including Medicare financing, education spending, etc.).

Rejoinders:

- **Why do pain if there are surpluses available?** Those who argue that we should rely less on surpluses and higher returns and that we should rely more on traditional benefit cuts and revenue increases must explain why we should make painful adjustments to Social Security when the surpluses are otherwise likely to go for defense spending and tax cuts for the rich.

- **Uses Social Security surpluses for Social Security.** Since most of the surpluses are due to Social Security, it makes sense to use them to strengthen Social Security. If the surpluses are used for other things, we could be attacked for using Social Security tax revenue for non-Social Security purposes.

- **Tax cuts would make long run fiscal situation even worse.** If we fail to achieve Social Security reform and the surpluses are used for permanent tax cuts, the long run fiscal situation will be even worse when we finally do get around to fixing Social Security.

- **Still allows some use of the surplus.** The surpluses remaining after this plan is enacted could be used for a combination of individual accounts, tax cuts, and discretionary spending.

GOVERNMENT OWNERSHIP OF PRIVATE SECURITIES

Critiques of this approach

- **Government ownership.**

    -- Government would own at least 7 percent of the stock market and perhaps as much as 14 percent. Critics could potentially use a methodology that produced estimates that are even higher.

    -- If the government owned 10 percent of the market, it would be the largest shareholder in more than 70 percent of U.S. publicly traded corporations.

    -- People would question why we were encouraging other countries to move toward private markets when our government was acquiring shares in private companies.

- **Political influence on investment decisions.** There might be pressure for the government to invest in socially desirable activities such as affordable housing that may have lower rates of return and to divest from companies in unpopular but profitable industries.

- **Corporate Governance.** Government voting of shares would likely be perceived as interference, but government abstinence from voting might give too much influence to remaining shareholders or management. Any structure of investment, no matter how independent could be altered by Congress and the President at any time in the future.

Rejoinders

- **Independent structures like the Federal Reserve System have proved resilient.** Could create an independent organization like the Federal Reserve. Reischauer and Aaron have proposed a Social Security reserve trust fund with triple insulation:
    -- 14 year staggered terms.
    -- The board would choose managers, not the investments themselves.
    -- Eliminating voting influence.

- **Independent funding**. Funding for the independent body could come out of the system's own revenue, so that the system would not to be reliant on Congress for annual appropriations.

- **Canada has recently adopted this approach**. While it is too early to tell how successful the Canadian system will be, the fact that Canada was able to set up such a system suggests that it may be possible to defend such a system politically.

- **TSP-style Individual accounts have many of the same downsides that trust fund investments do.** While individual accounts may avoid perceptions of government ownership, TSP-style individual accounts would still raise issues of political influence over investment decisions and of how shares would be voted.

Critiques of this approach

- **Stock market could perform poorly.** In real terms, the Dow Jones did not rebound to its 1968 peak until 1987. On three occasions during the past 70 years, the S&P 500 index has declined over two years by more than 35 percent. Japan's Nikkei has fallen by 60 percent since 1989.

- **Individual does not get sense of control or of accomplishing personal saving**. Much of the appeal of individual accounts is the perceived opportunity to build wealth, leave bequests, and get more Americans into the spirit of saving. Collective investments do not offer these advantages.

- **Administrative costs could be kept low through a TSP-style individual account plan.**

Rejoinders

- **There is significant market risk in almost all public and private pension plans.** People generally find the higher rewards to be sufficient to justify the additional risk.

- **If the economy performs poorly over long periods of time it doesn't matter what type of Social Security system we have, it will be hard to pay full benefits.**

- **Collective investing permits risk-pooling both within and across cohorts.** During the 20th century in the US, even large stock market declines have been more than made up by subsequent rebounds. For example, a portfolio of a worker who lived through the 1929 crash would have fully recovered by the end of 1936. By pooling risk, the trust fund approach removes the sensitivity of worker's retirement income to the particular year in which they reached retirement.

- **Collective investing provides high returns with low administrative costs.** Wall Street won't receive 20 percent of people's retirement income as it might in a moderately expensive individual account plan.

ALTERNATIVE A: SOCIAL SECURITY PLUS ACCOUNT
• Spend three-quarters of remaining surpluses on individual account and one quarter on discretionary spending. Account could be flat dollar or it could provide matches for voluntary contributions. Could afford approximately $200 per worker contributions for about 20 years (there would be shortfalls in early years).

Advantages:

- **Provides best of both worlds: saves Social Security and also provides individual accounts.**

- **Because the individual accounts are strictly in addition to the current law Social Security benefit, it is less essential that they be funded forever.** This reduces the "Stockman risk" of needing to fund them once surpluses run out.

- **Solidifies traditional Social Security while offering options for compromise with individual account supporters.**

- **Flat distribution would be progressive.**

Disadvantages:

- **Relatively high administrative costs.** Individual accounts will be very small, and therefore administrative costs will absorb a larger fraction of investment returns.

- **Just another tax-favored savings vehicle.** While small individual accounts may be a valuable new benefit for low-income workers, it may be perceived is just one more tax preferred savings vehicle by upper-income workers.

- **Still significant Stockman risk.** Even though the individual accounts will be small and are not essential to the total Social Security benefit, there may be some pressure to continue to fund them even after the surpluses run out, thereby creating pressure on other government programs.

- **Little surplus for other needs.** Leaves virtually no room for surpluses to be used to address other needs.

ALTERNATIVE B: DO TRADITIONAL REFORMS OR ACROSS THE BOARD CUTS AS WELL
• Include 3 basic provisions (increase computation years, cover state and local workers, increase taxable maximum). Do additional 3 percent across the board cut in benefits. • Transfer 50 percent of the currently projected surpluses to trust fund to purchase equities for only ten years (1999-2008). Limit trust fund to 25 percent equities. Alternatively, could transfer 35 percent of the surplus for as long as it lasts.

Advantages:

- **More fiscally responsible**. Closes some of the long run imbalance between taxes and benefits. Potentially relies on only 10 years of surpluses.

- **Frees up more of the long-run surpluses for Medicare and discretionary spending.** People might be willing to tolerate small cuts in Social Security if the savings were allocated to Medicare.

Disadvantages:

- **May not be able to prevent surpluses from being spent on tax cuts for the rich.**

- **Will have to compete with Republican individual account initiatives that promise no reductions in benefits.**

- **Preserving surpluses for Medicare may not be a viable strategy since there is unlikely to be a significant Medicare agreement this year.**

- **This plan has no individual accounts and no tax cuts. It is hard to see how such a plan results in a bipartisan consensus.**

THE WHITE HOUSE

WASHINGTON

MEETING ON CONGRESSIONAL AND THINK-TANK SOCIAL SECURITY REFORM APPROACHES

PART II

Cabinet Room

November 24, 1998

3:05 p.m.

AGENDA

III. PLANS THAT USE SURPLUSES BOTH TO STRENGTHEN THE TRUST FUND AND ESTABLISH INDIVIDUAL ACCOUNTS

Discussed Last Time:

I. PLANS THAT TRANSFER SURPLUSES TO TRUST FUND

II. PLANS THAT USE SURPLUSES TO FUND INDIVIDUAL ACCOUNTS

A Basic Typology of Plans

We will be discussing six forms of Social Security plans. All of these plans use the surplus in one way or another, and all could be designed to do so to a greater or lesser extent.

Title	Description
A. Plans That Use the Surplus to Shore up the Trust Fund	
1. Bond-only plans	Maintain current policy of holding only Treasury securities.
2. Equities in the Trust Fund	Introduce equities into the system, but hold them collectively.
B. Plans That Use the Surplus in Creating Individual Accounts	
3. Add-on individual accounts	Continue to use all of the current 12.4 percent payroll tax to fund traditional Social Security benefits; make sufficient adjustments to the system (benefit cuts, revenue increases) to bring it into balance. Establish individual accounts in addition to the current system.
4. Carve-out individual accounts	Divert some of the current 12.4 percent payroll tax into individual accounts. Individual accounts *replace* part of the current system, and could potentially be described as a tax cut. Relatively large surplus transfers and/or cuts to the traditional Social Security benefit would be necessary to restore solvency. So far, most carve-out plans have been "fiscally conservative" with significant cuts through such provisions as raising the retirement age. With more use of the surplus, the cuts could be softened.
C. Plans That Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts	
5. Integrative plans	Use surplus to establish individual accounts. At retirement, part of the proceeds of the accounts are used to finance traditional benefits, while part provide an add-on individual account.
6. Hybrid plans	Contribute part of the surplus directly into the Trust Fund, as under (1) or (2), and part into individual accounts as under (3) or (4).

THREE BASIC REFORMS

At this point, we want our discussion to focus on fundamental issues of plan design that could impact our short-term strategy for achieving reform, and to avoid spending too much time on details that can be worked out at a later date.

- **Many of our plans contain three basic provisions that are meant as place holders for benefit cuts and/or revenue increases to be determined later.** The three provisions we happen to have chosen close 44 percent of the 75-year actuarial imbalance. There would be many other ways to achieve similar solvency effects.

  -- **Raise the taxable maximum for the OASDI payroll tax so that 90 percent of earnings are taxed by 2010:** This would return the percentage of earnings that are covered to where it was in 1982 and 1983. In 1998 dollars, it would be equivalent to raising the taxable maximum from \$68,400 to \$95,100. It would raise taxes by up to \$1,655 (each for workers and employers) for the six percent of workers with earnings above \$68,400. We are exploring ways to raise revenues without having such a large effect.

  -- **Cover state and local government new hires beginning in 2011.**

  -- **Increase the number of years used in calculating Social Security benefits from 35 to 38.**

- **These proposals could be replaced with an across-the-board benefit cut of 10 percent.** While all three of these proposals are likely to run into serious political opposition, it is important to note that only one of these three provisions results in a reduction in Social Security benefits for future retirees, and that the reduction equals only 3 percent of current-law benefits. Replacing these provisions with an across-the-board benefit cut would require a 10-percent cut in benefits for 2015 and later (or 20 percent by 2040 if the cuts were phased in more slowly). Such benefit cuts may be even less palatable than these three basic provisions.

I. Plans that Transfer Surplus to the Trust Fund

TRANSFER UNIFIED BUDGET SURPLUSES TO SOCIAL SECURITY TRUST FUND AND INVEST IN BONDS ONLY

- Transfer **91 percent** of the *currently projected* unified budget surpluses to the Trust Fund for as long as they last (2033), and continue to invest the Trust Fund in government bonds only.

- Do not include common set of reforms.

KEY ATTRACTIONS OF THIS APPROACH
• Continues the program on a completely defined benefit basis, avoiding potentially costly and risky alternative approaches.
• Preserves benefits at current law levels.
• Prevents nearly all of the surplus from being used for other purposes.
• Very consistent with our message of the past year that surpluses have been reserved pending Social Security reform.

KEY DISADVANTAGES OF THIS APPROACH
• See box on next page.

IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)	
Common set of reforms	NA
General revenue transfer to Trust Fund	+2.22
Remaining Actuarial Balance	+0.03

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Total	+0.0	+0.0	+0.0

ALTERNATIVE VERSION WITH 3 COMMON REFORMS:

- Transfer **55 percent** of the *currently projected* UB surplus to Trust Fund for as long as they last (2031), and continue to invest the Trust Fund only in government bonds.

- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).

Key Challenges Associated With Bonds Only Plans

- **Will Transfers of the Surplus Help Us Prepare for the Future?** Transfers of the budget surplus to the Trust Fund do not reduce the mismatch between annual tax revenues and benefit obligations in the out years. However, to the extent that transfers allow us to use the surplus to pay off debt (or purchase private securities), they will leave us in a stronger financial position when the demographic challenges arrive.

- **Will Transfers Succeed in Removing Surpluses from the Books?** Under current budget scoring rules, transfers used to purchase government bonds would not remove any unified budget surplus from the books, and therefore would not prevent the surplus from being used for tax cuts or new spending. However, allocating the surpluses for Social Security could lead to a change in scoring rules.

- **The Double Counting Problem.** The Trust Fund has already been credited with the excess of Social Security taxes over benefits. The current unified budget surplus is entirely due to the Social Security surplus. Under OMB projections, 89 percent of unified budget surpluses over the next 10 years are due to Social Security (under CBO projections, 98 percent are due to SS). If we were to transfer the surplus to Social Security, some might complain that we were crediting the Trust Fund twice. Indeed, some people already argue that the Trust Fund is not "real" and that we are "raiding" the Social Security Trust Fund to mask non-Social Security deficits.

- **Maintains and Expands Social Security Trust Fund Structure.** Many Democrats and Republicans do not support the trust fund structure, saying that it does not truly set aside money for Social Security and does not prevent the funds from being spent. By transferring additional funds to the trust fund, this type of plan would expand Social Security's reliance on the trust fund structure.

- **Sustaining Transfers If Surpluses Do Not Materialize.** If the full projected surpluses do not materialize and transfers are scored as outlays, then the transfers could result in budget deficits. To the extent that these deficits are financed by issuing debt, then we will not have done anything to improve the long run fiscal situation. In addition, it the future it may appear strange to be transferring amounts based on projections of surpluses from many years before.

TRANSFER SURPLUS TO TRUST FUND AND INVEST IN EQUITIES

- Transfer **68 percent** of the *currently projected* unified budget surpluses to the Trust Fund for **1999-2032** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.

KEY ATTRACTIONS OF THIS APPROACH

- Continues the program on a completely defined benefit basis.
- Achieves higher returns with low administrative costs while spreading risk across the population and over time.
- Preserves benefits at current law levels.

KEY DISADVANTAGES OF THIS APPROACH

- The government would own between 5 and 11 percent of the stock market depending on the methodology used. See the box on the next page for details

IMPACT ON 75-YEAR ACTUARIAL BALANCE **(current balance is -2.19)**

Common set of reforms	NA
General revenue transfer to Trust Fund	+2.20
Across the board cuts to achieve solvency	NA
Remaining Actuarial Balance	+0.01

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Total	+0.0	+0.0	+0.0

ALTERNATIVE VERSION WITH COMMON SET OF REFORMS:

- Transfer **50 percent** of the currently projected UB surpluses to the Trust Fund for **1999-2008** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make across the board benefit cuts of 6 percent to achieve solvency.

