

January 22, 1987

TO: SHEILA BURKE

FROM: ROBERT J. MYERS

SUBJECT: APPRAISAL OF DU PONT AND GINGRICH PROPOSALS TO
RESTRUCTURE THE SOCIAL SECURITY PROGRAM

Recently, Governor Pierre du Pont (Delaware) and Congressman Newt Gingrich (Georgia) have made proposals to restructure significantly the Social Security program (Old-Age, Survivors, and Disability Insurance). These proposals have not related to the Medicare program.

Although I support the general economic goals of these proposals insofar as the national economy is concerned, I do not believe that either one represents a desirable change in the Social Security program. Both proposals would change the basic nature of the system and would have undesirable side effects, as will be brought out hereafter. Neither proposal is likely to be supported by management organizations (such as the Chamber of Commerce of the U.S., the National Association of Manufacturers, and the American Council of Life Insurance), by labor organizations, or by aging organizations (such as the AARP).

Although I do not claim to be a political expert, I feel confident that the liberal Democrats will, unfairly, use these proposals as "evidence" that the Republican party is "opposed to Social Security". On the other hand, in fact, I believe that it is fair to state that the Republican party is, in general, in favor of a moderate, soundly financed social security system.

This memorandum will first analyze each of the proposals separately, based on material which has been distributed publicly. Then, discussion will be made as to certain errors and misunderstandings contained in such material.

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The material for the du Pont proposal is, in part, from Governor du Pont's speech to the Magazine Publishers Association in Orlando, Florida on November 10. The material for the Gingrich proposal is from Congressman Gingrich's speech to the Georgia Business Council on November 10.

THE DU PONT PROPOSAL

Governor du Pont has proposed a plan, termed the Financial Security Program, under which individuals could elect to establish Financial Security Accounts (FSAs) as a substitute for part or all of their Social Security retirement benefits. The details of the proposal are not fully spelled out in the material that I have, but I will attempt to describe it briefly. The proposal appears to be one which was advocated by Peter J. Ferrara of the Cato Institute several years ago.

Individuals (and their employers) would continue to pay Social Security contributions just as at present. Each year, the individual could elect to receive a tax credit against income tax, equal to part or all of the total employee social security contribution -- presumably only the employee contribution and not the employer tax (no mention made as to what would be done for the self-employed); however, note that, in one place, reference is made to the maximum tax credit being for only part of the employee total contribution (presumably to recognize that part of the contributions goes for other items than retirement benefits -- namely, survivor benefits for death before retirement, survivor benefits for death after retirement, disability benefits, and hospital benefits under Medicare).

The resulting tax credit would automatically be invested in an approved FSA (of the individual's choice as to investment media). The individual's social security retirement benefit would be reduced, in a manner not specifically described, "commensurate with their contributions" (through the tax credits) to FSA's. Presumably, although again it is not specifically stated, all disability and survivor benefits under Social Security and all hospital benefits under Medicare would be payable as under present law.

As far as the Social Security system is concerned, the proposal could -- as Governor du Pont points out -- only strengthen its financing, because it would have the same income over the years as under present law, and it would have less outgo (due to reduced retirement benefits being payable to those with FSA's---not much such effect in the near-future years, but considerable in the long run).

As far as individuals are concerned, depending upon how the plan would operate (which, as stated previously, is not entirely clear), and depending on other factors such as age, sex, family status, earnings level, and investment experience, the benefit derived from the FSA might be larger than the reduction in the social security benefits--or it might be smaller. There is no assurance that the FSAs would have a high "real" rate of investment return that would not only provide higher benefits, as well as cost-of-living adjustments, but would also make up for the absence of auxiliary benefits for spouses and children,.

As far as the Federal Government is concerned, the proposal would, for many years, exacerbate the budget deficit problem--by granting huge amounts of tax credits each year. Governor du Pont estimates--although I see no reasonable basis for doing so--that \$20 billion of FSA tax credits will be given in the first year, meaning that the budget deficit will be increased by that amount. (The \$20 billion estimate means that about 20% of all employee contributions will be so involved!) And this budget-unbalancing effect will continue at about the same magnitude for a number of years.

