REFORM PROPOSALS OF COMMISSIONERS

REFORM PROPOSAL OF SENATORS J. ROBERT KERREY AND JOHN C. DANFORTH

PLANNING FOR THE FUTURE: THE KERREY–DANFORTH APPROACH

The following principles guided the development of the Kerrey-Danforth approach: Section 1 begins with a rationale for action; Sections 2 through 6 present the specific reform proposals; and Section 7 reaffirms the need to act now to address one of the most important fiscal issues facing this country.

1. We must plan for the future by addressing and solving our long-term fiscal problem head on.

2. We must lead by example — Congress cannot be exempt.

3. We must plan for the aging of America's population.

4. We must address rising health care costs by emphasizing market incentives and personal responsibility.

5. We must fulfill our promises to today's retirees and ensure the long-term solvency of Social Security. We do this by reducing the payroll taxes of today's younger workers in exchange for a revised long-term contract.

6. We must design a solution that is fair to all Americans.

7. We must act now to give people time to plan for the future and to avoid significant future revenue increases or benefit reductions.

1. WE MUST PLAN FOR THE FUTURE BY ADDRESSING AND SOLVING OUR LONG-TERM FISCAL PROBLEM HEAD ON.

The Commission's Interim Report graphically displays the need to address our future fiscal imbalance. The conclusion of the Report is clear and inescapable: If we do not plan for the future, entitlement spending promises will exceed financial resources in the next century. The current spending trend is unsustainable.

The problem, however, is not simply one of numbers. In addition to demographic problems created by the aging of America's population, we are also faced with human problems caused by the increasing inadequacy of Federal health care and retirement programs.

The American people expect their elected officials to plan for the Nation's future as they plan for their own future and that of their children. Recognizing and admitting our long-term fiscal problem is the first step toward addressing it. The effects of any problemsolving approach must be weighed against the effects of inaction. If we fail to act, we have made a choice that threatens the economic future of our children and our Nation.

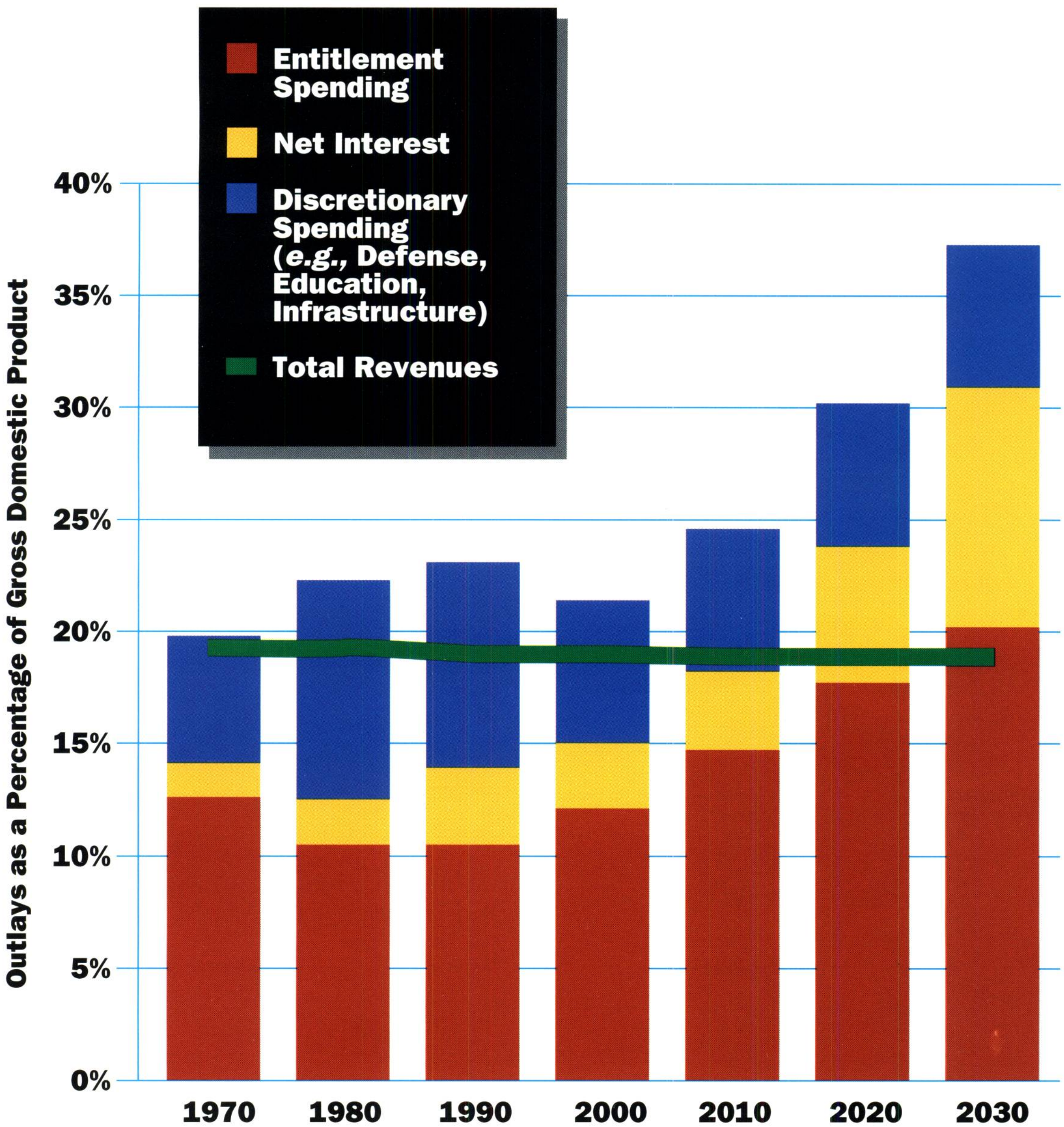
— By 2012, unless appropriate policy changes are made in the interim, projected outlays for entitlements and interest on the national debt will consume all tax revenues collected by the Federal government.

— The supply of savings available for private investment, "net national savings," has dropped from more than 8 percent of the economy to less than 2 percent today. This decrease restricts American productivity and growth.

— By 2030, unless appropriate policy changes are made in the interim, projected spending for Medicare, Medicaid, Social Security, and Federal employee retirement programs alone will consume all tax revenues collected by the Federal government. If all other Federal programs (except interest on the national debt) grow no faster than the economy, total Federal outlays would exceed 37 percent of the economy. Today, outlays are 22 percent of the economy and revenues are 19 percent. (Chart I)

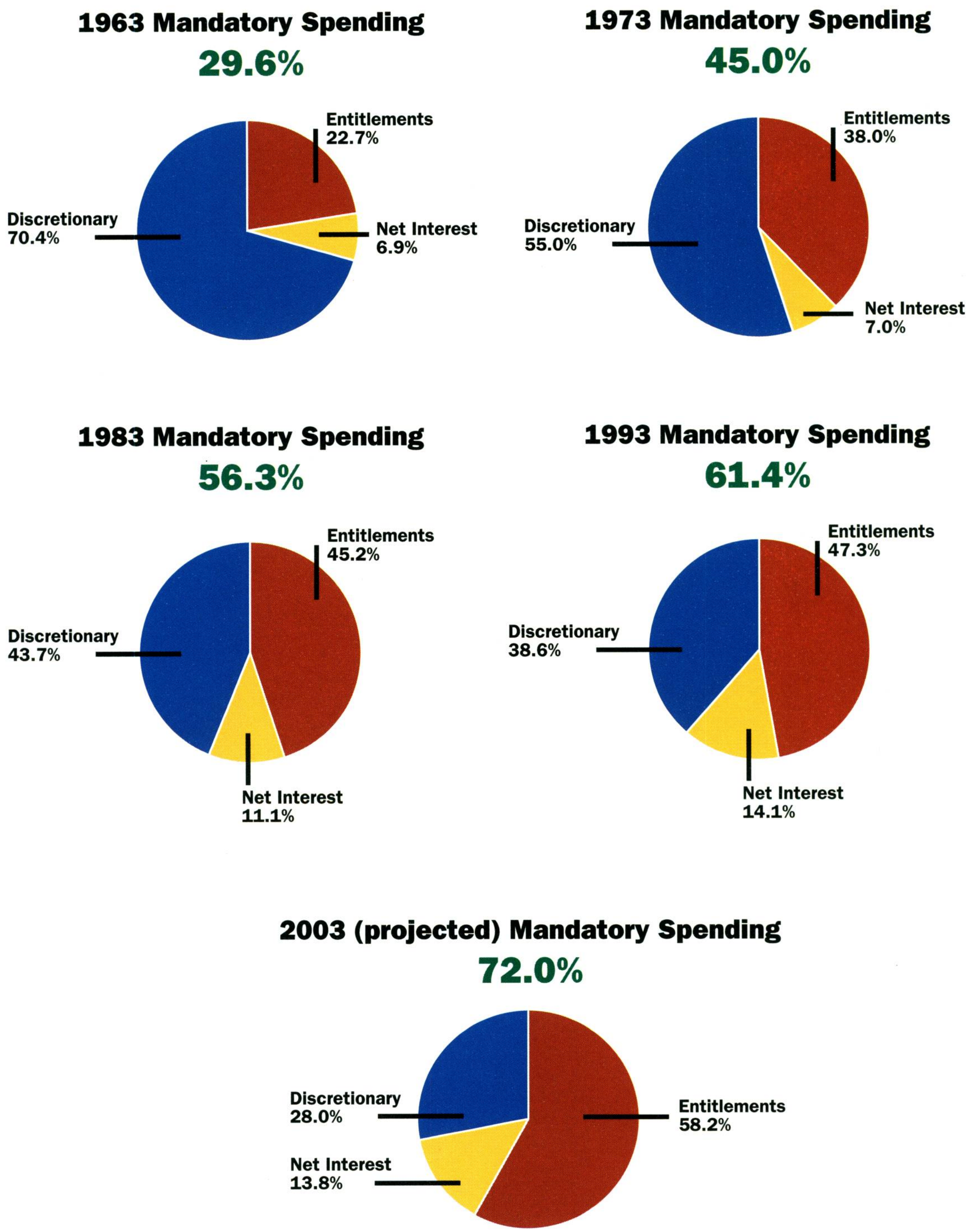
CHART I: THE PRESENT TREND IS NOT SUSTAINABLE

The gap between Federal spending and revenues is growing rapidly. Absent policy changes, entitlement spending and interest on the national debt will consume almost all Federal revenues in 2010. In 2030, Federal revenues will not even cover entitlement spending.