SUBOPTION:
SAVE SOCIAL SECURITY WITH SOCIAL SECURITY PLUS ACCOUNT

- It would be possible to use the surplus remaining after achieving actuarial balance to fund individual accounts that are truly in addition to the traditional benefit. The equities in the trust fund would be preserving the traditional structure, and the individual accounts would be on top of the full traditional benefit. Therefore, doubts about sustainability and risk of the individual accounts would not threaten the traditional Social Security program. However, the plan would rely on essentially all of the currently projected surpluses for 30 years. Thereafter, this plan could create demands for deficit funding of the individual accounts.

ISSUES ARISING FROM INVESTING THE TRUST FUND IN EQUITIES

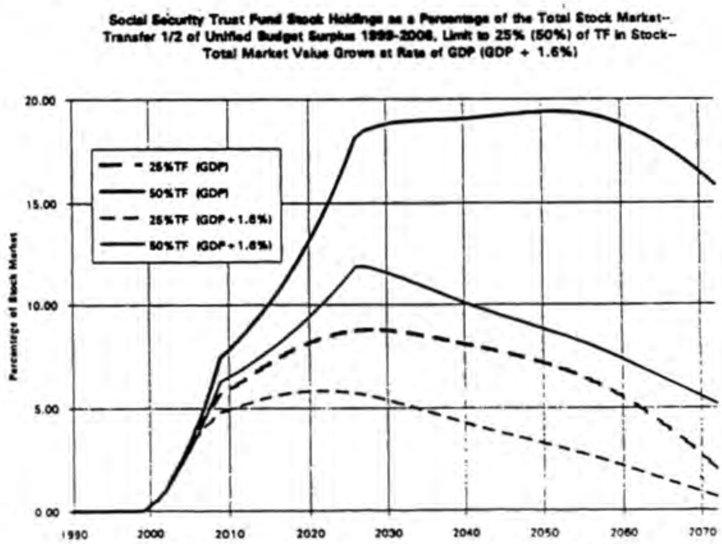
- **Government Ownership of Private Securities.** In the plans shown on the previous page, the government would eventually hold between 5 and 11 percent of the overall stock market. This raises three important concerns:

    1. **Largest Shareholder.** If the Trust Fund owned 10 percent of the stock market, the government would be the largest shareholder in at least 70 percent of U.S. publicly traded corporations.

    2. **Political Influence on Investment Choices.** Congress could legislate restrictions on what the funds could invest in (e.g. no tobacco stocks).

    3. **Corporate Governance Issues.** For example, how would government-owned shares be voted at stockholder meetings?

There are different methodologies for projecting the future size of the stock market. Depending on the methodology chosen, one obtains different estimates of the share of the total stock market held by the trust fund. The chart below shows the share of the stock market held by the trust fund for two different reform plans under two different assumptions about the future growth rate of the stock market.



The Pervasiveness of Corporate Governance Issues

- While issues of government ownership of private securities do not arise in the case of individual accounts, issues of political influence over investment choices and of corporate governance could still be large, especially if investment choices were limited to a few government-authorized index funds.

What Happens If the Stock Market Performs Poorly?

- If the stock market performs worse than is projected, the balance in the trust fund will be lower than projected, creating pressure for additional revenue sources or benefit cuts. This is a common feature of plans that depend on stock market returns to fund traditional Social Security benefits.

II. Plans That Use the Surplus to Fund Individual Accounts

Five Key Issues Concerning Individual Accounts

Key Issue #1: Perceptions of Benefit Levels

- People might perceive that the individual account is part of the total Social Security benefit, and has more than made up for the reduction in the traditional benefit.
- Alternatively, people might think of their individual account as risky and uncertain, and perceive that they received a 16-percent reduction in their Social Security benefit.
- Plans which guarantee benefit levels or which integrate the individual account and the defined benefit may be more successful in getting people to look at their total benefit.

Example: Impact on Benefits (Percentage of current law benefits)

Change in traditional benefit	-16.3 percent
Annuity from individual account	+20.8 percent
Total	+4.5 percent

Key Issue #2: Benefit Guarantees

Because individual accounts expose individuals to more risk, it might be desirable to shift some of that risk to society as a whole.

- **Providing a Safe Investment Option.** One way to do this would be to offer a safe investment option -- for example, Treasury Inflation Protected Securities -- and to design a reform package to ensure that workers who chose this safe investment option have a reasonable level of benefits.

  -- The downside of this approach is that it might encourage individuals -- particularly low-income individuals -- to take too little risk.

- **Guaranteeing Current-law Benefits.** Another option would be to let people invest however they choose, but to guarantee that the combined benefit from traditional Social Security and the individual account would at least equal the current-law traditional Social Security benefit (Sen. Gramm's plan adopts this approach).

  -- A guaranteed benefit might encourage workers to take too much risk, since they would receive the upside gains, while the government would protect them on the downside. However, some argue that many investors do not take on enough risk. Moreover, if the portfolio choices were limited to basic index funds, the extent of this "moral hazard" problem would probably be minimal.

  -- A guarantee shifts risk away from individuals and onto the unified budget. We are currently trying to quantify the extent of this risk.

KEY ISSUE #3: FISCAL SUSTAINABILITY

For How Long Can We Afford to Fund Individual Accounts Out of the Surplus?

- If remaining surpluses are spent, 2 percent individual accounts can be afforded until around 2023.

- Once the surpluses have run out we could continue to fund the individual accounts out of general revenues (this would cost around 0.8 percent of GDP), or we could trigger in traditional reforms to pay for the individual accounts.

- It might also be possible to set aside some of the extra surpluses in the early years to prefund individual account contributions in later years. We present a plan like this later in the packet.

KEY ISSUE #4: DESIGNING A PACKAGE WITH "WINS" FOR BOTH PARTIES

- **Individual accounts can be provided in a way that is more progressive than the current defined benefit Social Security system.** We could propose a negotiating principle that the traditional benefit must remain as progressive as it currently is, and that any individual accounts must be *more* progressive.

- **Our reform package could include initiatives to reduce elderly poverty, particularly among widows, and to help other needy populations.** We are developing a list of policy options in this area. For example, if progressive individual accounts were at least partially bequeathable, low-income families with short life expectancies could potentially benefit more from the progressivity of the individual accounts than they do from the progressivity of the current system.

KEY ISSUE #5: FEASIBILITY AND COST OF INDIVIDUAL ACCOUNTS

- **Individual accounts in foreign countries have proven very costly.** In both the U.K. and Chile, administrative costs absorb 20 percent or more of account accumulations under their systems of individual accounts.

- **Lower costs might be achievable by limiting choice.** At the cost of severely limiting choices, it may be possible to keep costs down significantly. Our benefit numbers assume a very low administrative cost of 10 basis points per year. This would correspond to a reduction in account accumulation of only 2 percent.

- **Low-cost plans would also be low-service plans.** The level of services associated with a plan this cheap would be very low, and in particular would compare unfavorably with the level of services offered through most 401(k) plans. Specifically, a bare-bones plan might offer annual reporting rather than monthly or even daily reporting, a much narrower range of asset choice, and a far lesser ability to switch among available assets.

- **Contributions would lag earnings.** For individual account funding approaches that are tied to past earnings, the delays in making contributions into accounts could be perceived to be very long. Under current procedures, workers' earnings for the prior year are not verified until November in the current year. Thus, if a system of this type were in force currently, workers' last recorded contribution as of today might be for 1996; or workers might *just* have received their contributions for 1997.

- **Funding out of the surplus might alleviate the perception problem.** It might be argued that since the funding of these accounts was coming from the surplus, individuals would not perceive the contributions to be tied to their earnings, and therefore not see it as arriving late.

- **Other approaches might be possible.** It is also possible, though not yet fully verified, that some acceleration of contributions could be achieved through a change in procedures.

Flat-Dollar Add-on Individual Account with Across the Board Benefit Cuts to Restore Solvency

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

Key Attractions of This Approach

- Gives individuals control over their retirement savings. Could be described as building wealth.
- Achieves higher returns while avoiding government ownership of private securities.

Key Disadvantages of This Approach

- Surpluses are not sufficient to fund individual accounts forever.

Impact on 75-Year Actuarial Balance (current balance is -2.19)

Common set of reforms	+0.97
Across the board cuts to achieve solvency	+1.22
Remaining Actuarial Balance	+0.01

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+34.4	+20.8	+15.8
Total	+18.1	+4.5	-0.5

Partially Voluntary Individual Accounts

- Fund $290 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds. ***Allow workers to voluntarily contribute an additional 1 percent of earnings to their accounts.***
- Make common set of reforms.
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

Key Attractions of This Approach
• Cuts in half the long-term fiscal obligation of the government to finance individual accounts.
• Preserves benefit levels for low-income workers even if they do not make voluntary contributions.

Key Disadvantages of This Approach
• Some may feel they are being asked to add an additional one percent of payroll taxes simply to maintain their existing Social Security benefit level.

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total without voluntary contribution	**+0.9**	**-5.9**	**-8.4**
Maximum annuity provided by voluntary Individual Account	+8.1	+10.8	+13.1
Total	**+9.0**	**+4.9**	**+4.7**

Under current law, annual benefit levels are $6010 for the low earner, $9925 for the average earner, and $13,112 for the high earner.

III. Plans that Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts

HYBRID PLANS: INDIVIDUAL ACCOUNTS AND TRUST FUND EQUITY INVESTMENTS

- Create $290 per worker individual accounts funded out of general revenue.
- Invest Trust Fund assets worth 1 percent of payroll in stocks. Limit the share of the Trust Fund invested in stocks to 25 percent.
- Make common set of reforms.
- Make additional across the board cut in benefits to achieve solvency.

KEY ATTRACTIONS OF THIS APPROACH

- Provides wins for both sides. Shores up traditional Social Security and establishes individual accounts.
- Because individual accounts are small, sustaining them in the out years will not create much pressure on other programs.
- Because transfers to the trust fund are modest, the peak share of the stock market owned by the trust fund will be between 3.7 and 5.7 percent.

KEY DISADVANTAGES OF THIS APPROACH

- Has the downsides of both individual accounts and trust fund investments: the high administrative costs of small individual accounts and the problems of government ownership of private securities.

IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

Common set of reforms	+0.97
Tax indiv. accounts like OASDI	+0.06
Redeem TF assets to buy stocks	+0.58
Across the board cuts to achieve solvency	+0.73
Remaining Actuarial Balance	+0.00

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-8.0	-8.0	-8.0
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total	+6.2	-0.6	-3.1

ARE THERE WAYS TO REDUCE GOVERNMENT OWNERSHIP CONCERNS?

- **Trust Fund investments could be allocated according to investment choices of individuals in their individual accounts.** In plans that combine Trust Fund investments with individual accounts, it might be possible to have the Trust Fund allocate its investments according to the aggregate investment behavior of individuals in their individual accounts. This idea -- and other ideas like it -- could allow defenders of government investment to say that it was millions of individual choices and not a government board that was allocating funds.

- **Many of the fundamental issues of corporate governance continue to arise in this approach.** Because the individual accounts being "mirrored" by the trust fund investments are presumed to be invested TSP-style, in government-authorized funds, issues of political influence over investment choices and of corporate governance could still be large.

Add-on Individual Account with Escrow Account to Sustain Individual Accounts

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- After funding individual accounts, place 70 percent of remaining surpluses in an escrow account invested 50-50 in stocks and bonds. Use the escrow account to fund individual account contributions after the unified budget surplus runs out.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

Key Attractions of This Approach

- Sustains individual accounts even after surpluses run out, thereby avoiding pressure to cut other programs to fund the new individual account "entitlement."

Key Disadvantages of This Approach

- Has same disadvantages as other plans that combine individual accounts and government investment in private securities.
- Some may find this proposal unusual and therefore not sound because it uses the escrow account to prefund individual account contributions rather than retirement benefits. People are used to the idea of prefunding pension benefits, but it would be novel to prefund pension contributions.

Impact on 75-Year Actuarial Balance (current balance is -2.19)

Common set of reforms	+0.97
Across the board cuts to achieve solvency	+1.22
Remaining Actuarial Balance	+0.01

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+34.4	+20.8	+15.8
Total	+18.1	+4.5	-0.5

FLAT-DOLLAR ADD-ON IA WITH 50 PERCENT INTEGRATION

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 stocks and bonds.
- Use 50 percent of individual accounts to fund traditional Social Security benefit. Tax other half of retirement income from individual accounts like Social Security
- Make common set of reforms and additional adjustments to traditional Social Security program to restore solvency.

KEY ATTRACTIONS OF THIS APPROACH

- Traditional benefits (after six percent reduction) are guaranteed regardless of how the market performs.
- Achieves nearly the same outcome as a trust fund investment in equities plan without creating perception of government ownership of private securities. Indeed, some prominent Republicans have embraced this approach.
- Integration of the benefit may make people more likely to perceive that their individual account is added together to their traditional benefit in providing their overall benefit.

KEY DISADVANTAGES OF THIS APPROACH

- When the government uses 50 percent of the individual account to fund the traditional benefit, people may feel that they are losing half of their account rather than understanding all along that the account has two parts -- one part which funds the traditional benefit and another part that provides additional retirement income.
- May be perceived as complicated.

IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)

Common set of reforms	+0.97
Tax individual accounts like OASDI	+0.06
50 percent clawback of indiv. accounts	+0.90
Across the board cuts to achieve solvency	+0.26
Remaining Actuarial Balance	+0.00

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-3.2	-3.2	-3.2
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total	+11.0	+4.2	+1.7

Plans That Fund Individual Accounts Out of the Existing 12.4 Percent Social Security Payroll Tax

BREAUX-GREGG-KOLBE-STENHOLM PLAN

- Use 2 percent of the existing 12.4 percent Social Security payroll tax to fund 2 percent of payroll individual accounts.

- Make reforms to traditional Social Security program:
  - -- Reduce second and third bend points by 2 percent per year for 20 years.
  - -- Reduce COLA by 0.5 percentage points.
  - -- Increase normal retirement age by 2 months per year until it reaches 70, then index.
  - -- Cover new state and local workers.
  - -- Reduce spouse benefits from 50 to 33 percent of PIA.
  - -- Increase computation period to 40 years, but count all earnings.
  - -- Eliminate earnings test.
  - -- Credit all taxation of Social Security benefits to OASDI.
  - -- Create new minimum benefit.