One "inefficient" effect of the FSAs is that, in many instances, they will not go toward providing retirement-income protection, but rather to providing sizable lump sums available at death before retirement for persons who leave no dependents.

In summary, the du Pont proposal does not seem to be a desirable change, for a number of reasons--besides the facts that the existing program is well designed to provide the floor of economic security for our nation, is operating successfully, and is adequately financed over both the short range and, very likely, over the long range too. These reasons include the following:

1. The significant unfavorable effect on the budget deficit for many years.
2. The complexity of the plan's operations, both for individuals to make the "right" choice and for its administration.
3. The possibility of individuals making the wrong choice and thus having inadequate retirement income, lower than under the present program.
4. The availability of windfalls for well-informed persons, such as a homemaker who has less than 10 years

of covered employment and selects a FSA, with some benefits resulting--as against none under the present system (under which the contributions paid could be said to pay for part of the cost of the auxiliary and survivor benefits which he/she receives from the spouse.

5. The indefiniteness of the description of the plan, which, if described more adequately, might show other flaws.

THE GINGRICH PROPOSAL

Congressman Gingrich has proposed a plan under which the social security program would eventually be eliminated, being replaced by a dual system of Individual Retirement Accounts (IRAs) and means-tested benefits to raise all senior citizens' incomes up to the poverty level (to be financed by a Value Added Tax).

In 1989, the Social Security (FICA) tax would be abolished, and workers over age 40 would have their pay increased by 7% (in addition, their takehome pay would be increased by not paying the FICA tax any more), while workers under age 40 would have their pay increased by 4%, but would be required to contribute 10% to an IRA. (A question is could employers be required to do this, or could they evade it by otherwise cutting pay?)

On the benefit side, current beneficiaries would continue to receive their benefits (no mention as to whether cost-of-living adjustments would be given in the future) and, in fact, would get an increase to offset the VAT proposed (no indication of its magnitude) and also an increase for those below the poverty level to bring them up to it. Those now aged 40 or over who are not beneficiaries would "be grandfathered into the social security system" (no indication as to how benefits would be computed with regard to earnings after 1988) to reflect that "they have earned significant retirement benefits through their past payments into social security" (although under the proposal, none in the future). Also proposed would be the elimination of the income-taxation of social security benefits for high-income persons and the elimination of the retirement earnings test (which will, in effect be done under the present law for those attaining normal retirement age after 2008--indirectly, but preferably, by increasing the delayed retirement credits to their actuarially-equivalent value).

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The proposed VAT would pay not only for the needs-tested poverty-level benefits, but also the benefits for those now on the roll and the (indeterminate) benefits for those now over age 40, but not retired. (I believe that the VAT rate would be very high to accomplish all of this!).

I believe that the Gingrich proposal is incompletely described. In my view, it is completely untenable and has many voids and gaps, as follows:

1. What would be the required (undoubtedly large) VAT rate to finance the larger benefits for existing beneficiaries (to recognize the effect of the VAT itself), "earned" benefits for those over age 40, the increase in benefits to the poverty level for those current beneficiaries now below it, and for other persons retiring into the indefinite future with below-poverty-level income?
2. What would be done about disability and young-survivor benefits? What would be done about the financing of the Hospital Insurance portion of Medicare if the FICA taxes are eliminated?
3. How could employers be required to increase workers' pay by 7% (note, the employer tax in 1989 will be 7.56%, not 7%).
4. The proposed means-tested program to bring the aged (query -- what age limit) up to the poverty level would be subject to all sorts of abuses (hiding income and disposing of assets), as well as in discouraging savings and private pensions for those who would be only a little above (at best) the poverty level.
5. Can individuals really get such high "real" rates of return in the private investment area as to produce benefits which are both significantly larger than Social Security benefits and that will keep up to date with changes in the cost of living?
6. Will not the possibly larger IRA-type benefits for the higher-paid persons (especially the younger ones) be significantly counterbalanced by their paying, through the VAT and otherwise, for much of the cost of the needs-tested benefits for lower-income persons and the cost of the present benefits for current retirees and for other persons "insured" under the present program who are over age 40?