— By 2003, unless appropriate policy changes are made, fewer than 15 cents of every dollar will be available for nondefense discretionary programs that can raise productivity and contribute to economic growth. (Chart II)

CHART II: GROWTH OF MANDATORY SPENDING IN THE FEDERAL BUDGET



2. WE MUST LEAD BY EXAMPLE — CONGRESS CANNOT BE EXEMPT.

The President and Congress must lead by example. Change must begin in Washington. It is essential that the Federal government reform its own entitlement programs before asking anything of the American people. In this spirit, the Kerrey-Danforth approach reduces the growth in congressional pensions and brings Federal civil and military retirement programs more in line with private sector standards. It includes the following proposals —

- *Reduce pensions for Congress by up to 50 percent for each additional year of service.* This proposal would reduce congressional pension accrual rates to the rates applied to other Federal employees. It would apply to current Members of Congress and congressional employees for their remaining years of work and to all new workers hired after January 1, 1996.

- *Reduce Federal Employee Retirement System (FERS) benefits by up to 10 percent, and Civil Service Retirement System (CSRS) benefits by up to 5 percent.* This proposal would reduce the CSRS and FERS accrual rates by 0.1 percentage points for each year of work, effective January 1, 2000.

- *Raise the Federal retirement age to 60.* This proposal would gradually phase out eligibility for unreduced benefits for Federal workers before age 60, effective January 1, 2000.

- *Adjust CSRS and FERS benefit formula to "high-five" pay.* The benefit formula for both CSRS and FERS would be adjusted by changing the salary base from the employee's highest three consecutive years of pay to his or her highest five years, effective January 1, 2000.

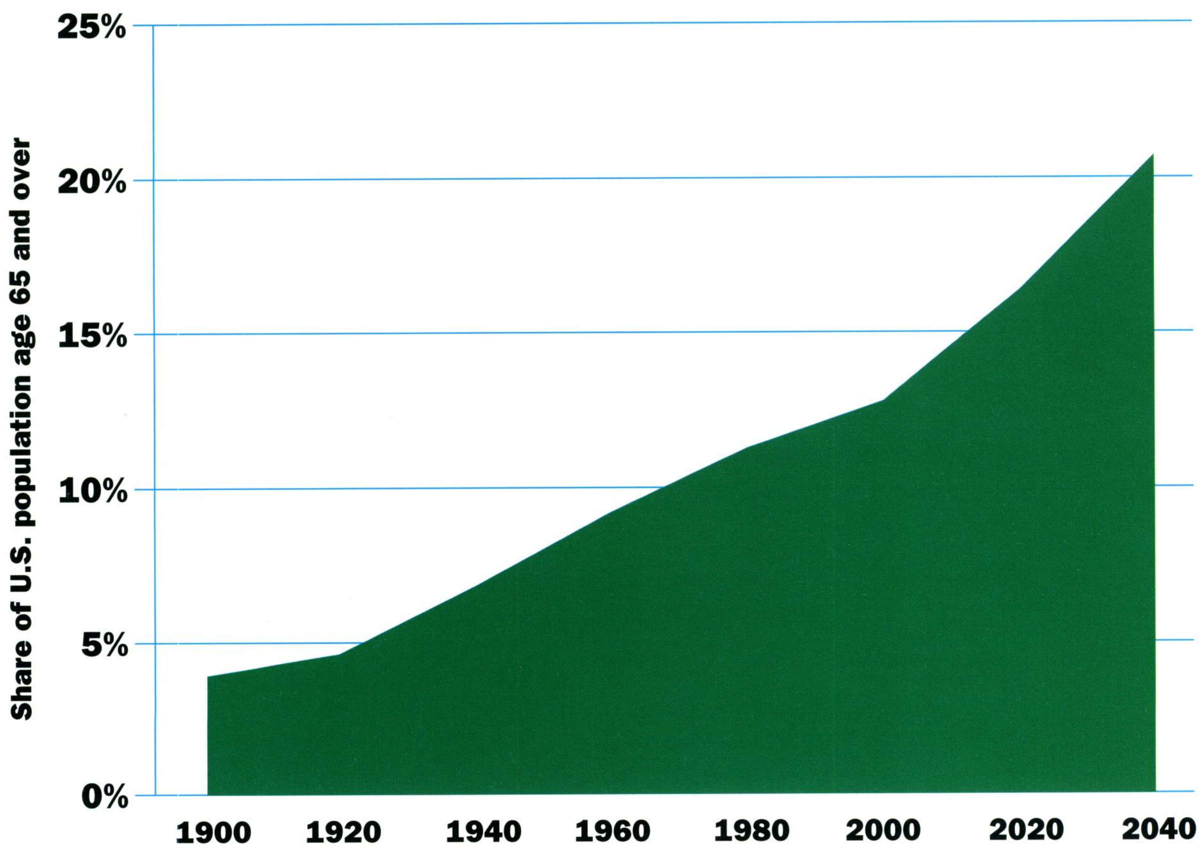
- *Reduce the rate at which military retirement benefits accrue from 3.5 percent to 2 percent of basic pay for retirees with more than 20 years of service.* This proposal would reduce the addition to retirement pay for each year of service after 20 years from 3.5 percent to 2 percent per year. It would also drop the one-time increase in retirement pay at age 62 of 10 percent. It would retain the CPI minus 1 percentage point COLA that applies until age 62 and the one-time COLA adjustment at age 62. This proposal applies to military personnel hired after August 1, 1986.

3. WE MUST PLAN FOR THE AGING OF AMERICA'S POPULATION.

America's population is growing older because of longer life expectancies and the aging of the Baby Boom generation. Federal retirement and health benefits programs must be revised to adapt to these new realities.

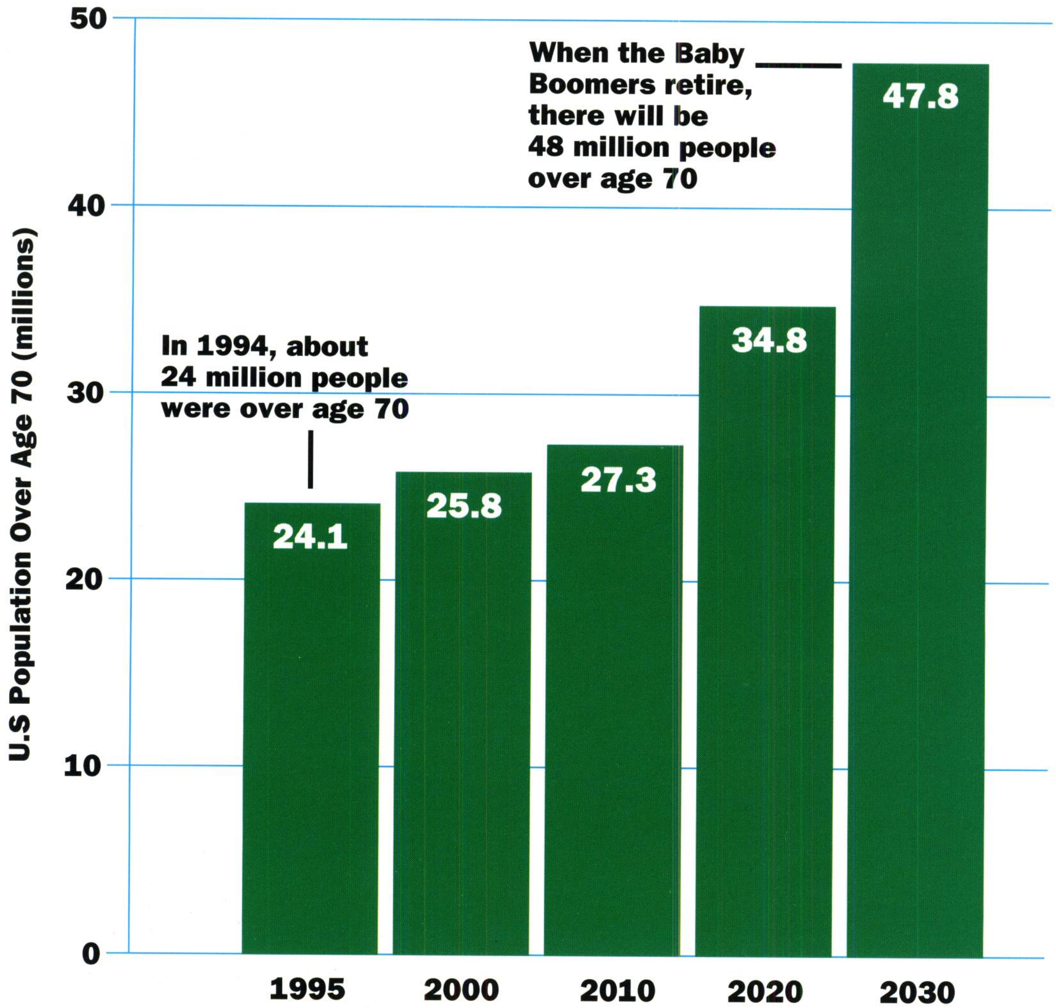
— The share of the population over 65 has grown from fewer than 5 percent in 1900 to 13 percent in 1994, and is expected to reach 20 percent by the year 2025. (Chart III)