KEY ATTRACTIONS OF THIS APPROACH
• Plan is fiscally responsible.

KEY DISADVANTAGES OF THIS APPROACH
• Reduces benefits compared to present law (though not compared to the 72 percent of benefits that are affordable in 2032 if no changes are made).

IMPACT ON 75-YEAR ACTUARIAL BALANCE (current balance is -2.19)	
Remaining Actuarial Balance	+0.00

IMPACT ON BENEFITS IN 2030 PERCENT OF CURRENT LAW BENEFITS			
	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Change in Traditional Benefits	-25.1%	-39.5%	-42.2%
Annuity provided by Individual Account	16.2	21.6	26.2
Total	-8.9	-17.9	-16.0

2 Percent Carve-out for 2 Percent Individual Accounts with Transfer of Remaining Surplus for Bonds

- Redirect 2 percent of OASDI payroll tax beginning in 2000 to fund 2 percent of payroll individual accounts. Assume these funds are invested 50-50 in stocks and bonds. Transfer remaining *currently projected* surpluses to the trust fund and invest them in bonds.

- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).

- Make additional across the board cuts by revising the benefit formula.

Key Attractions of This Approach

- Plan is fiscally responsible and would reduce long-term budget deficits and increase national savings even compared with the baseline that uses the surplus to pay off debt.

- The combined retirement income from individual accounts and traditional benefit would be close to currently promised benefit levels.

Key Disadvantages of This Approach

- In the long run, the individual account would be providing roughly 40 percent of the total benefit. Benefit levels would depend heavily on stock market performance.

- Because it uses some of the current payroll tax to fund individual accounts, this plan could be perceived as the first step toward total privatization.

Impact on 75-year Actuarial Balance (current balance is -2.19)

Common set of reforms	+0.97	
Two percent carve-out	-1.92	
Transfer of remaining surpluses to OASDI		+1.45
Across the board cuts to achieve solvency		+1.71
Remaining Actuarial Balance	+0.03	

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-18.7	-18.7	-18.7
Annuity provided by Individual Account	+16.2	+21.6	+26.2
Total	-5.5	-0.1	+4.5

Note: if individual accounts were funded more progressively, the total benefits for low earners could exceed currently promised levels.

I. Why Social Security Reform?

- Perceived and real insolvency of Social Security system threatens confidence in crown-jewel of progressive government.
- Seeking reform under Democratic President in second term offers ability to reform Social Security in a way that is progressive and universal.
- Failure to achieve reform could lead to budget surplus being dissipated on spending or tax cut proposals, making eventual Social Security reform more painful and less generous.
- Waiting longer can make reforms within more traditional Social Security structure more difficult, could erode confidence in the system, and lead to more radical reform down the road.

II. Substantive Goals of Social Security Reform

- Reform that meets or strengthens five principles President laid out at Kansas City conference:

1. Strengthen and Protect Social Security for the 21st Century.
2. Maintain Universality and Fairness.
3. Provide a Benefit People Can Count on.
4. Preserve Financial Security for Low-Income and Disabled Beneficiaries.
5. Maintain Fiscal Discipline.

Possible Other Goals:

- Maintain or strengthen progressivity of current system.
- Increase national savings (compared to the surplus being spent).
- Achieve higher returns from Social Security system.
- Reduce widow poverty.
- Strengthen system even more for disadvantaged minorities.

III. Strategic Considerations for Social Security Reform

Bipartisan Reform Must Allow Wins for Both Sides:

- Republicans must have <u>either</u> Individual Accounts or surplus-funded tax cuts.

- Democrats must have <u>either</u> traditional Social Security reform without Individual Accounts or reform that secures the basic Social Security system and also achieves Democratic wins, such as increased progressivity, reduction in widow poverty, improvements for disadvantaged minorities, perception of universal pensions, or Individual Accounts seen as voluntary or on-top of normal structure.

Win-Win Compromises:

- Social Security reform <u>with</u> progressive Individual Account structure.

- Social Security reform <u>without</u> Individual Accounts, but large tax cuts.

Tone:

- We face a choice about our tone heading into this process. We could <u>either:</u>

  - Take a harder edge with Democratic rhetoric and hope to bring the Republicans to the table (and have greater leverage to get bipartisan deal with progressive support).

  - We could stay above the fray, acting as the honest broker seeking to craft and bless any acceptable compromise.

IV. Strategic Goals for Completing Reform in Current Environment

- Must convince <u>Democrats</u> to be open to progressive Individual Account structure as long as the basic Social Security program is maintained (consistent with the President's five principles).

  - Must convince Democrats that without reform this year, surplus will be used for tax cuts -- which would make eventual reform more difficult and less generous.

  - Individual Accounts -- if structured with a basic guarantee and structured like the Thrift Savings Plan (TSP) -- will not be open to harshest critiques and could be popular with some Democratic constituencies.

- Show that being open to Individual Accounts could bring significant wins for Democrats on progressivity, widow poverty, disadvantaged minorities, etc.

- May need to create principled framework for Individual Accounts:

  - Individual Accounts must make system more progressive -- and basic system stays as progressive as currently.
  - Individual Accounts must offer basic guarantee.
  - Individual Accounts must be structured like TSP with limited choices, low fees, and measures to minimize churning, etc.

- Must convince Republicans to minimize size of Individual Accounts and meet President's demands on progressivity.

V. Challenges We Must Overcome To Achieve Bipartisan Reform

- Most bipartisan efforts currently involve fiscally conservative Democrats that don't represent mainstream of party. Likewise, a bipartisan agreement among members of the Senate Finance Committee would not get a majority of House Democrats.

- Many Republicans see Individual Accounts as a means to a completely privatized system. Their demands must be moderated to smaller Individual Accounts and allow for Democratic wins on progressivity.

- Democrats must be open to small Individual Accounts as trade-off for gains on progressivity, widow poverty, etc.

- Middle ground for Democrats has not emerged. Democrats are either for trust fund investments in equity which would leave the government with a significant share of the stock market or relatively harsh Individual Accounts with significant cuts in the traditional program (e.g., Kerrey, Moynihan, Breaux, Stenholm). We must help bring Democrats to middle ground.

  Possible Members With Whom To Build Coalition:

  - *Senate Democrats:* Daschle, Bingaman, Conrad.

  - *House Democrats:* Few options, but possibilities include Pomeroy (Gephardt's representative on Social Security reform), Cardin, Rangel, and New Democrats.

  - *Senate Republicans:* Gregg, Gramm, Santorum, Domenici, Chafee, Grassley all expressed desires to work with us. Many Republicans are scared of being targeted as "privatizers." The key challenge with Senate Republicans is that, for example, Gramm and Domenici have a broad clawback approach with 3 percent Individual Accounts and they would need to move to the center.

  - *House Republicans:* Kolbe has shown moderate leadership; Sanford wants to work with us, but his proposal is still too excessive. It is unclear how much Gingrich and Armey will move to the center for the sake of reform.

VI. Options on Process

Timing:

- Should bipartisan process begin this year (November/December)?

  or

- Should it begin early next year (January/February)?

Initial Substantive Action:

- President's initial substantive action:
  - Does President put out additional framework, guidelines, principles that could lay out map for Individual Accounts or anti-poverty goals that must be accomplished?
  - Does President put out specific framework for legislation in discussion paper without legislative details?
  - Does President put out specific plan? Key timing issues: December Conference, Early January, or State of the Union.

Process Options:

Process Option #1:

o Republicans and Democrats each appoint head of Senate Finance and House Ways and Means plus one leadership choice for both Democrats and Republicans. (Both sides would be able to designate others on key issues to bring more people into the process.) The negotiating sides would likely be: Moynihan, Bingaman, Rangel, and Pomeroy and Roth, Gregg, Archer, and Sanford, plus Administration representatives. That would be 10-12 people at the table. If we go to next level -- by adding majority and minority members of the budget committees -- there would be 18-20 people in the room.

- Key Challenge: There will be resistance to formal negotiating structure because people do not want to be cut out (e.g., Gramm, Conrad, Domenici, Kolbe, Stenholm, Breaux, Santorum, Grassley).

Process Option #2:

o Senate Finance Committee becomes vehicle for first negotiations happening among its members with White House participation.

- Key Challenge: A bipartisan agreement among members of the Senate Finance Committee would not get a majority of House Democrats.

Process Option #3:

- o Use model of tobacco strategy: President puts out detailed guidelines (which he could do under any of these options) and vows to work with any group that wants comprehensive Social Security reform.

  - <u>Key Challenge:</u> May lose leadership points for not putting out specific plan. May be only starting point and issue would be when in process to put something forward that is more specific.

Process Option #3a:

- o President puts out detailed guidelines, but <u>not</u> specific plan. Provides framework for negotiations to go forward with Finance Committee and Ways and Means.

Process Option #4:

- o President does serious consultations and puts out specific Social Security reform plan.

  - <u>Pros:</u>

    President would get immediate leadership points for putting out specific plan.

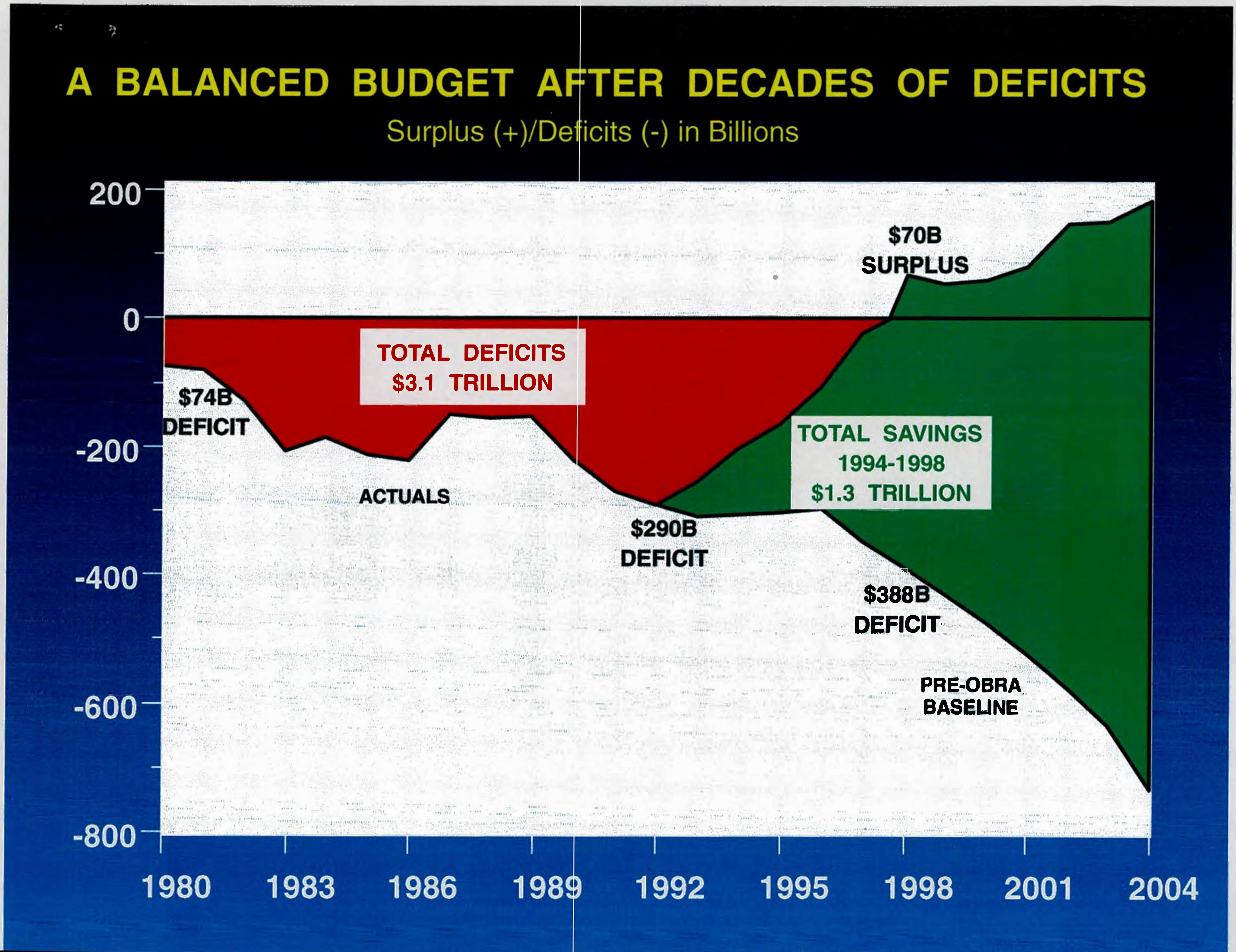
    Would help jump-start Social Security process to have Presidential plan on the table.