Errors and Misunderstandings in Material on du Pont Proposal

The material available to me on the du Pont proposal contains a number of errors and misunderstandings, including the following:

1. The present program is in poor financial condition, and it could require an eventual combined employer-employee tax rate of 37%. That figure, in the first place, undoubtedly includes the contribution rate for the Hospital Insurance portion of Medicare -- and also the cost of the Social Security disability and survivor benefits. Further, such a figure would be based on very pessimistic assumptions, including greatly increased longevity (whose cost could be met in other ways, such as a higher retirement age for full benefits).
2. People are not confident about the future of the Social Security system. This statement is true, but it does not recognize that, at the same time, the survey respondents were overwhelmingly in support of the program and that there is really not the likelihood of it having financial problems in the future as many people believe.
3. Most changes to remedy Social Security's financing problems in the past have entailed tax increases. This is not the case. The 1977 Amendments had mostly benefit reductions for the long-range situation, (though not for the short run) and the 1983 Amendments were equally divided as between tax increases and benefit reductions for the short run, but were predominantly benefit reductions over the long range.
4. Devoting over 14% of payroll to Social Security causes a drag on the American economy. All of the payroll tax is not for Social Security (rather some is for Medicare). There would be an equal drag if wages were that much higher. Also, many countries have considerably higher social security tax rates.
5. When the baby boom retires, there will be only two workers to finance each retiree's benefits. This makes the situation look much worse than it really is. The statistic quoted is "workers per beneficiary" (the latter item includes eligible spouses and children of retired workers, disabled workers and their eligible spouses and children, and eligible survivors).

6. In 1935, the average life expectancy at birth was 63, and now it is well over 70. The actual figures are 61 and 74 1/2, but these are not relevant because what should be considered is the life expectancy at ages 20 and 65, for which the increases are much less (e.g., for age 65, 12 1/2 and 16 1/2 years, respectively).
7. High "real" interest rates, such as more than 6%, can be expected in the future for FSAs. Most economists believe that the "real" interest rate possible is only 2-3%. Depending upon the period selected, the "real" rate of return of common stocks can vary widely -- even being negative during the 1970's; in the future, with the great investment in stocks by private pension plans, the rate of return could well be much lower than 6%.

Errors and Misunderstandings in Material on Gingrich Proposal

1. Based on life expectancies at birth (63 in 1935 and much higher now), the minimum retirement age for full benefits should be 76, instead of 65. Any "standard" for the minimum retirement age for full benefits should be based on either the retirement life expectancy measured at age 20 or at age 65, not at birth. The result would be about 71 or 72, not 76.
2. "Social Security was originally designed to provide only a small portion of an individual's overall retirement needs." Not so! Under the 1935 Act, a person with average earnings (then \$75 a month) would receive a benefit after 40 years of coverage of \$42.50, or 57% of earnings. Under present law, the replacement rate for a person with average earnings is 42%, plus supplements for dependents (if any) of 21% for 1 dependent and 33% for 2 or more dependents.
3. "Today's Social Security payroll tax burden is 60 times greater than the tax paid by a worker in 1950." This is an unfair comparison (although actually, considered in dollars, the figure should be 70), because it does not recognize the 6-fold rise in the general earnings level and the additional benefits provided (disability and hospital).

4. The FICA taxes increase the cost of production too much, especially as compared with other countries. Other countries have high payroll taxes for social insurance (some much higher than ours). In the absence of Social Security, wages and/or fringe-benefits costs would well have been higher in this country.
5. "The Social Security and Medicare Trust Funds would be taken off budget (by the proposal) so that politicians could not use them to balance the rest of the budget". This was done for OASDI in 1986 and will be done for HI in 1993, under present law.
6. A Value Added Tax would be provided. No recognition is given to the fact that, just as the payroll tax, this would bear heavily on workers.