CHART III: THE SHARE OF THE POPULATION OVER 65 WILL CONTINUE TO GROW



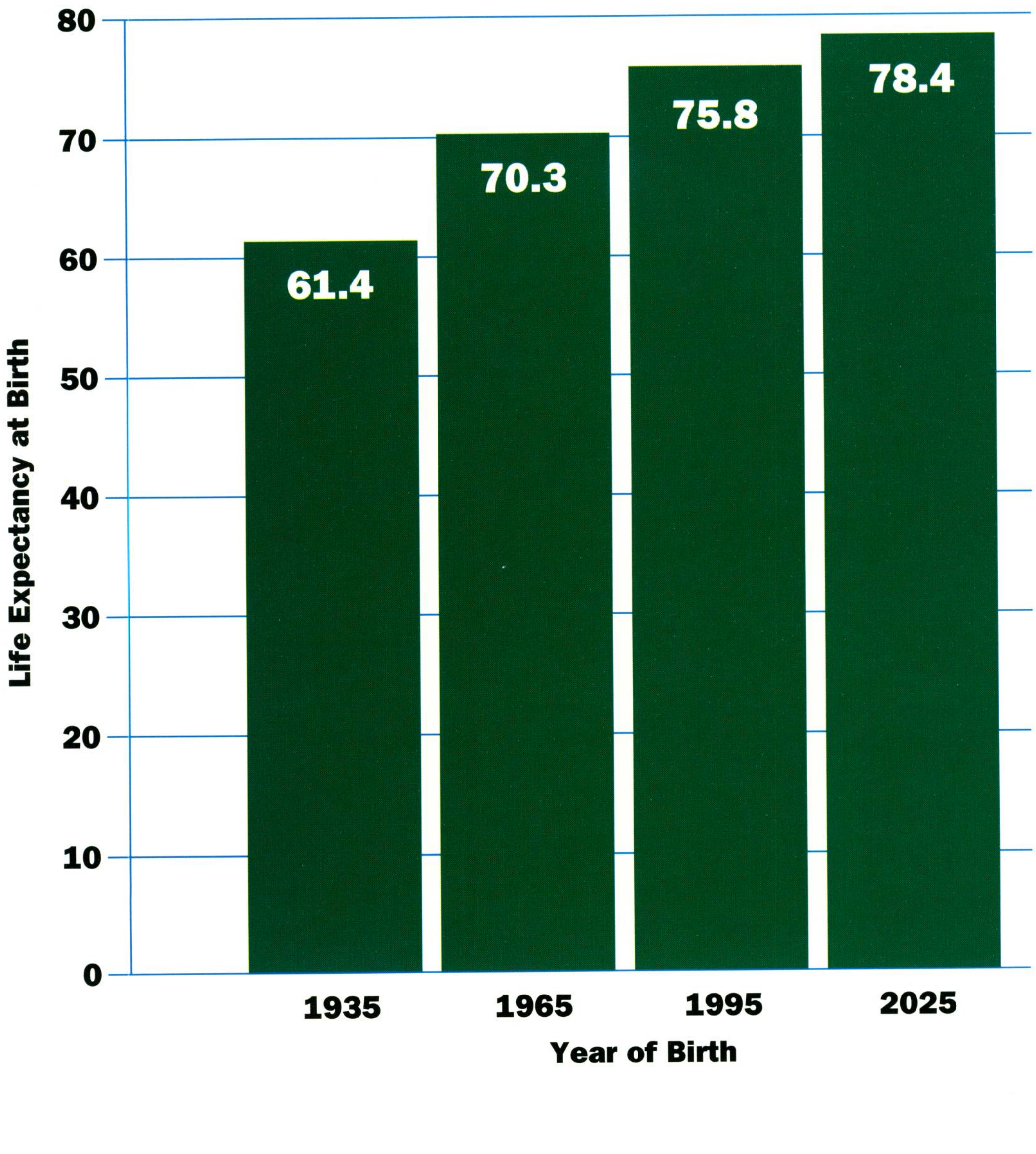
— The number of Americans over 70 will double in the next 35 years, from 24 million today to 48 million in the year 2030. (Chart IV)

CHART IV: THE NUMBER OF AMERICANS OVER 70 WILL DOUBLE



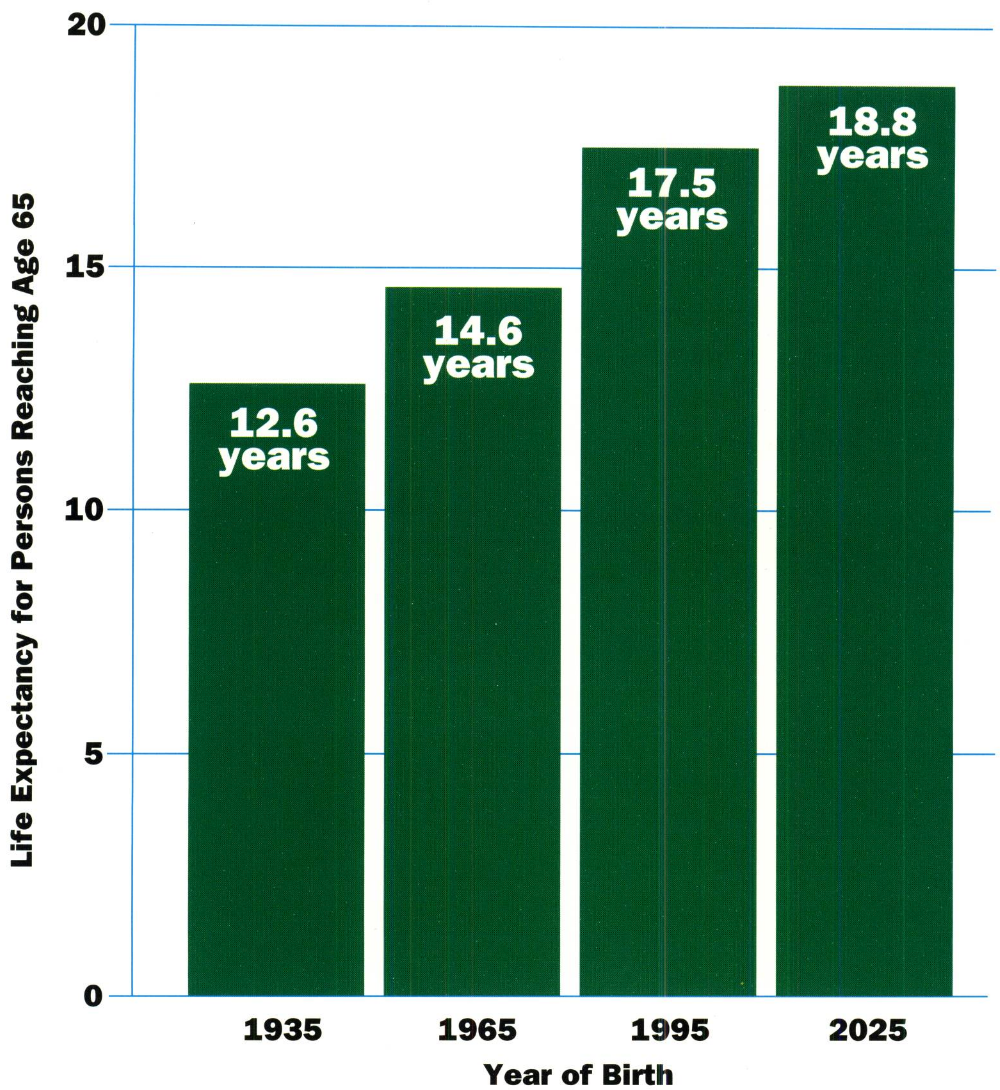
— In 1935, when Social Security was established, the average American lived to 61 years of age. In 1994, the average American's life expectancy was 76. By 2025, it is expected to be 78 years of age. (Chart V)

CHART V: AMERICANS ARE LIVING MUCH LONGER THAN WHEN SOCIAL SECURITY BEGAN



— In 1965, when Medicare was enacted, the average American expected to receive retirement and health care benefits for 15 years, up from 13 years in 1935. In the year 2025, benefits are expected to be provided for an average of 19 years. (Chart VI)

CHART VI: LIFE EXPECTANCY FOR PERSONS REACHING AGE 65



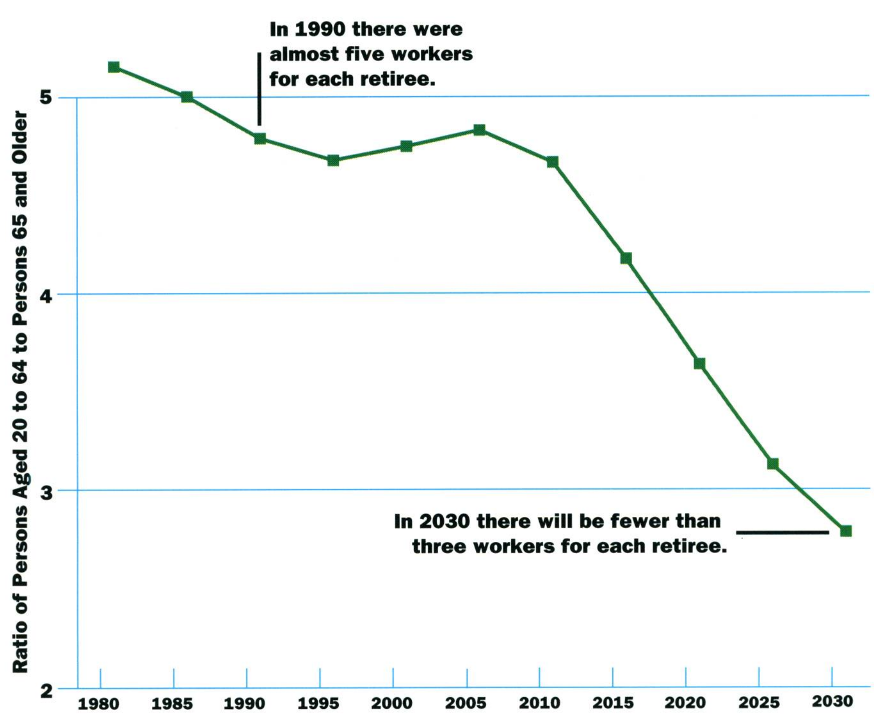
Social Security and Medicare benefits are funded primarily from payroll taxes on current workers. As the population ages and the Baby Boom generation retires, there will be fewer workers to support the increased number of retirees. In 1990, there were almost five workers to support each retiree. In 2030, there will be fewer than three workers to support each retiree. (Chart VII)

To plan for the changing demographics caused by longer life expectancies and the aging of the Baby Boom generation, the Kerrey-Danforth approach —

- *Retains the Social Security eligibility age at 62, and raises the age for retirement with full benefits from 67 to 70, phased in over 30 years.* This proposal would accelerate the phase-in period that is already in current law to age 67. In addition, the eligibility age would continue to rise by two-month increments until it reaches age 70 for those persons under age 28. ***No one currently over the age of 50 would be affected, and the Early Retirement Age would remain at 62.***

- *Increases the Medicare eligibility age to 70 and allows seniors to enroll in Medicare at age 62 with a charge for early enrollment spread over life.* This proposed change would gradually raise the Medicare eligibility age to match the scheduled increases in the Social Security Normal Retirement Age. To ensure continued access to health insurance for older Americans, access would be expanded by allowing those age 62 to enroll in Medicare if they agree to pay for it. The charge would be spread over the actuarial life of the Medicare enrollee.