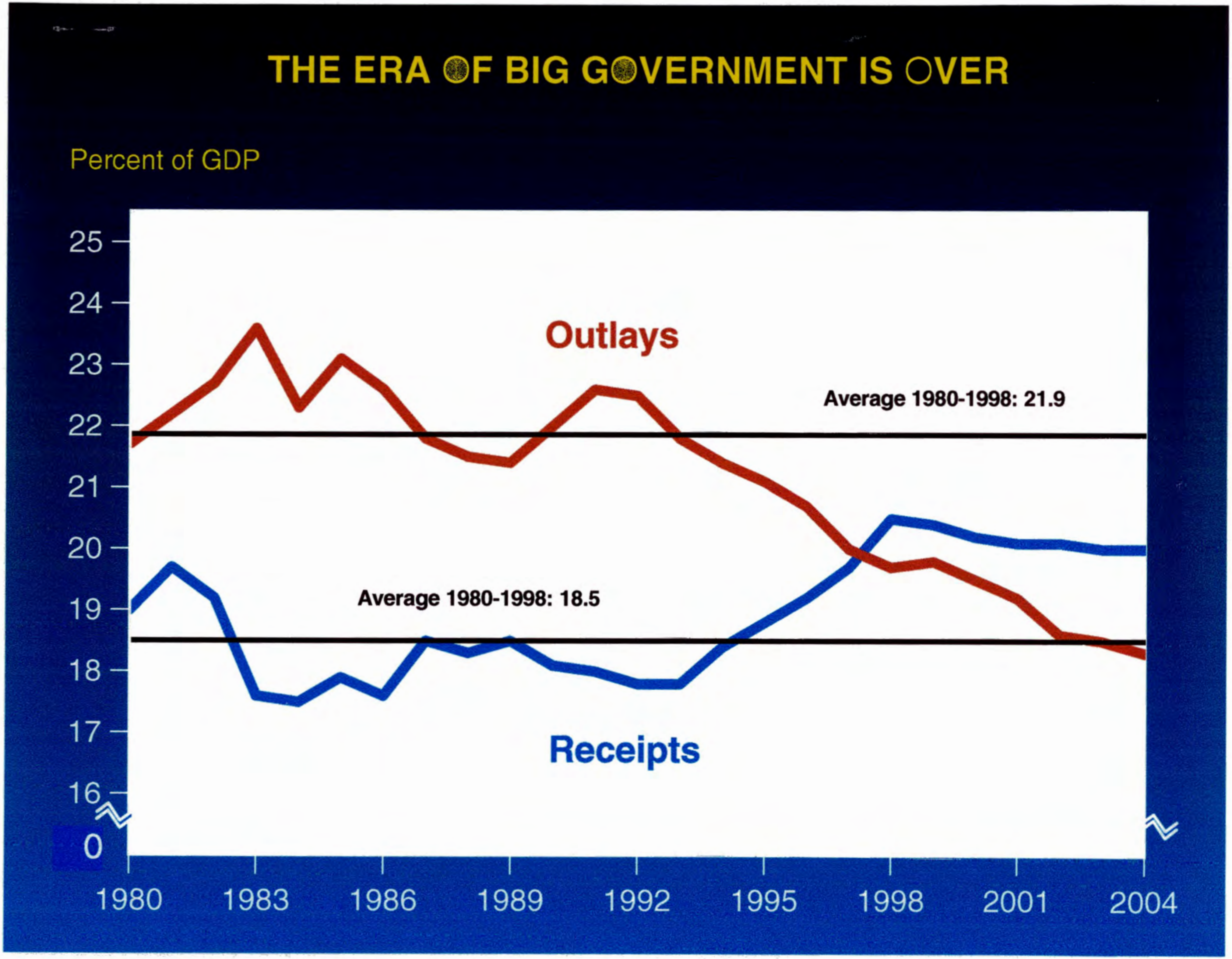
  - <u>Cons:</u>

    A centrist proposal -- "center-out" strategy -- by the President could be criticized by base groups for giving up too much at the start, while Republicans may feel they need to move to the right of the President (even if it would otherwise be acceptable).

    A "left-in" strategy may solidify our base's position that we do <u>not</u> need to compromise and may give Republicans the impression that we are <u>not</u> serious about Social Security reform.

Julie is not to believe
having the program own
design - needs to be meaty.

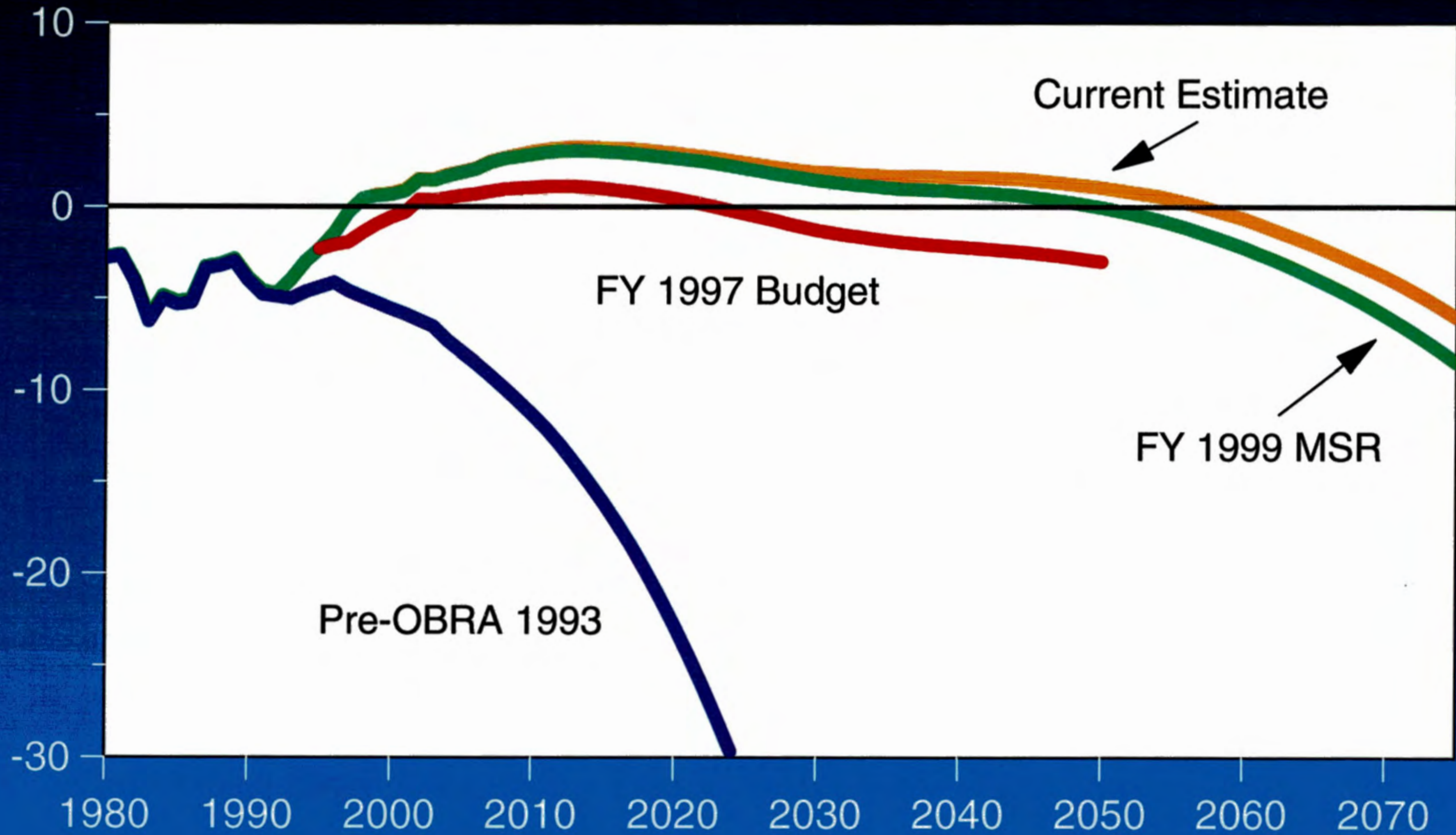

A BALANCED BUDGET AFTER DECADES OF DEFICITS
Surplus (+)/Deficits (-) in Billions
200
0
-200
-400
-600
-800
1980
1983
1986
1989
1992
1995
1998
2001
2004
$74B DEFICIT
TOTAL DEFICITS $3.1 TRILLION
ACTUALS
$290B DEFICIT
TOTAL SAVINGS 1994-1998 $1.3 TRILLION
$70B SURPLUS
$388B DEFICIT
PRE-OBRA BASELINE

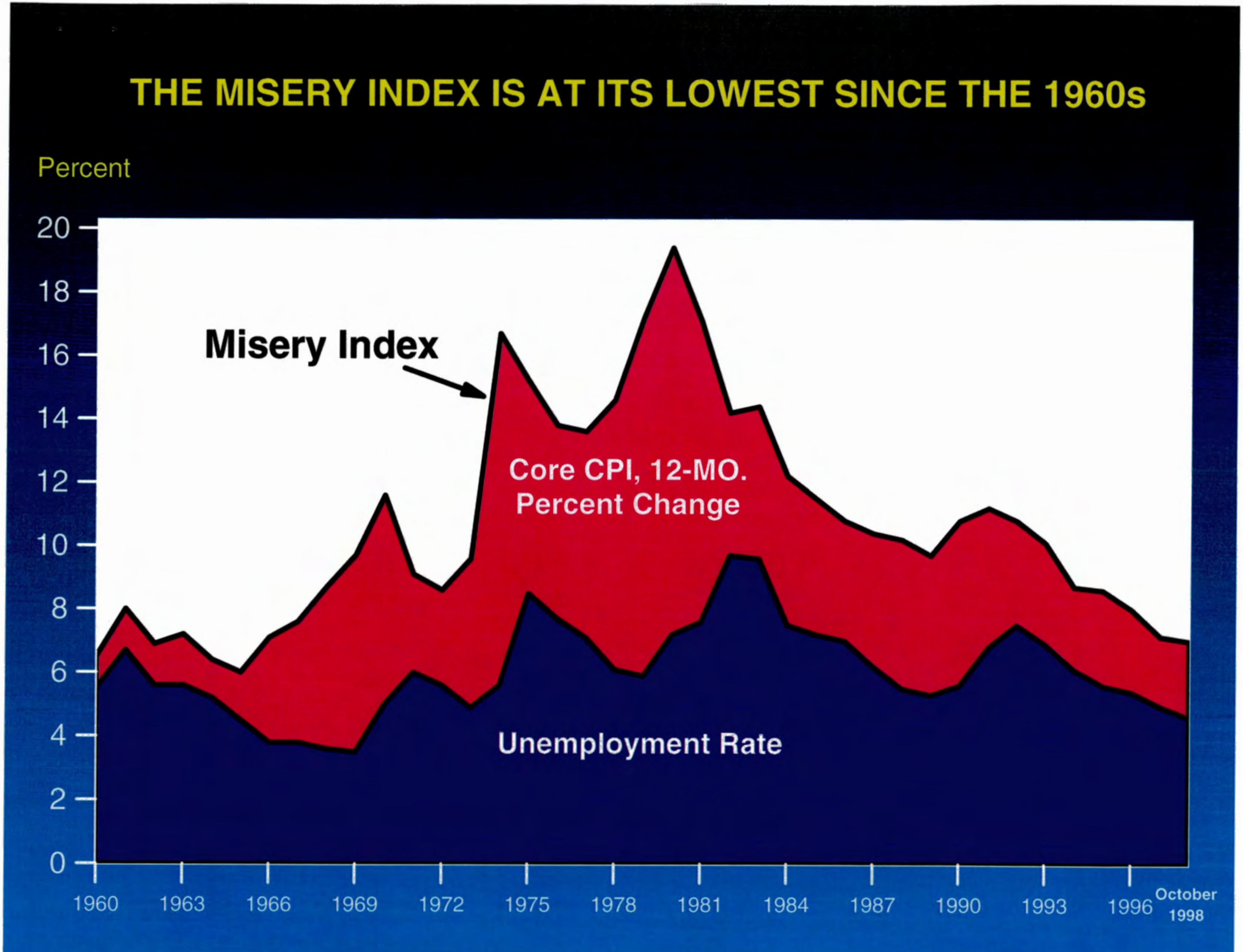


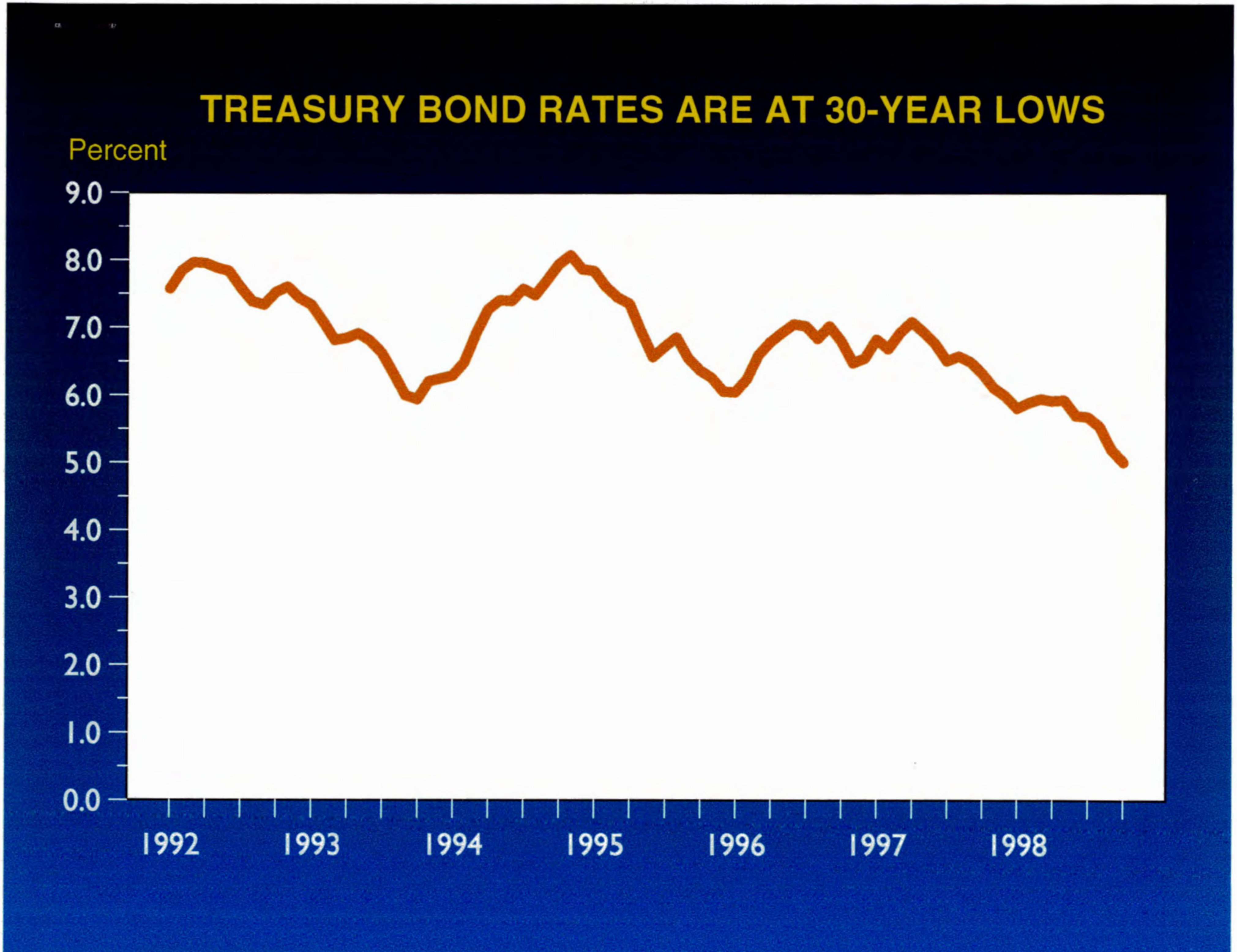
THE ERA OF BIG GOVERNMENT IS OVER
Percent of GDP
25
24
23
22
21
20
19
18
17
16
0
Outlays
Average 1980-1998: 21.9
Average 1980-1998: 18.5
Receipts
1980
1983
1986
1989
1992
1995
1998
2001
2004

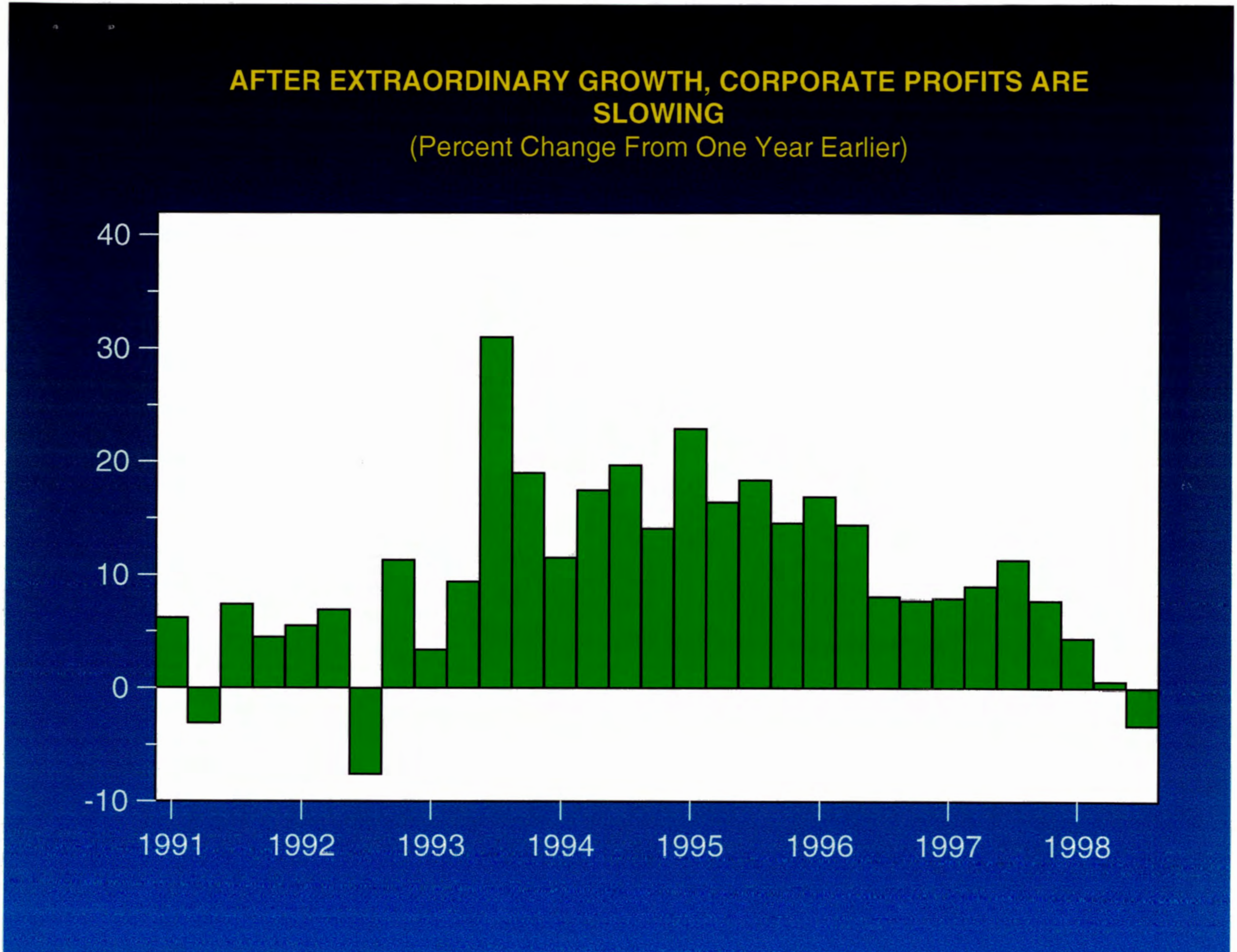
IMPROVED OUTLOOK: UNIQUE OPPORTUNITY TO SAVE SOCIAL SECURITY

Surplus/Deficit (-) As A Percent of GDP

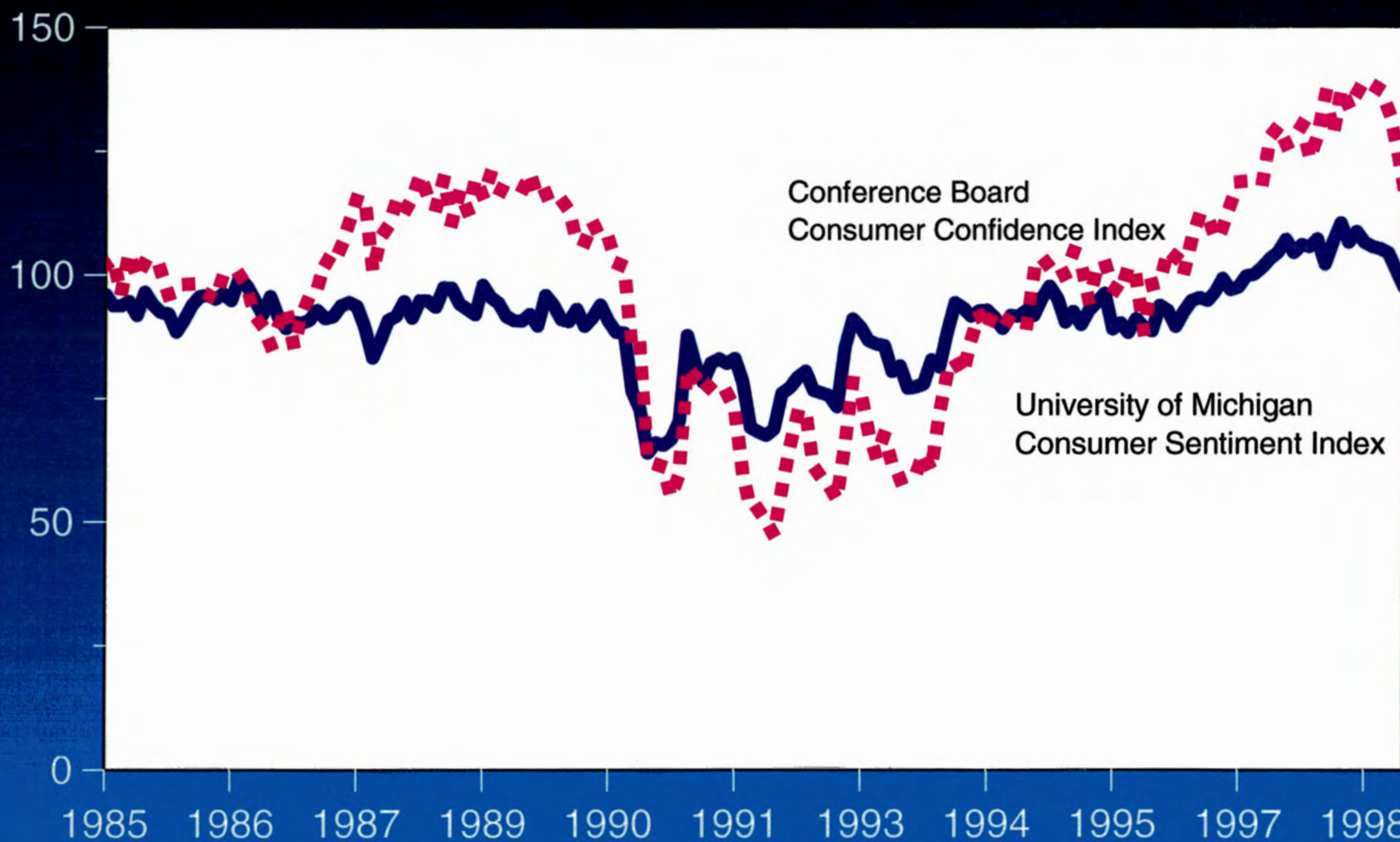


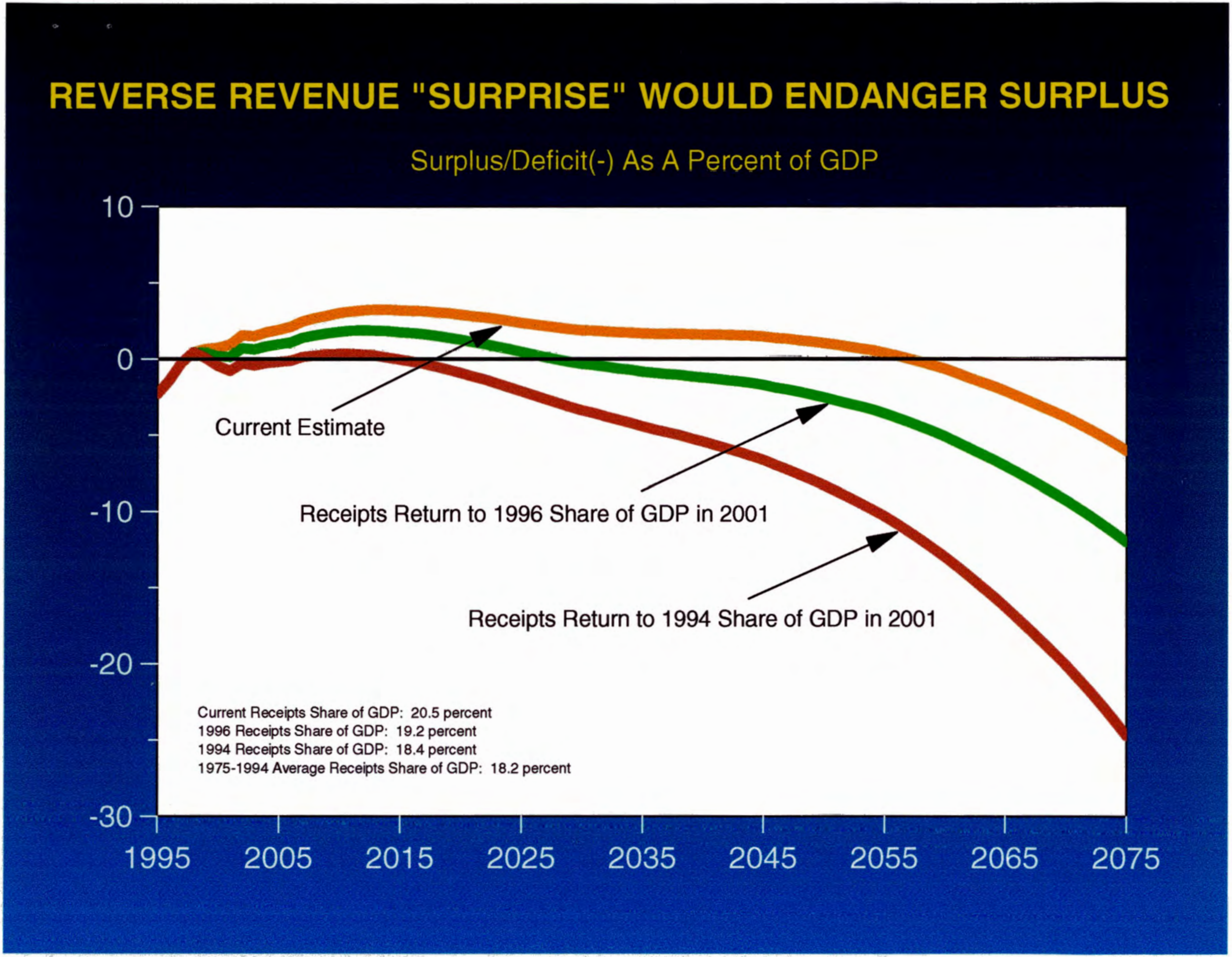

THE MISERY INDEX IS AT ITS LOWEST SINCE THE 1960s
Percent
20
18
16
14
12
10
8
6
4
2
0
Misery Index
Core CPI, 12-MO.
Percent Change
Unemployment Rate
1960
1963
1966
1969
1972
1975
1978
1981
1984
1987
1990
1993
1996
October
1998