CHART VII: AN AGING POPULATION MEANS FEWER WORKERS TO SUPPORT EACH RETIREE'S BENEFITS

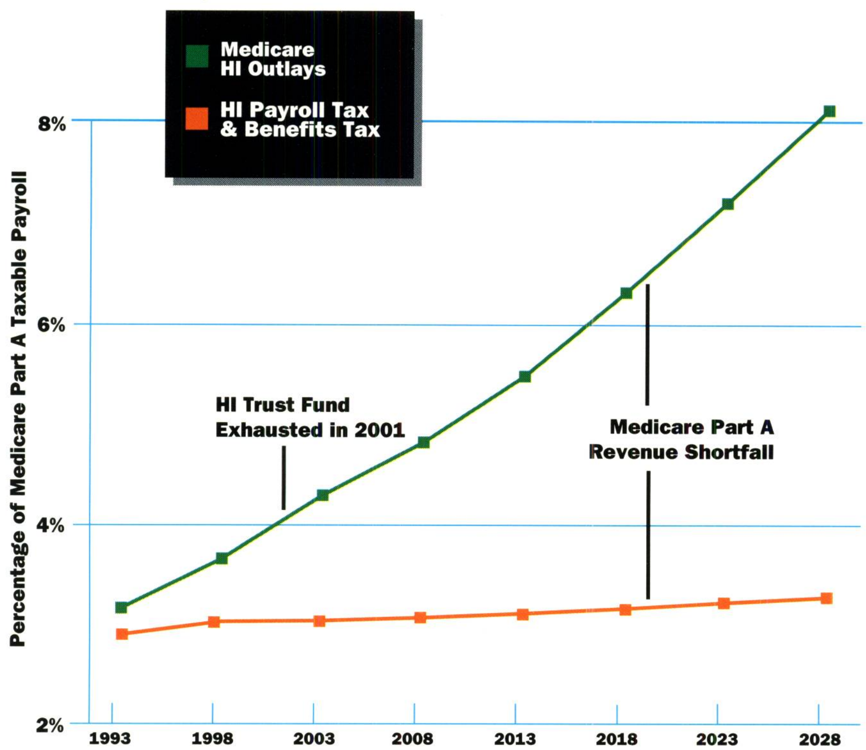


4. WE MUST ADDRESS RISING HEALTH CARE COSTS BY EMPHASIZING MARKET INCENTIVES AND PERSONAL RESPONSIBILITY.

Federal health program spending has been increasing at annual rates averaging 10 percent or more during the past five years. According to the Medicare Trustees, the Hospital Insurance (HI) Trust Fund is projected to be insolvent by the year 2001. In the long run, spending on Medicare and Medicaid will triple as a percentage of the economy by 2030. (Chart VIII)

CHART VIII: MEDICARE PART A IS PROJECTED TO BE INSOLVENT BY 2001

To cover Medicare HI outlays, the payroll tax rate would have to increase from 2.9% today to more than 8% in 2030.



When Medicare Part A was enacted, it was a self-supporting system, financed solely by payroll tax contributions. Today, Part A coverage averages about $3,100 per enrollee, while the average enrollee pays only 32 percent of the cost (26 percent for couples with only one worker). As a result, the average enrollee collects benefits equaling approximately three times the amount contributed during his or her working life.

The Kerrey-Danforth approach creates incentives in the Medicare program to control costs and introduces market forces to allow greater flexibility and a wider variety of delivery systems.

Individuals can make their own decisions about purchasing health care. Medicare enrollees would be given the option to stay in the current fee-for-service Medicare program or elect to enroll in an accredited private health plan paid for by a government voucher. The voucher would be equal in value to average fee-for-service per capita program costs. The above options are subject to the following program changes in Medicare Part A and B —

- *Add a graduated Part A premium.* Beginning in 2000, this proposal would require Medicare beneficiaries with incomes above 150 percent of poverty to pay a premium for Part A coverage. The premium would be graduated, starting at 150 percent of poverty and peaking at $60 for persons with incomes at twice the poverty rate, effective January 1, 2000. (Chart IX)

The share of Medicare Part B costs paid by enrollees as monthly premiums has been shrinking since the program began. When the program started, the enrollee and the Federal government had a 50-50 partnership — each paid 50 percent of the cost. Today, the Federal government pays 70 percent of Part B costs; by 2030 the government's share is projected to increase to 92 percent. (Chart X)

The Kerrey-Danforth approach would —

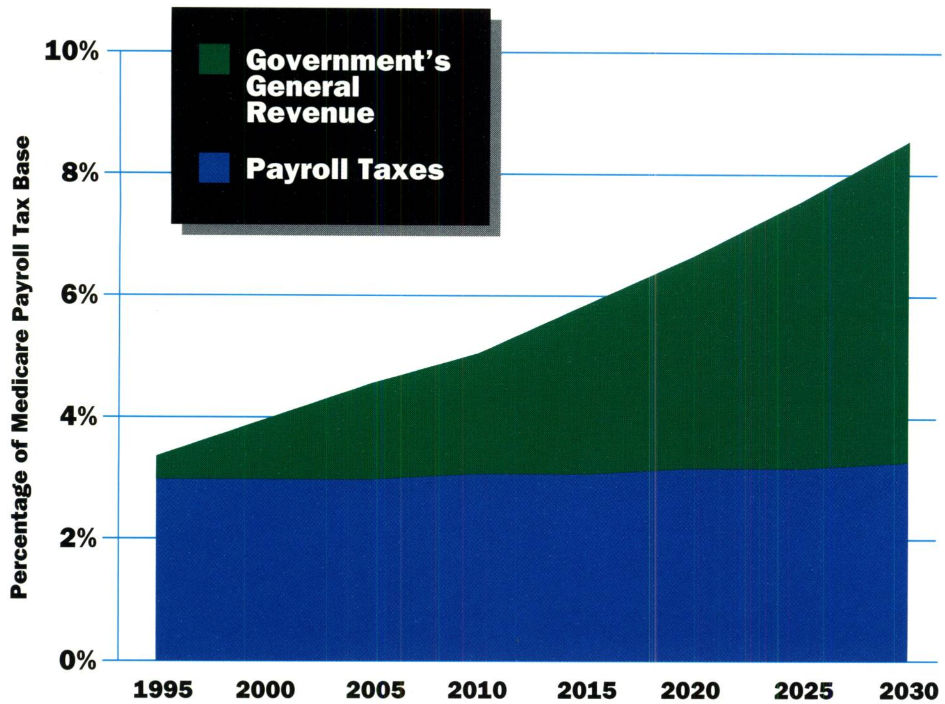
- *Index the Part B premium to program costs to keep the subsidy from increasing.* Part B premiums for 1994 covered about 30 percent of the cost of the Part B program. Beginning in 1996, this option would permanently index the Part B premium to maintain the 30 percent share of program costs currently paid by enrollees.

- *Raise the $100 Part B deductible to $300 and index it.* This proposal would increase the Part B deductible to $300 on January 1, 2000, and index it to medical care inflation thereafter.

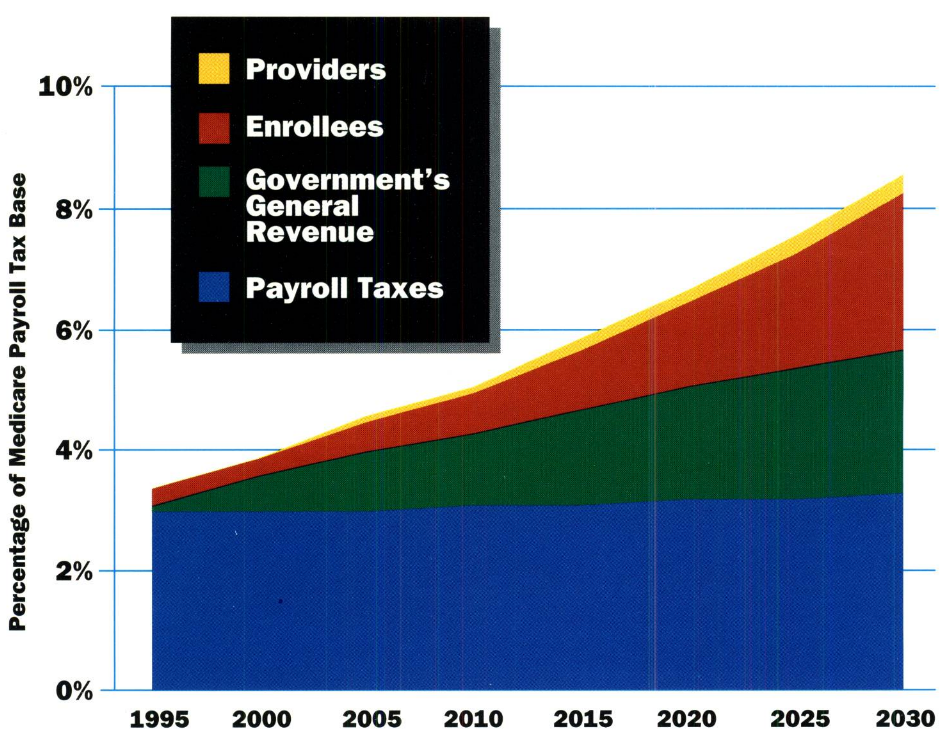
- *Add a 20 percent coinsurance payment for clinical lab services and home health care.* Beginning in 2000, this proposal would establish a uniform coinsurance rate of 20 percent on home health services paid by Part A and Part B and laboratory services in excess of $10.

CHART IX

GENERAL REVENUES WILL BE NEEDED TO SUBSIDIZE THE COSTS OF PART A UNDER CURRENT LAW



PART A COST INCREASES ARE SHARED UNDER KERREY-DANFORTH



The Federal government also subsidizes a substantial part of health costs by allowing health insurance costs paid by employers to be deductible and exempt from income tax when received by the employee. In 1994, the value of this subsidy was more than $50 billion. In addition to the program changes outlined above, the Kerrey-Danforth proposal would —

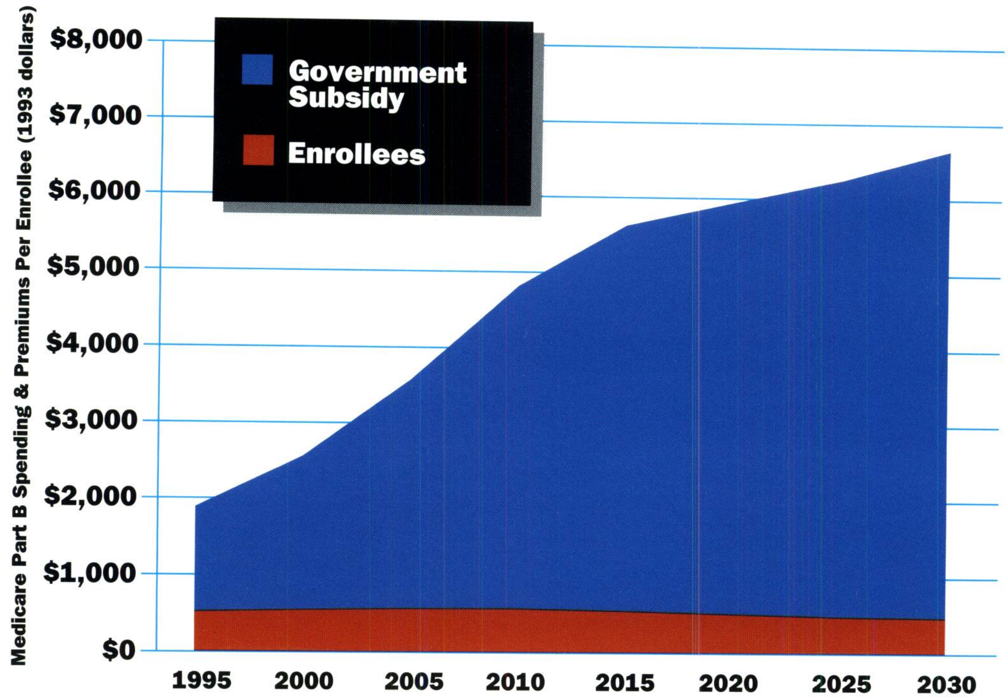
- *Cap the employer-paid health insurance deduction.* It would limit the amount of employer-paid health insurance and medical care that could be excluded from an employee's income for income tax purposes. The cap would be based on projected average health insurance premiums, effective January 1, 2000.