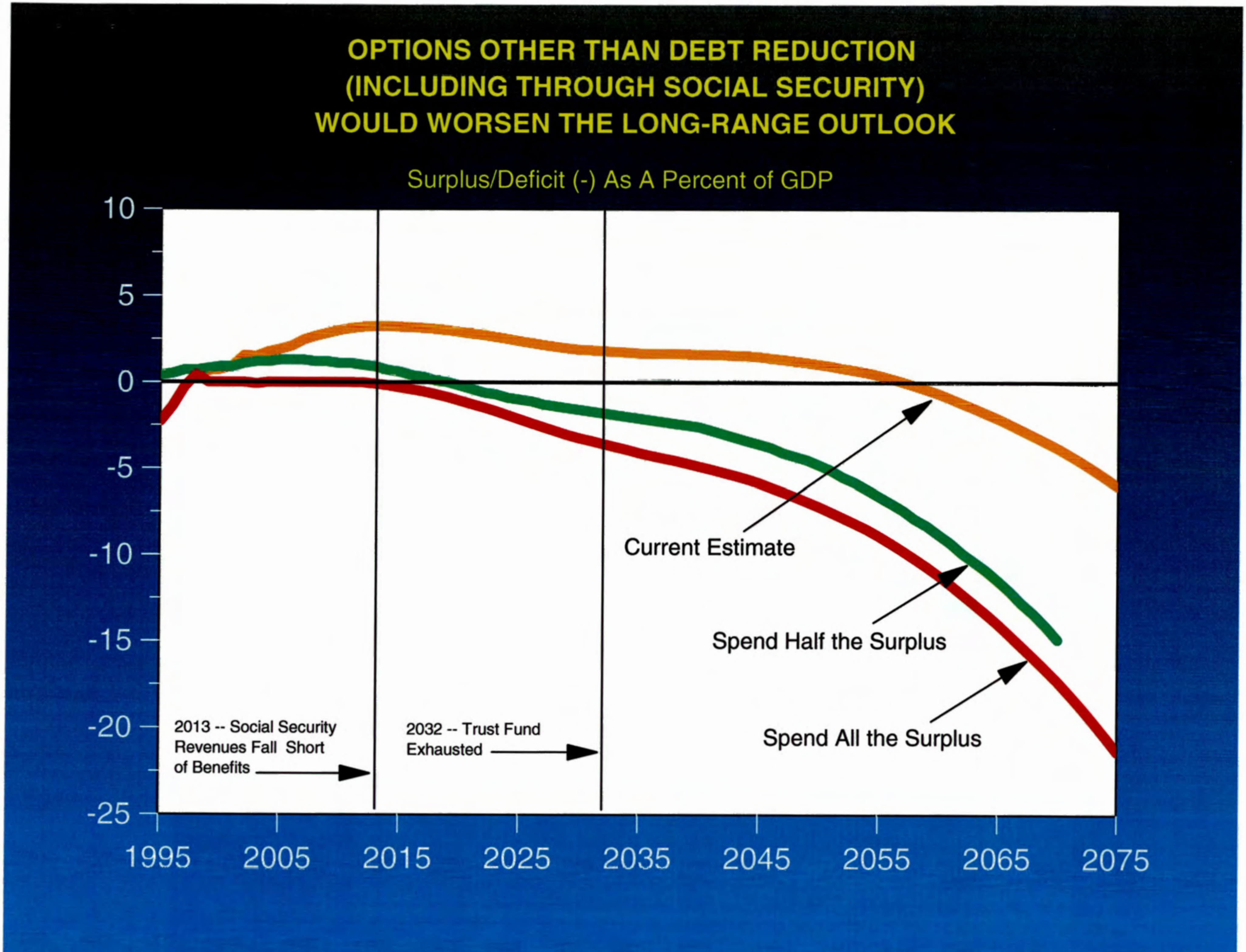

TREASURY BOND RATES ARE AT 30-YEAR LOWS
Percent
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
1992
1993
1994
1995
1996
1997
1998


AFTER EXTRAORDINARY GROWTH, CORPORATE PROFITS ARE SLOWING
(Percent Change From One Year Earlier)
40
30
20
10
0
-10
1991
1992
1993
1994
1995
1996
1997
1998

CONSUMER CONFIDENCE IS BEGINNING TO SLIP



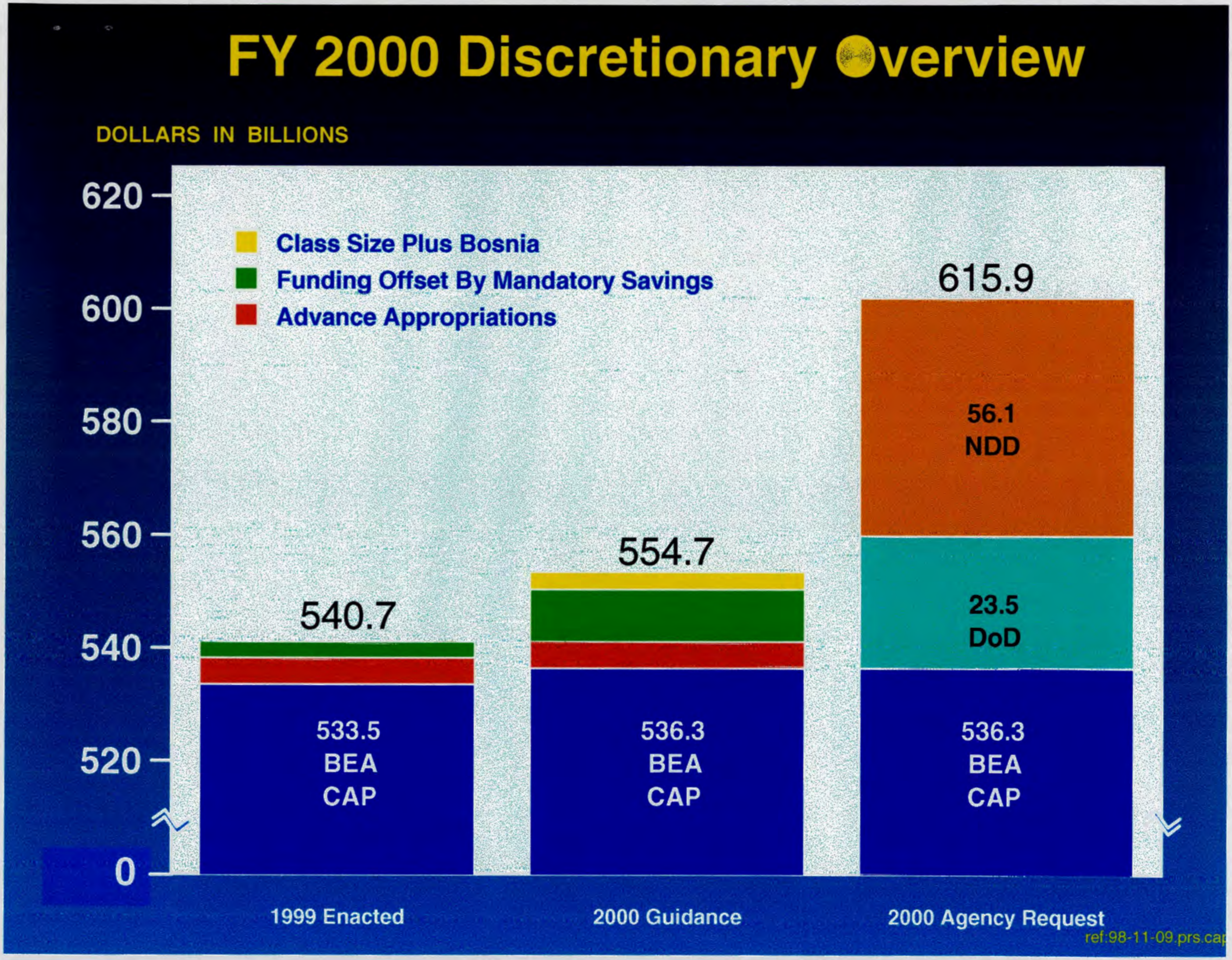

REVERSE REVENUE "SURPRISE" WOULD ENDANGER SURPLUS
Surplus/Deficit(-) As A Percent of GDP
10
0
-10
-20
-30
1995
2005
2015
2025
2035
2045
2055
2065
2075
Current Estimate
Receipts Return to 1996 Share of GDP in 2001
Receipts Return to 1994 Share of GDP in 2001
Current Receipts Share of GDP: 20.5 percent
1996 Receipts Share of GDP: 19.2 percent
1994 Receipts Share of GDP: 18.4 percent
1975-1994 Average Receipts Share of GDP: 18.2 percent


OPTIONS OTHER THAN DEBT REDUCTION
(INCLUDING THROUGH SOCIAL SECURITY)
WOULD WORSEN THE LONG-RANGE OUTLOOK
Surplus/Deficit (-) As A Percent of GDP
10
5
0
-5
-10
-15
-20
-25
1995
2005
2015
2025
2035
2045
2055
2065
2075
Current Estimate
Spend Half the Surplus
Spend All the Surplus
2013 -- Social Security Revenues Fall Short of Benefits
2032 -- Trust Fund Exhausted

SURPLUS/DEFICIT (-) ESTIMATES

(In Billions of Dollars)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Total
1999 MSR	54	61	83	148	150	184	213	245	300	342	**1788**
Current Estimate	47	64	89	157	166	192	221	253	305	348	**1842**


FY 2000 Discretionary Overview
DOLLARS IN BILLIONS
620
600
580
560
540
520
0
Class Size Plus Bosnia
Funding Offset By Mandatory Savings
Advance Appropriations
540.7
533.5
BEA
CAP
554.7
536.3
BEA
CAP
615.9
56.1
NDD
23.5
DoD
536.3
BEA
CAP
1999 Enacted
2000 Guidance
2000 Agency Request
ref:98-11-09.prs.cap

Additional Requirements and Initiatives

	00	(Outlays)	5-Year
• **Mandatory Reproposals:**			
– Child Care and Early Learning	1.2		9.3
– Medicare Buy-In	0.1		2.1
– Superfund Orphan Shares	0.2		1.0
– Other	0.7		5.1
• **Tax Reproposals:**			
– Affordable Child Care	0.3		5.6
– Energy Efficiency/Climate Change	0.4		4.4
– School Construction	0.2		5.0
– Expiring Provisions	1.0		3.5
– Other	1.3		5.9
• **Expiring Programs:**			
– Welfare-To-Work	0.2		5.6
– COPS	1.2		3.6

- **New Initiatives**

2000 Budget Goals

- Save Surplus for Social Security
- Fulfill Prior Commitments
- Adequately Fund Core Government
- Finance Initiatives

FISCAL CRITERIA FOR SOCIAL SECURITY REFORM

1. TRUST FUND 75-YEAR ACTUARIAL BALANCE

- While Social Security is currently bringing in more money than it is paying out, this balance will be reversed early in the first half of the next century.

OASDI Income and Cost Rates, Calendar Years 2000-2070 (As percentage of taxable payroll)			
	Income rate (Social Security revenue excluding interest as percentage of taxable payroll)	Cost rate (Social Security outgo as percentage of taxable payroll)	Balance
2000	12.63	11.16	1.48
2010	12.74	12.19	0.54
2030	13.10	17.76	-4.66
2050	13.22	18.29	-5.07
2070	13.34	19.54	-6.20

Note: income rate exceeds 12.4 percent because it includes income from taxation of benefits.

- 75-year shortfall is 2.19 percent of payroll. Eliminating this 75-year shortfall is the target that most reform plans try to achieve.

- Plans often achieve 75-year actuarial balance by combining positive cash flow in early years with negative cash flow in later years. This implies that the passage of time will eventually leave us out of 75-year actuarial balance again.

- However, a plan that keeps us solvent until 2080 will continue to keep us solvent until that date (if demographic and economic assumptions are correct). Thus, so long as the plan is described as a plan to restore solvency through a particular date rather than as a plan to achieve 75-year balance, we may be immune to the critique that the reform failed to save Social Security.

- Some people argue that the goal of reform should be to have the system in balance forever. Others, point out that delaying the date of trust fund exhaustion by 50 years would be a significant achievement even if it did not result in the system being sustainable in perpetuity.

2. IMPACT ON UNIFIED BUDGET

Two Key Budget Assumptions

What assumption should we make about the growth rate of discretionary spending?

- For the standard 10-year budget window, it is conventional to assume that discretionary spending grows with the CPI. Any change to this would likely meet with heavy Republican resistance since it would imply higher levels of spending.

- For longer term forecasts, some have suggested that it makes sense to use a different assumption about the growth rate of discretionary spending. Assuming that discretionary spending growth slower than GDP would imply that such spending will be a much smaller share of the economy in the long run. Since all of the projections we use assume that discretionary spending grows with the CPI for the first 10-years, even the more generous assumptions result in discretionary spending that is a smaller share of the economy in the future than it is today.

	Discretionary spending as share of GDP			
Discretionary spending grows with:	2000	2010	2040	2070
CPI	6.3	4.9	3.2	2.2
CPI+population	6.3	4.9	3.7	2.7
GDP	6.3	4.9	4.9	4.9

Note: All three projections assume that discretionary spending grows at CPI for the first 10 years. Source: OMB, Analytical Perspectives.

- Under OMB mid-session review projections, surpluses last until 2053 if discretionary spending grows with CPI, 2037 if discretionary spending grows at CPI+population, and 2028 if discretionary spending grows at the same rate as GDP. These projections assume that the surplus is used to pay off debt.

We compare plans to both a spend-surplus baseline and a save-surplus baseline.

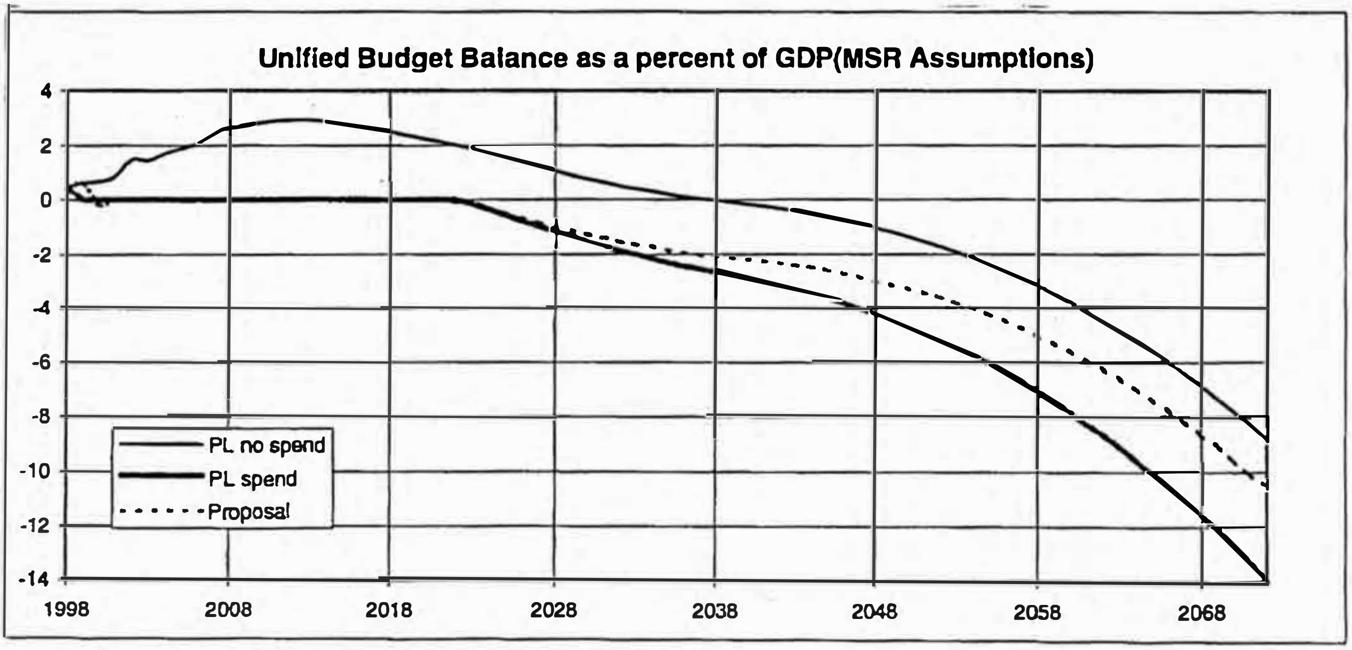
- Surpluses last longer if they are used to pay off debt than if they are spent. For example, under the assumption that discretionary spending grows at CPI+population, surpluses last until 2037 if surpluses are used to pay off debt, but only until 2022 if the surpluses are spent.

- These budget projections assume that Social Security benefits continue to be paid in full out of general revenues even after the trust fund is exhausted. General revenue transfers would eventually become large -- 2.26 percent of GDP in 2070. Moreover, if debt were issued to finance these transfers, the combined impact of the transfers and the additional interest expense would reach 4.6 percent of GDP in 2070.

Unified Budget Benchmarks
(share of GDP)

	Unified Budget Surplus under baseline (pay off debt) (1)	Unified Budget Surplus if surpluses are spent (2)
2000	0.67	0.00
2010	2.82	0.00
2030	0.76	-1.54
2050	-1.33	-4.65
2070	-7.82	-12.72
change from 2000-2070	-8.49	-12.72

Source: OMB Mid-session Review and SSA calculations based on OMB economic assumptions. Assumes discretionary spending grows at CPI+population.



THREE BASIC REFORMS

- At this point, we want our discussion to focus on fundamental issues of plan design that could impact our short term strategy for achieving reform, and to avoid spending too much time on details that can be worked out at a later date.

- All of our plans contain three basic provisions that are meant as place holders for benefit cuts and/or revenue increases to be determined later. These provisions by themselves close 44 percent of the 75-year actuarial imbalance.

- The three provisions are:

  -- Raise the tax base for the OASDI payroll tax so that 90 percent of earnings are taxed.

  -- Cover state and local government new hires beginning in 2011.

  -- Increase the number of years used in calculating Social Security benefits from 35 to 38.

- While all three of these proposals are likely to run into serious political opposition, it is important to note that only one of these three provisions results in a reduction in Social Security benefits for future retirees, and that reduction is only 3 percent.

- Replacing these provisions with an across the board benefit cut would require a 10 percent cut in benefits for 2030 (if the cuts were phased in over 15 years) and a 20 percent cut by 2040 (if the cuts were phased in over 40 years). Such benefit cuts may be even less palatable than these three basic provisions.

THE WHITE HOUSE

WASHINGTON

MEETING ON CONGRESSIONAL AND THINK-TANK SOCIAL SECURITY REFORM APPROACHES

Cabinet Room
November 12, 1998
11:20 AM

AGENDA

I. PLANS THAT TRANSFER SURPLUSES TO TRUST FUND

II. PLANS THAT USE SURPLUSES TO FUND INDIVIDUAL ACCOUNTS

III. PLANS THAT USE SURPLUSES BOTH TO STRENGTHEN THE TRUST FUND AND ESTABLISH INDIVIDUAL ACCOUNTS

A Basic Typology of Plans

We will be discussing six forms of Social Security plans. All of these plans use the surplus in one way or another, and all could be designed to do so to a greater or lesser extent.

Title	Description

A. Plans That Use the Surplus to Shore up the Trust Fund

1. Bond-only plans	Maintain current policy of holding only Treasury securities.
2. Equities in the Trust Fund	Introduce equities into the system, but hold them collectively.

B. Plans That Use the Surplus in Creating Individual Accounts

3. Add-on individual accounts	Continue to use all of the current 12.4 percent payroll tax to fund traditional Social Security benefits; make sufficient adjustments to the system (benefit cuts, revenue increases) to bring it into balance. Establish individual accounts in addition to the current system.
4. Carve-out individual accounts	Divert some of the current 12.4 percent payroll tax into individual accounts. Individual accounts *replace* part of the current system, and could potentially be described as a tax cut. Relatively large surplus transfers and/or cuts to the traditional Social Security benefit would be necessary to restore solvency. So far, most carve-out plans have been "fiscally conservative" with significant cuts through such provisions as raising the retirement age. With more use of the surplus, the cuts could be softened.

C. Plans That Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts

5. Integrative plans	Use surplus to establish individual accounts. At retirement, part of the proceeds of the accounts are used to finance traditional benefits, while part provide an add-on individual account.
6. Hybrid plans	Contribute part of the surplus directly into the Trust Fund, as under (1) or (2), and part into individual accounts as under (3).

(1) Cut
(2) Tax
(3) Surplus
(4) Higher Return

Any Fix
(1) taxes can't pay benefits
(2) Prepare for BBoom generally – eg Med costs
(3) Stop bad use of surplus?

THREE BASIC REFORMS

At this point, we want our discussion to focus on fundamental issues of plan design that could impact our short-term strategy for achieving reform, and to avoid spending too much time on details that can be worked out at a later date.

- **Many of our plans contain three basic provisions that are meant as place holders for benefit cuts and/or revenue increases to be determined later.** The three provisions we happen to have chosen close 44 percent of the 75-year actuarial imbalance. There would be many other ways to achieve similar solvency effects.

    -- **Raise the taxable maximum for the OASDI payroll tax so that 90 percent of earnings are taxed by 2010.** This would return the percentage of earnings that are covered to where it was in 1982 and 1983. In 1998 dollars, it would be equivalent to raising the taxable maximum from $68,400 to $95,100. It would raise taxes by up to $1,655 (on both workers and employers) for the six percent of workers with earnings above $68,400. We are exploring ways to raise revenues without having such a large effect.

    -- **Cover state and local government new hires beginning in 2011.**

    -- **Increase the number of years used in calculating Social Security benefits from 35 to 38.**

- **These proposals could be replaced with an across-the-board benefit cut of 10 percent.** While all three of these proposals are likely to run into serious political opposition, it is important to note that only one of these three provisions results in a reduction in Social Security benefits for future retirees, and that the reduction equals only 3 percent of current-law benefits. Replacing these provisions with an across-the-board benefit cut would require a 10-percent cut in benefits in 2015 and later (or 20 percent by 2040 if the cuts were phased in more slowly). Such benefit cuts may be even less palatable than these three basic provisions.

I. Plans that Transfer Surplus to the Trust Fund

TRANSFER UNIFIED BUDGET SURPLUSES TO SOCIAL SECURITY TRUST FUND AND INVEST IN BONDS ONLY

- Transfer **91 percent** of the *currently projected* unified budget surpluses to the Trust Fund for as long as they last (2033), and continue to invest the Trust Fund in government bonds only.

- Do <u>not</u> include common set of reforms.

KEY ATTRACTIONS OF THIS APPROACH
• Continues the program on a completely defined benefit basis, avoiding potentially costly and risky alternative approaches.
• Preserves benefits at current law levels.
• Prevents nearly all of the surplus from being used for other purposes.
• Very consistent with our message of the past year that surpluses have been reserved pending Social Security reform.

KEY DISADVANTAGES OF THIS APPROACH
• See box on next page.

IMPACT ON 75-YEAR ACTUARIAL BALANCE	
Common set of reforms	NA
<u>General revenue transfer to Trust Fund</u>	<u>+2.22</u>
Remaining Actuarial Balance	+0.03

IMPACT ON BENEFITS IN 2030 PERCENT OF CURRENT LAW BENEFITS			
	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Total	**+0.0**	**+0.0**	**+0.0**

ALTERNATIVE VERSION WITH 3 COMMON REFORMS:

- Transfer **55 percent** of the *currently projected* UB surplus to Trust Fund for as long as they last (2031), and continue to invest the Trust Fund only in government bonds.

- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).

KEY CHALLENGES ASSOCIATED WITH BONDS ONLY PLANS

- **Will Transfers of the Surplus Help Us Prepare for the Future?** Transfers of the budget surplus to the Trust Fund do not reduce the mismatch between annual tax revenues and benefit obligations in the out years. However, to the extent that transfers allow us to use the surplus to pay off debt (or purchase private securities), they will leave us in a stronger financial position when the demographic challenges arrive.

- **Will Transfers Succeed in Removing Surpluses from the Books?** Under current budget scoring rules, transfers used to purchase government bonds would not remove any unified budget surplus from the books, and therefore would not prevent the surplus from being used for tax cuts or new spending. However, allocating the surpluses for Social Security could lead to a change in scoring rules.

- **The Double Counting Problem.** The Trust Fund has already been credited with the excess of Social Security taxes over benefits. The current unified budget surplus is entirely due to the Social Security surplus. Under OMB projections, 89 percent of unified budget surpluses over the next 10 years are due to Social Security (under CBO projections, 98 percent are due to Social Security). If we were to transfer the surplus to Social Security, some might complain that we were crediting the Trust Fund twice. Indeed, some people already argue that the Trust Fund is not "real" and that we are "raiding" the Social Security Trust Fund to mask non-Social Security deficits.

- **Maintains and Expands Social Security Trust Fund Structure.** Many Democrats and Republicans do not support the trust fund structure, saying that it does not truly set aside money for Social Security and does not prevent the funds from being spent. By transferring additional funds to the trust fund, this type of plan would expand Social Security's reliance on the trust fund structure.

- **Sustaining Transfers If Surpluses Do Not Materialize.** If the full projected surpluses do not materialize and transfers are scored as outlays, then the transfers could result in budget deficits. To the extent that these deficits are financed by issuing debt, then we will not have done anything to improve the long run fiscal situation. In addition, it may appear strange to be transferring amounts based on projections of surpluses from many years ago.

TRANSFER SURPLUS TO TRUST FUND AND INVEST IN EQUITIES

- Transfer **68 percent** of the *currently projected* unified budget surpluses to the Trust Fund for **1999-2032** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.

KEY ATTRACTIONS OF THIS APPROACH

- Continues the program on a completely defined benefit basis.
- Achieves higher returns with low administrative costs while spreading risk across the population and over time.
- Preserves benefits at current law levels.

KEY DISADVANTAGES OF THIS APPROACH

- The government would own between 5 and 11 percent of the stock market depending on the methodology used. See the box on the next page for details

IMPACT ON 75-YEAR ACTUARIAL BALANCE

Common set of reforms	NA
General revenue transfer to Trust Fund	+2.20
Across the board cuts to achieve solvency	NA
Remaining Actuarial Balance	+0.01

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Total	**+0.0**	**+0.0**	**+0.0**

ALTERNATIVE VERSION WITH COMMON SET OF REFORMS:

- Transfer **50 percent** of the currently projected UB surpluses to the Trust Fund for **1999-2008** to purchase equities. Limit the share of the Trust Fund invested in equities to 25 percent.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make across the board benefit cuts of 6 percent to achieve solvency.

SUBOPTION:
SAVE SOCIAL SECURITY WITH SOCIAL SECURITY PLUS ACCOUNT

- It would be possible to use the surplus remaining after achieving actuarial balance to fund individual accounts that are truly in addition to the traditional benefit. The equities in the trust fund would be preserving the traditional structure, and the individual accounts would be on top of the full traditional benefit. Therefore, doubts about sustainability and risk of the individual accounts would not threaten the traditional Social Security program. However, the plan would rely on essentially all of the currently projected surpluses for 30 years. Thereafter, this plan could create demands for deficit funding on the individual accounts.

ISSUES ARISING FROM INVESTING THE TRUST FUND IN EQUITIES

- **Government Ownership of Private Securities.** In the plans shown on the previous page, the government would eventually hold between 5 and 11 percent of the overall stock market. This raises three important concerns:

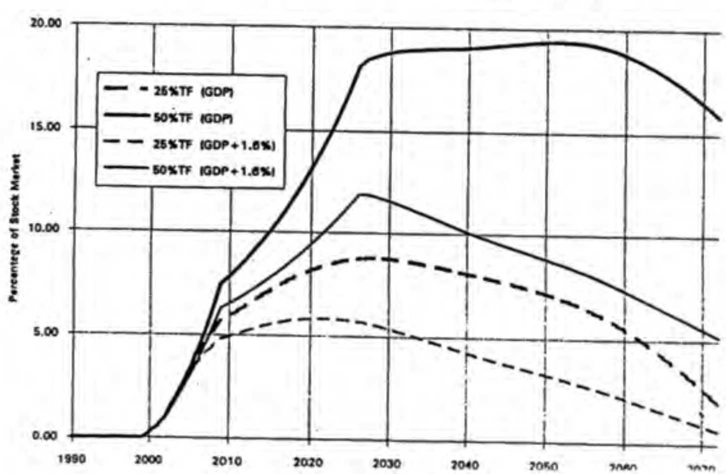
    1. **Largest Shareholder.** If the Trust Fund owned 10 percent of the stock market, the government would be the largest shareholder in at least 70 percent of U.S. publicly traded corporations.

    2. **Political Influence on Investment Choices.** Congress could legislate restrictions on what the funds could invest in (e.g. no tobacco stocks).

    3. **Corporate Governance Issues.** For example, how would government-owned shares be voted at stockholder meetings?

There are different methodologies for projecting the future size of the stock market. Depending on the methodology chosen, one obtains different estimates of the share of the total stock market held by the trust fund. The chart below shows the share of the stock market held by the trust fund for two different reform plans under two different assumptions about the future growth rate of the stock market.

Social Security Trust Fund Stock Holdings as a Percentage of the Total Stock Market-- Transfer 1/2 of Unified Budget Surplus 1999-2008, Limit to 25% (50%) of TF in Stock-- Total Market Value Grows at Rate of GDP (GDP + 1.6%)



THE PERVASIVENESS OF CORPORATE GOVERNANCE ISSUES

- While issues of government ownership of private securities do not arise in the case of individual accounts, issues of political influence over investment choices and of corporate governance could still be large, especially if investment choices were limited to a few government-authorized index funds.

WHAT HAPPENS IF THE STOCK MARKET PERFORMS POORLY?

- If the stock market performs worse than is projected, the balance in the trust fund will be lower than projected, creating pressure for additional revenue sources or benefit cuts. This is a common feature of plans that depend on stock market returns to fund traditional Social Security benefits.