To attack waste, fraud, and abuse in the health care system, as well as to ensure that all participants in the health care system contribute to solving the problem, health care providers are asked to accept reduced payments.

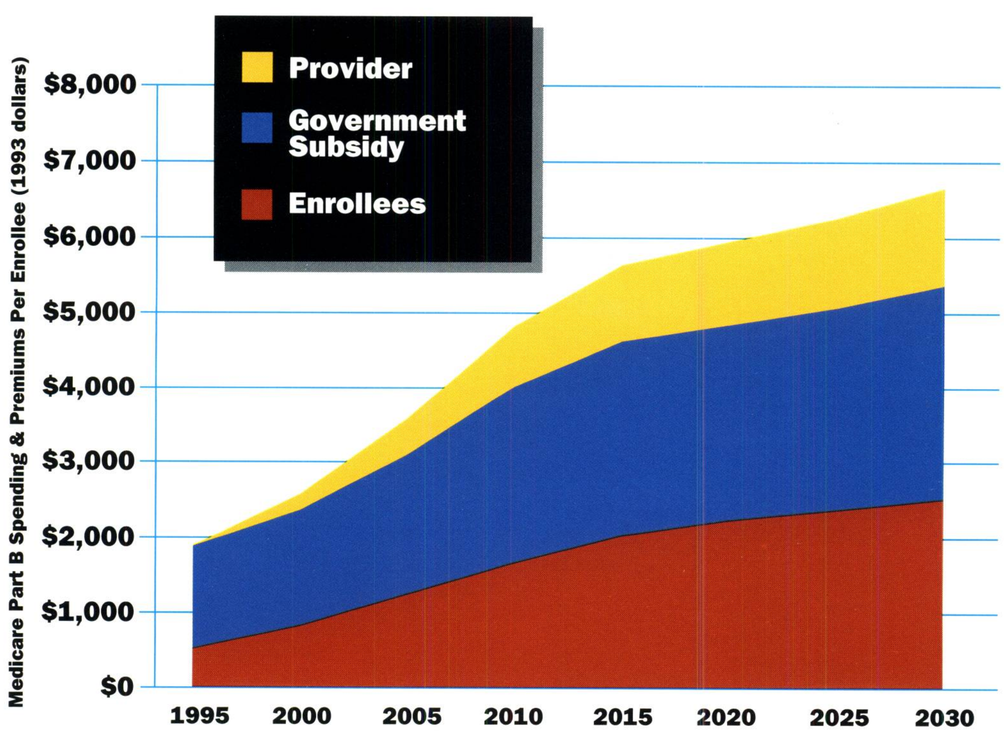
- *Reduce Medicare provider payments.* This change could be implemented through reductions in provider payments such as adjusting inpatient capital payments to reflect better cost data, revising disproportionate share hospital adjustments, and eliminating formula-driven overpayment in hospital outpatient departments. These options would take effect January 1, 2000.

CHART X

TODAY, THE PART B SUBSIDY FOR EACH ENROLLEE IS 70% OF PROGRAM COSTS AND IS GROWING



PART B COST INCREASES ARE SHARED UNDER KERREY-DANFORTH

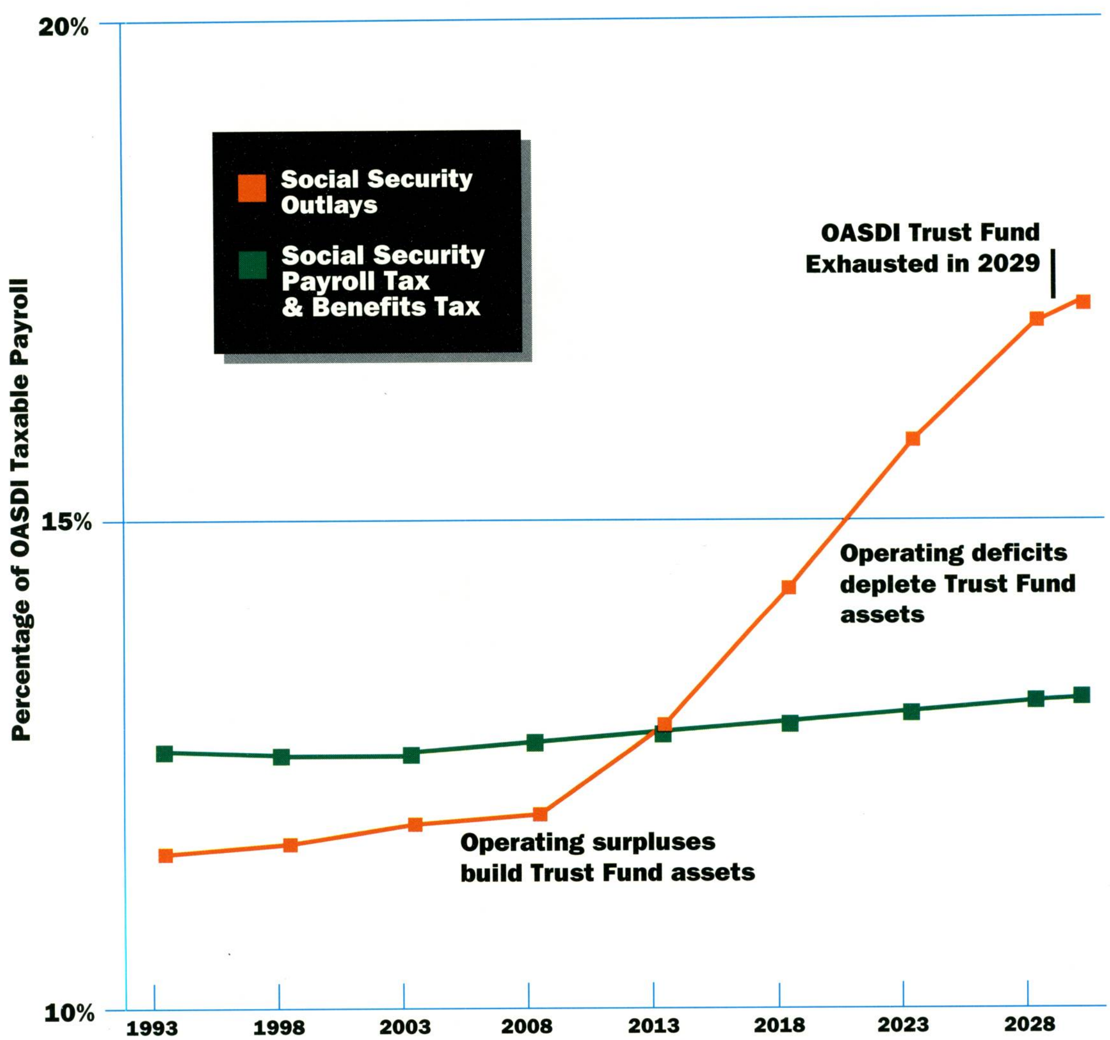


5. WE MUST FULFILL OUR PROMISES TO TODAY'S RETIREES AND ENSURE THE LONG-TERM SOLVENCY OF SOCIAL SECURITY. WE DO THIS BY REDUCING THE PAYROLL TAXES OF TODAY'S YOUNGER WORKERS IN EXCHANGE FOR A REVISED LONG-TERM CONTRACT.

The aging of the population will strain major entitlement programs, particularly Social Security. When the Baby Boom generation begins to retire in 2008, the cash flow surplus from Social Security will rapidly decline. According to the Social Security Trustees, by 2013 benefit payments will exceed dedicated tax revenues. Cash flow shortfalls in Social Security will then increase the Federal deficit rapidly unless policy changes are made. Trust Fund insolvency is also projected by 2029. (Chart XI)

CHART XI: SOCIAL SECURITY TAX COLLECTIONS EXCEED CURRENT BENEFITS BUT AREN'T ENOUGH TO FUND FUTURE PROMISES

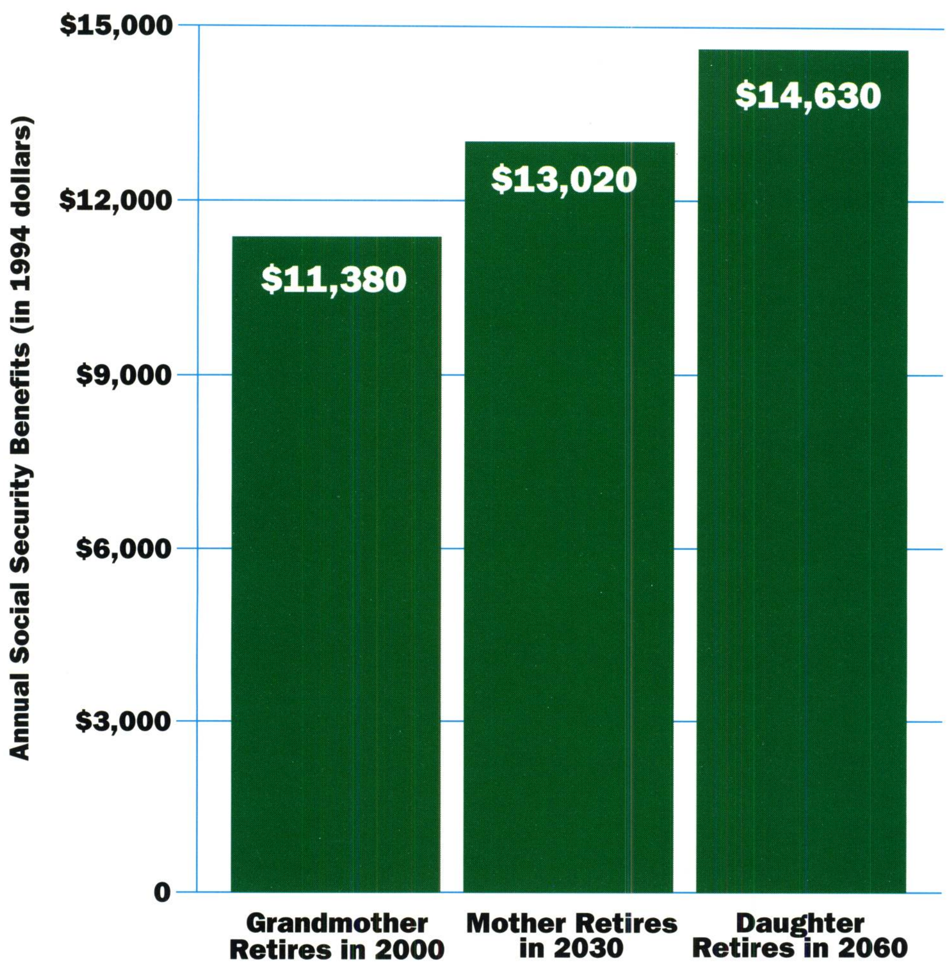
Revenue short falls will rise to more than 4% of payroll by 2030. To cover Social Security outlays, payroll taxes would have to increase from 12.4% today to more than 16.5% in 2030.