II. Plans That Use the Surplus to Fund Individual Accounts

Five Key Issues Concerning Individual Accounts

Key Issue #1: Perceptions of Benefit Levels

- People might perceive that the individual account is part of the total Social Security benefit, and has more than made up for the reduction in the traditional benefit.
- Alternatively, people might perceive their individual account as risky and uncertain, and perceive that they received a 16-percent reduction in their Social Security benefit.
- Plans which guarantee benefit levels or which integrate the individual account and the defined benefit may be more successful in getting people to look at their total benefit.

Example: Impact on Benefits (Percentage of Current Law)

Change in traditional benefit	-16.3 percent
Annuity from individual account	+20.8 percent
Total	+4.5 percent

Key Issue #2: Benefit Guarantees

Because individual accounts expose individuals to more risk, it might be desirable to shift some of that risk to society as a whole.

- **Providing a Safe Investment Option.** One way to do this would be to offer a safe investment option -- for example, Treasury Inflation Protected Securities -- and to design a reform package to ensure that workers who chose this safe investment option have a reasonable level of benefits.
  - -- The downside of this approach is that it might encourage individuals -- particularly low-income individuals -- to take too little risk.
- **Guaranteeing Current-law Benefits.** Another option would be to let people invest however they choose, but to guarantee that the combined benefit from traditional Social Security and the individual account would at least equal the current-law traditional Social Security benefit (Sen. Gramm's plan adopts this approach).
  - -- A guaranteed benefit might encourage workers to take too much risk, since they would receive the upside gains, while the government would protect them on the downside. However, some argue that many investors do not take on enough risk. Moreover, if the portfolio choices were limited to basic index funds, the extent of this "moral hazard" problem would probably be minimal.
  - -- A guarantee shifts risk away from individuals and onto the unified budget. We are currently trying to quantify the extent of this risk.

Key Issue #3: Fiscal Sustainability

For How Long Can We Afford to Fund Individual Accounts Out of the Surplus?

- If remaining surpluses are spent, 2 percent individual accounts can be afforded until around 2023.

- Once the surpluses have run out we could continue to fund the individual accounts out of general revenues (this would cost around 0.8 percent of GDP), or we could trigger in traditional reforms to pay for the individual accounts.

- It might also be possible to set aside some of the extra surpluses in the early years to prefund individual account contributions in later years. We present a plan like this later in the packet.

Key Issue #4: Designing a Package with "Wins" for Both Parties

- **Individual accounts can be provided in a way that is more progressive than the current defined benefit Social Security system.** We could propose a negotiating principle that the traditional benefit must remain as progressive as it currently is, and that any individual accounts must be *more* progressive.

- **Our reform package could include initiatives to reduce elderly poverty, particularly among widows, and to help other needy populations.** We are developing a list of policy options in this area. For example, if progressive individual accounts were at least partially bequeathable, low-income families with short life expectancies could potentially benefit more from the progressivity of the individual accounts than they do from the progressivity of the current system.

KEY ISSUE #5: FEASIBILITY AND COST OF INDIVIDUAL ACCOUNTS

- **Individual accounts in foreign countries have proven very costly.** In both the U.K. and Chile, administrative costs absorb 20 percent or more of account accumulations under their systems of individual accounts.

- **Lower costs might be achievable by limiting choice.** At the cost of severely limiting choices, it may be possible to keep costs down significantly. Our benefit numbers assume a very low administrative cost of 10 basis points per year. This would correspond to a reduction in account accumulation of only 2 percent.

- **Low-cost plans would also be low-service plans.** The level of services associated with a plan this cheap wold be very low, and in particular would compare unfavorably with the level of services offered through most 401(k) plans. Specifically, a bare-bones plan might offer annual reporting rather than monthly or even daily reporting, a much narrower range of asset choice, and a far lesser ability to switch among available assets.

- **Contributions would lag earnings.** For individual account funding approaches that are tied to past earnings, the delays in making contributions into accounts could be perceived to be very long. Under current procedures, workers' earnings for the prior year are not verified until November in the current year. Thus, if a system of this type were in force currently, workers' last recorded contribution as of today might be for 1996; or workers might just have received their contributions for 1997.

- **Funding out of the surplus might alleviate the perception problem.** It might be argued that since the funding of these accounts was coming from the surplus, individuals would not perceive the contributions to be tied to their earnings, and therefore not see it as arriving late.

- **Other approaches might be possible.** It is also possible, though not yet fully verified, that some acceleration of contributions could be achieved through a change in procedures.

FLAT-DOLLAR ADD-ON INDIVIDUAL ACCOUNT WITH ACROSS THE BOARD BENEFIT CUTS TO RESTORE SOLVENCY

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

KEY ATTRACTIONS OF THIS APPROACH

- Gives individuals control over their retirement savings. Could be described as building wealth.
- Achieves higher returns while avoiding government ownership of private securities.

KEY DISADVANTAGES OF THIS APPROACH

- Surpluses are not sufficient to fund individual accounts forever.

IMPACT ON 75-YEAR ACTUARIAL BALANCE

Common set of reforms	+0.97
Across the board cuts to achieve solvency	+1.22
Remaining Actuarial Balance	+0.01

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+34.4	+20.8	+15.8
Total	**+18.1**	**+4.5**	**-0.5**

PARTIALLY VOLUNTARY INDIVIDUAL ACCOUNTS

- Fund $290 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds. ***Allow workers to voluntarily contribute an additional 1 percent of earnings to their accounts.***

- Make common set of reforms.

- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

KEY ATTRACTIONS OF THIS APPROACH

- Cuts in half the long-term fiscal obligation of the government to finance individual accounts.

- Preserves benefit levels for low-income workers even if they do not make voluntary contributions.

KEY DISADVANTAGES OF THIS APPROACH

- Some may feel they are being asked to add an additional one percent of payroll taxes simply to maintain their existing Social Security benefit level.

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total without voluntary contribution	**+0.9**	**-5.9**	**-8.4**
Maximum annuity provided by voluntary Individual Account	+8.1	+10.8	+13.1
Total	**+9.0**	**+4.9**	**+4.7**

Under current law, annual benefit levels are $6,010 for the low earner, $9,925 for the average earner, and $13,112 for the high earner.

III. Plans that Use the Surplus Both to Shore up the Trust Fund and to Fund Individual Accounts

HYBRID PLANS: INDIVIDUAL ACCOUNTS AND TRUST FUND EQUITY INVESTMENTS

- Create $290 per worker individual accounts funded out of general revenue.
- Invest Trust Fund assets worth 1 percent of payroll in stocks. Limit the share of the Trust Fund invested in stocks to 25 percent.
- Make common set of reforms.
- Make additional across the board cut in benefits to achieve solvency.

KEY ATTRACTIONS OF THIS APPROACH

- Provides wins for both sides. Shores up traditional Social Security and establishes individual accounts.
- Because individual accounts are small, sustaining them in the out years will not create much pressure on other programs.
- Because transfers to the trust fund are modest, the peak share of the stock market owned by the trust fund will between 3.7 and 5.7 percent.

KEY DISADVANTAGES OF THIS APPROACH

- Has the downsides of both individual accounts and trust fund investments: the high administrative costs of small individual accounts and the problems of government ownership of private securities.

IMPACT ON 75-YEAR ACTUARIAL BALANCE

Common set of reforms	+0.97
Tax indiv. accounts like OASDI	+0.06
Redeem TF assets to buy stocks	+0.58
Across the board cuts to achieve solvency	+0.73
Remaining Actuarial Balance	+0.00

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-8.0	-8.0	-8.0
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total	**+6.2**	**-0.6**	**-3.1**

ARE THERE WAYS TO REDUCE GOVERNMENT OWNERSHIP CONCERNS?

- **Trust Fund investments could be allocated according to investment choices of individuals in their individual accounts.** In plans that combine Trust Fund investments with individual accounts, it might be possible to have the Trust Fund allocate its investments according to the aggregate investment behavior of individuals in their individual accounts. This idea -- and other ideas like it -- could allow defenders of government investment to say that it was millions of individual choices and not a government board that was allocating funds.

PHASED IN 2 PERCENT INDIVIDUAL ACCOUNTS WITH SHORT-TERM TRANSFER TO TRUST FUND FOR STOCKS

- Create $145 per worker plus 0.5 percent of earnings individual accounts for 2000-2009, $290 plus 1 percent thereafter funded out of general revenue.
- Transfer ½ of projected unified budget surplus to Social Security Trust Fund and invest in stocks. Limit the share of the Trust Fund invested in stocks to 25 percent.
- Make common set of reforms.
- Make additional adjustments in traditional Social Security to achieve solvency.

KEY ATTRACTIONS OF THIS APPROACH

- Ultimately creates 2 percent of payroll individual accounts while strengthening traditional Social Security as well.

KEY DISADVANTAGES OF THIS APPROACH

- The 2 percent of payroll individual account will need to be funded even after the surpluses run out.
- Government would eventually own between 5.3 and 8.0 percent of the stock market depending on methodology used.

IMPACT ON 75-YEAR ACTUARIAL BALANCE

Common set of reforms	+0.97
Tax indiv. accounts like ordinary income	+0.17
General revenue transfer to TF and buy stocks	+1.01
Across the board cuts to achieve solvency	+0.07
Remaining Actuarial Balance	+0.00

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-1.1	-1.1	-1.1
Annuity provided by Individual Account	+20.4	+17.1	+16.8
Total	**+16.3**	**+13.0**	**+12.7**

ADD-ON INDIVIDUAL ACCOUNT WITH ESCROW ACCOUNT TO SUSTAIN INDIVIDUAL ACCOUNTS

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 in stocks and bonds.
- After funding individual accounts, place 70 percent of remaining surpluses in an escrow account invested 50-50 in stocks and bonds. Use the escrow account to fund individual account contributions after the unified budget surplus runs out.
- Make common set of reforms (cover state and local workers, raise maximum taxable earnings limit, and increase number of years in computation base from 35 to 38).
- Make additional across the board benefit cuts by revising the benefit formula, but keep disability benefits at current-law levels.

KEY ATTRACTIONS OF THIS APPROACH

- Sustains individual accounts even after surpluses run out, thereby avoiding pressure to cut other programs to fund the new individual account "entitlement."

KEY DISADVANTAGES OF THIS APPROACH

- Has same disadvantages as other plans that combine individual accounts and government investment in private securities.
- Some may find this proposal unusual and therefore not sound because it uses the escrow account to prefund individual account contributions rather than retirement benefits -- a type of prefunding that people are more accustomed to in their pension plans.

IMPACT ON 75-YEAR ACTUARIAL BALANCE

Common set of reforms	+0.97
Across the board cuts to achieve solvency	+1.22
Remaining Actuarial Balance	+0.01

IMPACT ON BENEFITS IN 2030
PERCENT OF CURRENT LAW BENEFITS

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-13.3	-13.3	-13.3
Annuity provided by Individual Account	+34.4	+20.8	+15.8
Total	**+18.1**	**+4.5**	**-0.5**

Flat-Dollar Add-on IA with 50 percent Integration

- Fund $580 per worker individual accounts out of general revenue. Assume these funds are invested 50-50 stocks and bonds.
- Use 50 percent of individual accounts to fund traditional Social Security benefit. Tax other half of retirement income from individual accounts like Social Security
- Make common set of reforms.
- Make additional adjustments to traditional Social Security program to restore solvency.

Key Attractions of This Approach

- Creates individual accounts and strengthens traditional Social Security without government ownership of private securities.
- Integration of the benefit may make people more likely to perceive that their individual account is added together to their traditional benefit in providing their overall benefit.

Key Disadvantages of This Approach

- When the government uses 50 percent of the individual account to fund the traditional benefit, people may feel that they are losing half of their account rather than understanding all along that the account had two parts -- one part which funds the traditional benefit and another part that provides additional retirement income.
- May be perceived as complicated.
- The individual accounts would represent between 6.7 and 12.5 percent of the stock market.

Impact on 75-Year Actuarial Balance

Common set of reforms	+0.97
Tax individual accounts like OASDI	+0.06
50 percent clawback of indiv. accounts	+0.90
Across the board cuts to achieve solvency	+0.26
Remaining Actuarial Balance	+0.00

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	Average Earner ($27,000)	High Earner ($43,000)
Common Set of Reforms	-3.0%	-3.0%	-3.0%
Across-the-Board Cuts Implied by Remaining Shortfall	-3.2	-3.2	-3.2
Annuity provided by Individual Account	+17.2	+10.4	+7.9
Total	**+11.0**	**+4.2**	**+1.7**

Plans That Fund Individual Accounts Out of the Existing 12.4 Percent Social Security Payroll Tax

Breaux-Gregg-Kolbe-Stenholm Plan

- Use 2 percent of the existing 12.4 percent Social Security payroll tax to fund 2 percent of payroll individual accounts.

- Make reforms to traditional Social Security program:
  - -- Reduce second and third bend points by 2 percent per year for 20 years.
  - -- Reduce COLA by 0.5 percentage points.
  - -- Increase normal retirement age by 2 months per year until it reaches 70, then index.
  - -- Cover new state and local workers.
  - -- Reduce spouse benefits from 50 to 33 percent of PIA.
  - -- Increase computation period to 40 years, but count all earnings.
  - -- Eliminate earnings test.
  - -- Credit all taxation of Social Security benefits to OASDI.
  - -- Create new minimum benefit.

Key Attractions of This Approach

- Plan is fiscally responsible

Key Disadvantages of This Approach

- Reduces benefits compared to present law (though not compared to the 72 percent of benefits that are affordable in 2032 if no changes are made).

Impact on 75-Year Actuarial Balance

Remaining Actuarial Balance	+0.00

Impact on Benefits in 2030
Percent of Current Law Benefits

	Low Earner ($12,000)	**Average Earner** ($27,000)	**High Earner** ($43,000)
Change in Traditional Benefits	-25.1%	-39.5%	-42.2%
Annuity provided by Individual Account	+16.2	+21.6	+26.2
Total	**-8.9**	**-17.9**	**-16.0**

A Kinder and Gentler Carve-out Plan

- A carve-out plan does not have to result in large benefit cuts. If general revenues are used to the same extent as in the add-on individual account (but are transferred to the trust fund instead of being used to finance individual accounts, the benefit levels would be the same. It may be harder to sustain general fund transfers to Social Security once surpluses run out than it would be to sustain transfers to individual accounts.