There are two ways to prevent insolvency: (1) raise taxes or (2) revise long-term promises to today's younger workers. The Kerrey-Danforth approach chooses the second option. In so doing, the Kerrey-Danforth approach restores long-term solvency to Social Security.

Under current rules, Social Security benefits grow faster than inflation. This means that each generation is promised greater benefits (even if they earn the same real wages) than the preceding generation. Greater benefits require higher taxes on future workers. For example, if each generation of a family has wages of $24,000 per year (in 1994 dollars), each generation is promised 12.5 percent greater benefits than its predecessor (*e.g.*, benefits increase by 25 percent in constant dollars over 60 years). (Chart XII)

CHART XII: EACH GENERATION GETS GREATER BENEFITS EVEN IF THEY HAVE THE SAME WAGES



The Kerrey-Danforth approach promises that each generation will be treated equitably, by —

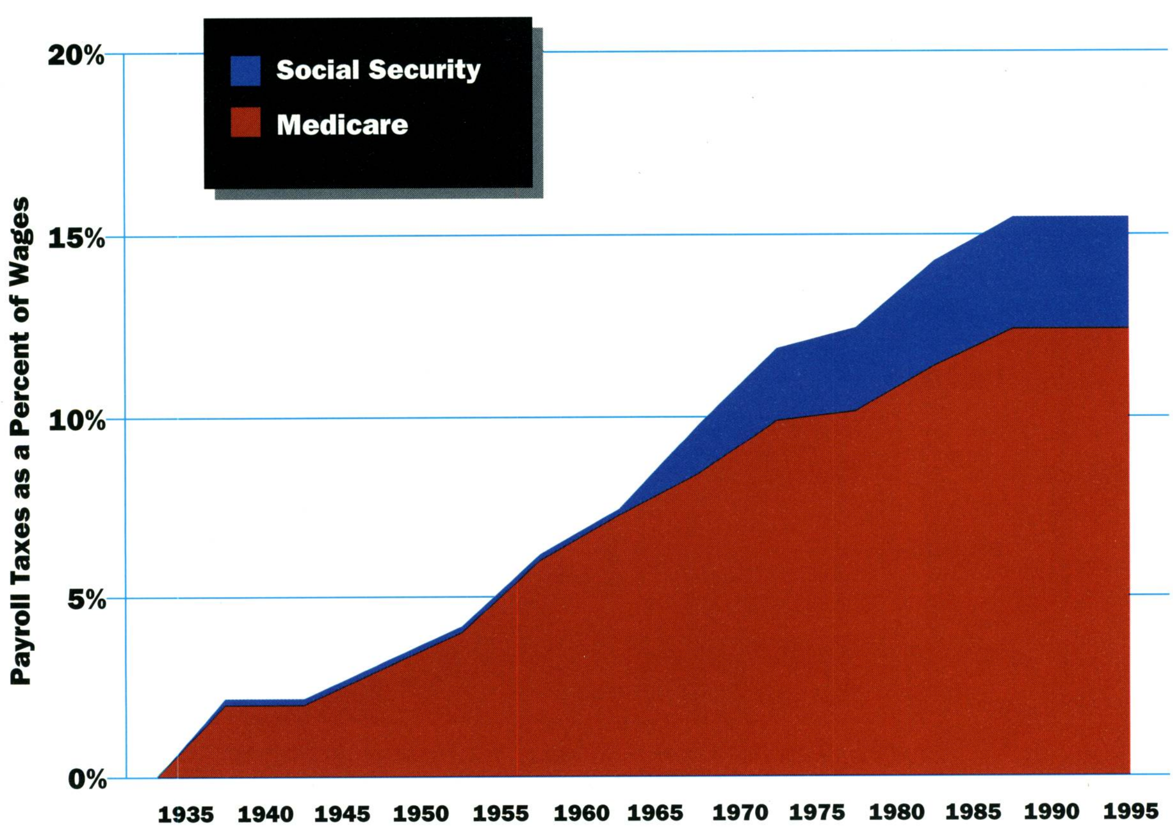
- *Indexing the Social Security "bend points" for inflation instead of average wage growth.* Effective in 1998 for new recipients only, this proposal would index the bend points in the benefit formula for inflation as measured by CPI instead of adjusting them for average wage growth.

- *Reducing growth of benefits to mid- and upper-wage workers by adding a third bend point.* This proposal would modify the benefit formula over a 50-year period beginning in 2000, gradually reducing the growth in benefits paid to workers with average and above-average earnings. No person age 55 or older would be affected, and in the first two decades after it takes effect, the impact would be minimal.

Americans are not saving for their futures — the current national savings rate of 1.7 percent is lower than historical rates and the savings rates of other major industrial nations. With the government taking increased amounts of wages through payroll taxes, this should come as no surprise. Since 1937, payroll taxes have increased from 2.0 percent of wages to 15.3 percent today. (Chart XIII and Chart XIV)

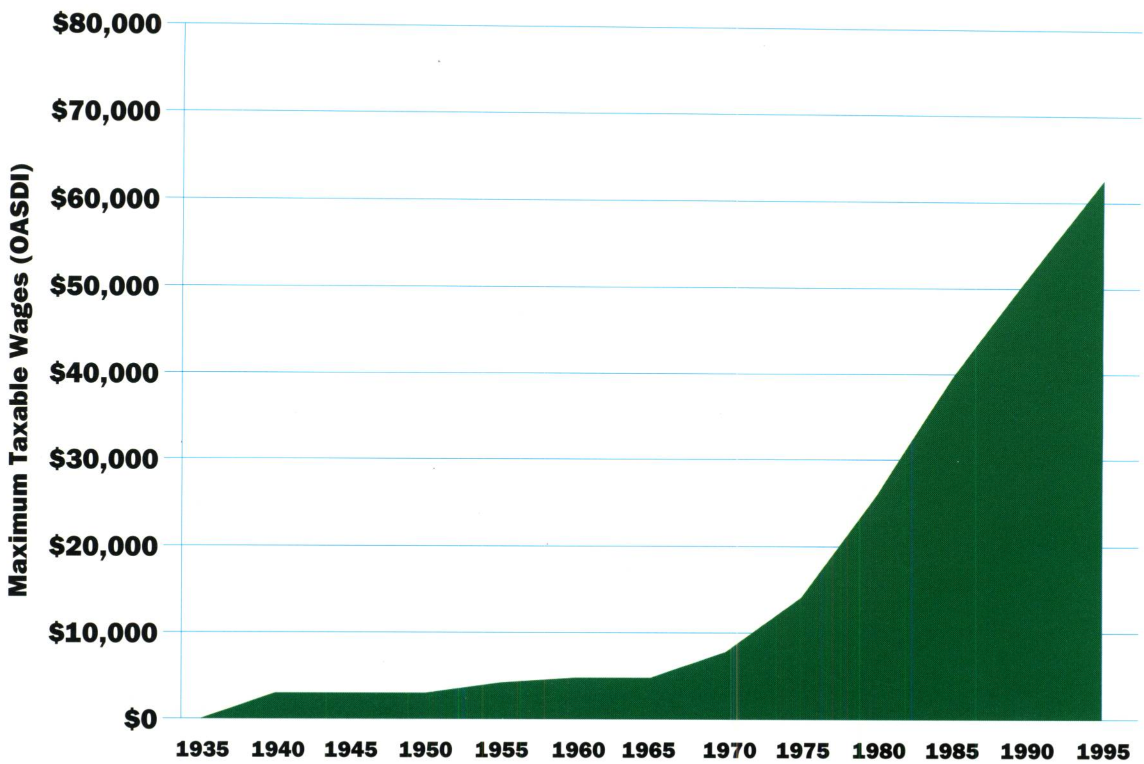
CHART XIII: PAYROLL TAX RATES HAVE GROWN STEADILY

COMBINED EMPLOYER AND EMPLOYEE TOTAL



If no policy changes are made, payroll taxes must increase to 24.6 percent by 2030 to support the Medicare and Social Security programs. As the payroll tax rate has increased, so has the wage base for both Social Security and Medicare taxes. The Kerrey-Danforth approach reduces the Social Security payroll tax by 1.5 percentage points ($57 billion in the year 2000 — one of the largest tax cuts in history) and requires that Americans invest that money for their family's health and retirement needs. Accordingly, the Kerrey-Danforth proposal promotes savings and personal responsibility for the future by —

CHART XIV: ANNUAL MAXIMUM TAXABLE EARNINGS FOR SOCIAL SECURITY

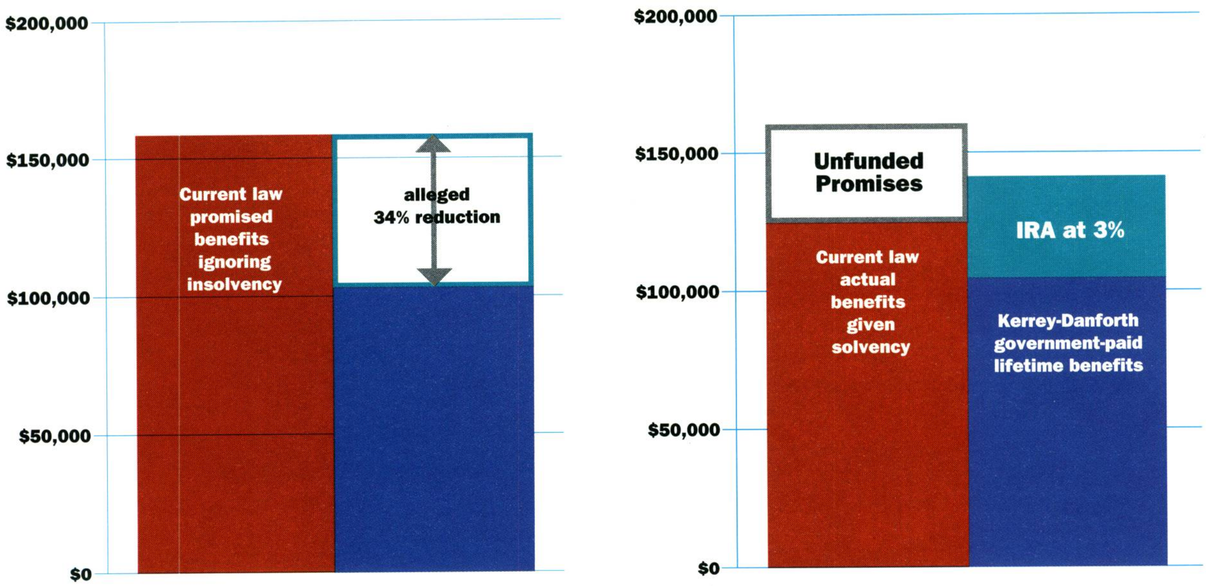


- *Providing a 1.5 percent Social Security payroll tax DECREASE and required contribution to personal savings/IRA.* This proposal would reduce the Social Security payroll tax for those under age 55 and require mandatory contributions to personal retirement accounts. Contributions to the individual's personal account would not be deductible, and earnings on the account would be taxed upon withdrawal. Withdrawal would be allowed only upon disability or retirement. This payroll tax decrease affects all workers in the Social Security system, and has no effect on benefits. It is equivalent to option 32 in the Staff Report on Entitlement Reform Options, except it is a tax ***decrease***. It is ***not*** the "personal investment plan option" listed as option 26 in the Staff Report. This proposal would take effect January 1, 2000. (Chart XV)

CHART XV

SOME MISTAKENLY CLAIM THAT KERREY-DANFORTH CUTS SOCIAL SECURITY BY 34% ...

BUT THEY IGNORE BOTH PROJECTED INSOLVENCY AND THE RETURN ON IRAS



Source: Social Security Trustees; C. Eugene Steuerle & Jan M. Bakija, *Retooling Social Security for the 21st Century* and calculations by the staff of the Bipartisan Commission on Entitlement and Tax Reform

A 25-year-old male born in 1970 who earns average wages can retire at age 67 in the year 2037. Under current law, he is promised lifetime benefits of $158,267 (in 1995 dollars). The Social Security Trustees project that the Trust Fund will be insolvent by the year 2029. The Trust Fund will then shift to a pay-as-you-go system. Thus, only 79% of this worker's promised benefits will be provided, absent changes in the law. The lifetime government-paid benefits delivered to this person by the Kerrey-Danforth package would be worth $104,456. In addition, under Kerrey-Danforth, the worker invests 1.5% of each paycheck in an IRA. If he receives a real 3% rate of return on his IRA, he will have an additional $36,661 in private savings when he retires. His total benefits (government + private) would be ($104,456 + $36,661) $141,117. His actual benefits under current law will be $124,589. Even if his IRA earns only the 2.3% real return assumed by the Social Security Trustees, his total benefits would be $135,516. If he earns 4%, his total benefits would be $151,326. Furthermore, if he dies before age 62, his surviving relatives would inherit the value of his IRA.

6. WE MUST DESIGN A SOLUTION THAT IS FAIR TO ALL AMERICANS.

We must all share the costs of planning for the future. As previously noted, Members of Congress, congressional and civil service employees, and military personnel all contribute under the Kerrey-Danforth approach. In addition, other entitlement programs must be evaluated to ensure that our tax dollars are spent judiciously. Accordingly, the Kerrey-Danforth approach asks for a 10 percent reduction in entitlement programs such as veterans compensation, agriculture, and welfare. After the reduction, the proposal caps the growth in these programs. The proposal would —

- *Cut other entitlements by 10 percent in 2000 and cap at CPI plus population growth thereafter.* This option would require a 10 percent reduction in all other entitlements from the 1999 level of spending (*i.e.*, about a $20 billion cut). Programs affected include Supplemental Security Income, Food Stamps, Aid to Families With Dependent Children (AFDC), veterans' pensions and compensation, farm price supports, and unemployment compensation. The proposal would take effect starting in fiscal year 2000.

Re-evaluate the Consumer Price Index (CPI) to ensure that it more accurately reflects increases in the cost of living. The Bureau of Labor Statistics is currently reviewing the methodology used to calculate the CPI. Many economists and technicians believe the current CPI formula overstates cost-of-living increases by between 0.2 and 0.8 percentage points. The Kerrey-Danforth approach would reduce increases in the CPI by one-half of one percentage point and direct the Bureau of Labor Statistics to evaluate the current formula.

- *Adjust the CPI to better reflect inflation.* A number of Federal programs are adjusted annually based on increases in inflation as measured by the CPI. The CPI is based on a "market basket" of goods and services purchased by a representative urban worker. Adjusted every 10 years, the current market basket was last revised in 1987 using data for the period 1982 to 1984. As a result, the CPI does not capture annual changes in the pattern of consumer preferences. In addition, the CPI may not adequately measure the consumer benefit derived from improvements in the quality of existing goods or from the introduction of new goods. This proposal would require the Bureau of Labor Statistics to modify the CPI formula to reflect changes in the cost of living more accurately. These changes would apply to cost-of-living adjustments for Social Security and Federal retirement, veterans' compensation, and indexation in the Federal individual income tax (*i.e.*, income brackets, exemptions, and deductions). A revised formula for the CPI could take effect January 1, 1998.

The burden of reform should be distributed based on ability to pay. Those who can afford to shoulder a greater portion of the burden should. The Kerrey-Danforth proposal would —

- *Means test Medicare, veterans compensation, and unemployment insurance.* This option would be phased in over five years, starting in 2000. The sum of income from government payments, earned income, and unearned income would determine the rate of benefit reduction for these three programs. The option would gradually reduce benefits for families with incomes over certain thresholds. For example, reductions would start at $0.10 for each additional dollar of income between $40,000 and $50,000; rise to $0.20 for each additional dollar of income between $50,000 and $60,000; and increase thereafter up to $0.85 for each additional dollar of income above $120,000. Regardless of income level, all beneficiaries would continue to receive a benefit. High-income beneficiaries, however, would see their benefits reduced.

- *Limit itemized deductions to 28 percent.* Itemized deductions would be limited to a rate of 28 percent regardless of the marginal tax rate applicable to the taxpayer. This would only affect couples whose incomes exceed $91,850 in 1994 dollars. This new provision would take effect January 1, 2000.

While asking all Americans to share in the costs of planning for our future, the Kerrey-Danforth proposal would make participation in the Social Security system mandatory for virtually all workers —

- *Include State and local workers in the Social Security system.* Starting in 2000, new State and local workers and those with five or fewer years of service would be required to participate in the Social Security program.

7. WE MUST ACT NOW TO GIVE PEOPLE TIME TO PLAN FOR THE FUTURE AND TO AVOID SIGNIFICANT FUTURE REVENUE INCREASES OR BENEFIT REDUCTIONS.

Americans must have time to plan for and adjust to necessary policy changes. Most elements of the Kerrey-Danforth approach do not begin before the year 2000, and are phased in over at least five years. The changes in Social Security are phased in over much longer periods of time. Although most of these policies do not take effect until the next century, allowing people time to plan dictates that action should occur soon. If the President and Congress choose inaction, demographics and the growth of health care costs will cause future solutions to the problem to be both draconian and politically fractious.

Although the short-term fiscal outlook has improved, the long-term situation requires immediate attention. For the next five years, the Federal deficit is projected to average 2.5 percent of the economy, its lowest level since the 1970s. After 1998, however, Federal spending is projected to grow faster than revenues, causing Federal deficits to rise rapidly.

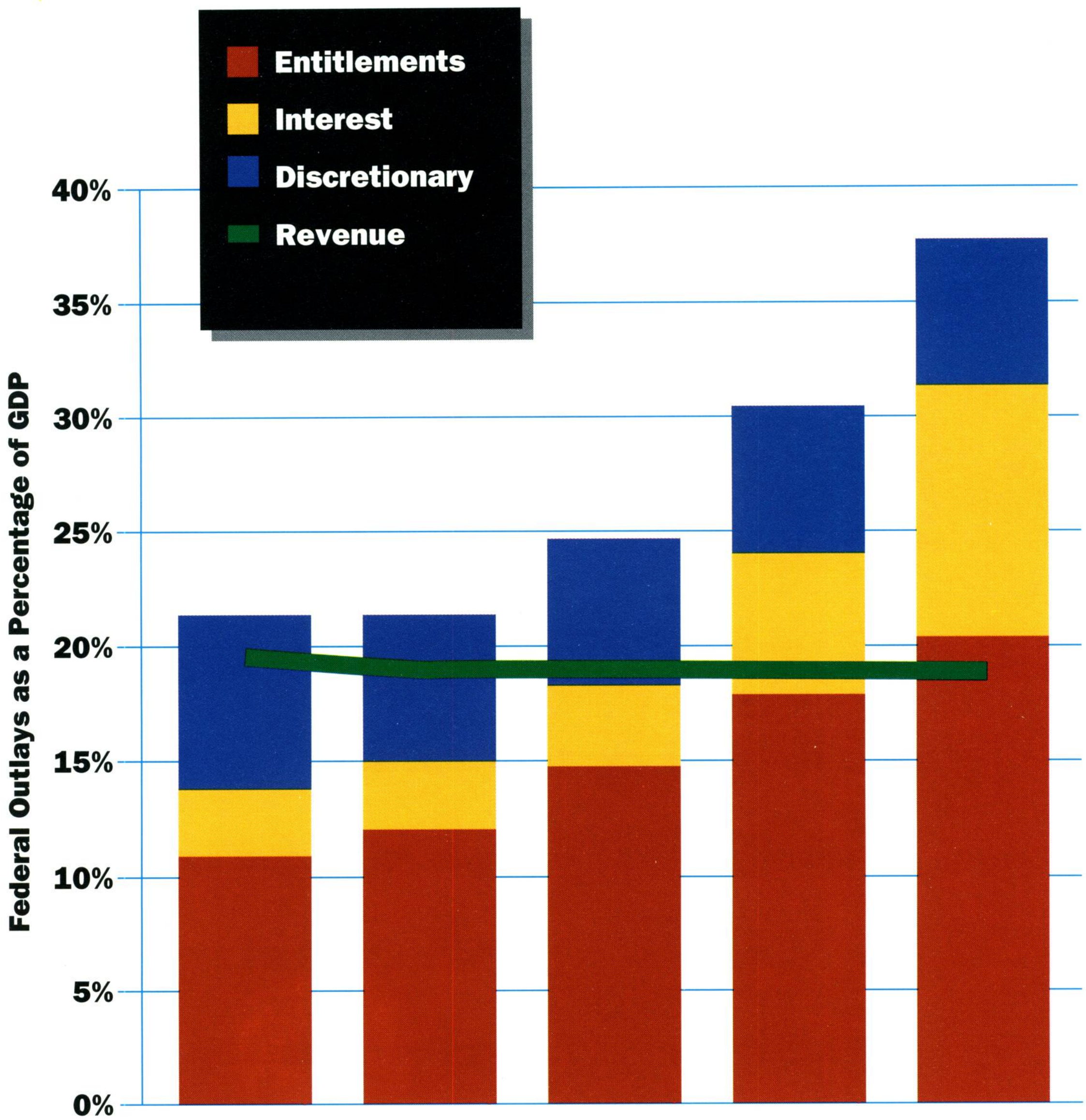
The costs of inaction are already apparent. Current long-term interest rates are high due to expectations of future spending policies. Moreover, funds needed for appropriate and essential government functions are being diminished by the rising costs of entitlement programs and payments on debt. If the President and Congress solve the Nation's long-term spending problems, families and businesses will enjoy lower interest rates and expanded investment opportunities that are vital to a strong economy in the next century.

"I RECOGNIZE THAT IT IS DIFFICULT TO DEAL WITH A PROBLEM WHOSE SYMPTOMS ARE HARD TO DETECT AND WHOSE FULL-BLOWN EFFECTS SEEM TO BE YEARS OR DECADES AWAY. BUT FINANCIAL MARKETS HAVE A WAY OF BRINGING FUTURE PROBLEMS INTO THE PRESENT."

— ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, (JULY 15, 1994)

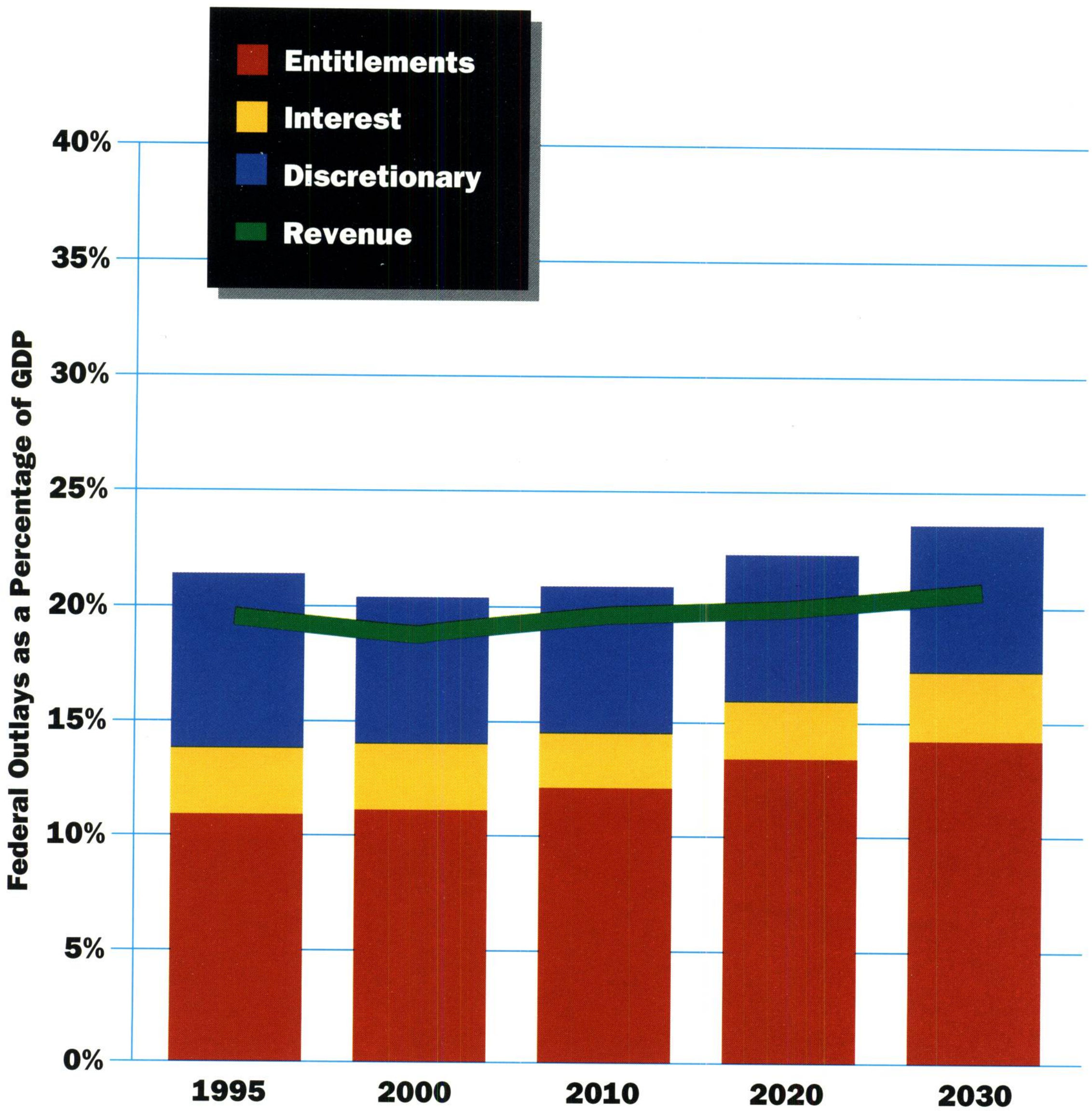
THE PRESENT TREND IS NOT SUSTAINABLE...

FUTURE IMPACT OF CURRENT LAW



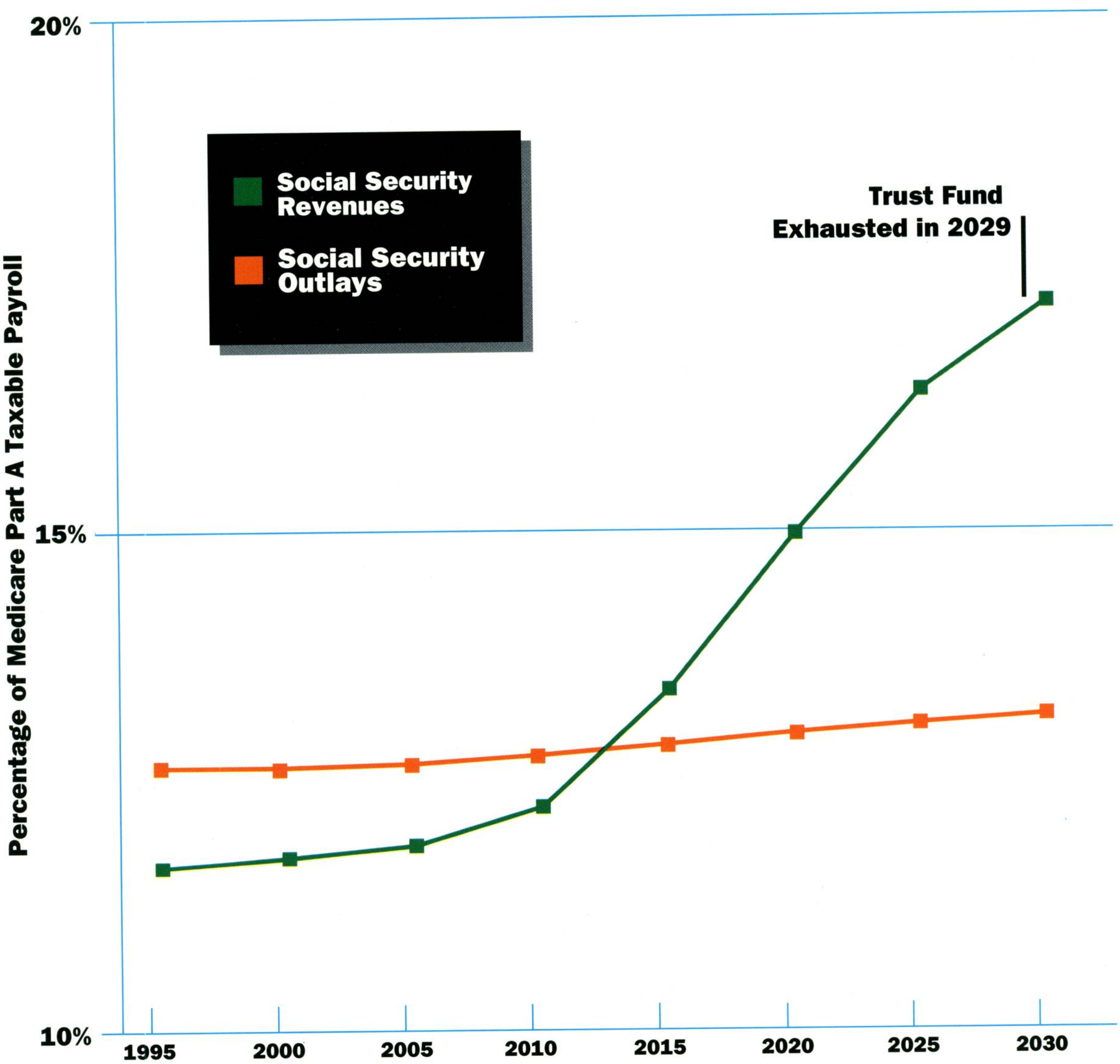
KERREY-DANFORTH ADDRESSES AND SOLVES THE PROBLEM

FUTURE IMPACT OF KERREY-DANFORTH



THE SOCIAL SECURITY TRUST FUNDS ARE THREATENED WITH INSOLVENCY...

FUTURE IMPACT OF CURRENT LAW



KERREY-DANFORTH ENSURES THE LONG-TERM SOLVENCY OF THESE PROGRAMS

FUTURE IMPACT OF KERREY-DANFORTH