

**THE NEW PROPOSAL TO OMIT SEVERAL TRILLION DOLLARS
IN COSTS FOR SOCIAL SECURITY PRIVATE ACCOUNTS
FROM THE FEDERAL BUDGET
TELECONFERENCE
TUESDAY, DECEMBER 14, 2004 AT 11:00 AM (ET)**

ROBERT GREENSTEIN: Good morning, everybody. This is Bob Greenstein from the Center on Budget and Policy Priorities. As you know, we're talking this morning about Social Security, which will be a major topic at a two-day White House conference that begins tomorrow.

Joining us for this morning's briefing are three experts in the area: Alan Blinder, nationally known professor of economics at Princeton and former vice chair of the Federal Reserve; Peter Orszag, senior fellow at the Brookings Institution and coauthor with Peter Diamond of MIT of one of the major books on Social Security of the past several years; and Jason Furman, who has been on the staff of the President's Council of Economic Advisors as well as a special assistant to the President for economic policy in the late 1990s. Jason is a former lecturer at Yale and Columbia universities and shortly will be joining the Center on Budget and Policy Priorities.

I should note, as I think you're all aware, that the Center issued several papers yesterday that form a backdrop for today's discussion. The papers are all jointly written by Jason Furman, Peter Orszag, and Bill Gale. As you know, Bill Gale also is at the Brookings Institution.

ALAN BLINDER: Thank you all for taking the time to listen to this relatively wonkish subject. I think it's very important, because misunderstandings of this issue — and by all accounts it's going to be a very major issue very soon — are rife. There are a tremendous number of very large misconceptions, and we people that labor in the policy vineyards rely on journalists to get the facts to the public, so we appreciate your attention.

I want to start with a few of these misunderstandings. The first is that this issue we're talking about today: the way you budget to cover the transition costs. This a question of budgetary honesty, not a question of whether privatizing Social Security is a good idea or a bad idea. Another way to say that is if you're honest about it, the budgeting issue comes out the same whether you're a "pro-privatizer" or an "anti-privatizer." The three of us on the call today are anti-privatizers and in the question period we can get into why, but that's really not the subject here. Even if you favored privatization, you should be against these hokey budget gimmicks that are being talked about.

The second misconception I want to clear up has to do with this phrase "transition costs," which all of us are guilty of using (and I think by now it's been used so much that it's hopeless to try to change it). You should understand that these are a very strange kind of transition costs, in that they will last for *decades*. This is not a ten-year issue, where you pay a trillion or two trillion and you finish with the transition costs. When you think about Social Security reform, the units of thought ought to be lifetimes, and in this case, the transition costs are likely to go on for several lifetimes.

Just as one example, in the Social Security Commission's Model 2, which was brought to the White House several years ago, the transition period — that is the period until you got back to the same place on national debt relative to GDP where you started — was 60 years long. In some of the other plans I've seen (there are many plans coming out of private-sector economists) the transition costs may last 60, 70, 80 years, or even longer. The cost is not one trillion or two trillion; it's many, many trillions. In that Model 2 I just mentioned, the so-called transition costs are two trillion for the first decade, but in the *second* decade, transition costs are about four and a half trillion, and so on. So this is a lot bigger and longer-lasting than what we usually call transition costs.

The question for any honest privatization scheme is how you are going to pay for these transition costs. There are three basic ways, each of which has many subcategories: you can cut benefits (and there are many ways to do that), you can bring more revenue into the system (and there are many ways to do that, the most obvious way being to raise the payroll tax but there are many others), or you can borrow the money.

As I read the newspapers it seems, although the Administration hasn't said so, that the Administration is leaning strongly toward relying on the third of these for what seems to be 100 percent of the transition costs — that is, to borrow it all. From a public policy perspective I don't think that's a very good decision, for exactly the same reasons that we don't want the national debt to keep spiraling up and financing everything by deficits. Thus far in the Bush Administration we've financed everything by deficits: the Iraq war, Medicare drug benefits, farm subsidies, you name it. A lot of us don't think that's very good public policy, and the same argument carries over to Social Security. That doesn't mean there wouldn't be any borrowing component whatsoever; it just means that it's very unlikely that the sensible public-finance solution to this problem is to rely 100 percent on borrowing and 0 percent on benefit cuts or infusions of more revenue.

Now I come then to the main question of one of the two papers by Jason and Bill and Peter. People are saying that this borrowing we would have to do to cover the transition costs isn't really borrowing at all, because the government already has the implicit liabilities inherent in the Social Security system. The borrowing would just be an explicit recognition of those liabilities, and as such, would be a non-event economically.

There are a number of things to be said about that idea, most of them bad. The first is the question of whether we really have these implicit liabilities. As you look to the long-term future, the problem is going to be solved through some combination of borrowing (there's the future liabilities), benefit reductions, and/or increases in taxes or some kind of revenue. It's by no means obvious that the solution to this problem is going to be 100 percent borrowing. The 1983 Greenspan Commission, for example, did not rely on borrowing; it relied on benefit cuts and tax increases in the future.

Second, you could make the same argument about a whole lot of liabilities. The federal government has an obligation for the national defense from now to infinity. I don't see that anything useful would be done by calculating the present value of that and saying, Why don't we borrow it today? I don't think anybody's going to propose that, and nobody really has said that the borrowing we now do to finance national security isn't really borrowing at all because it's just recognizing a liability that we had all along. This argument is reserved, it seems, for Social Security.

What about this idea that changing implicit debt to explicit debt is a non-event in terms of markets, interest rates, and so on? There are theoretical economic models under which that would be true, but if you talk to people in actual bond markets about those models, they think you've taken leave of your senses. By sheer coincidence I happened to be in New York yesterday talking to several bond traders, and I asked them if they knew about this proposal to float debt but say that it's not debt. They didn't. I told them about the argument that it's a non-event, since you're just turning implicit debt into explicit debt and that shouldn't affect the markets in any way. They guffawed at this thought; they thought it was completely ridiculous. And they were worried, of course — as most people in the bond markets would be — about what would happen if the markets had to swallow this much more explicit debt, never mind that it used to be implicit debt.

I'll finish with a plea. I realize journalists are not supposed to be advocates except when they're writing opinion pieces, which many of you do, but for the sake of public policy in general in the United States we've got to draw the line somewhere on budget gimmickry. We have seen over the last 25 years — excluding, I'd like to say, the Clinton years — an incredible panoply of budget gimmicks, and the Congress keeps inventing new ones. We need to draw the line somewhere. A budget gimmick like this, which is looking at bonds and saying they're not bonds, and letting this gimmick last for 60, seventy years involving trillions upon trillions of dollars, is a whopper. You don't even call that a gimmick anymore; this is the mother of all budget gimmicks. It seems to be that it's being trial-ballooned now, and since I had nothing to do with writing these papers, I'd like to commend Jason and Bill and Peter for trying to puncture a big hole in that trial balloon. It richly deserves to be punctured. Thanks.

ROBERT GREENSTEIN: Thank you Alan. We go now to Jason Furman.

JASON FURMAN: I will start with a balloon that's already been floated. In fact, whenever the President or his spokesmen talk about Social Security they float this balloon every other minute, and I think you're likely to hear it a lot tomorrow and the next day. It is the idea that the so-called transition costs of two trillion or something on that order are trivial compared to the \$10 trillion costs of doing nothing. That's quoting [White House spokesman] Scott McClellan, but the President has used very similar language. Bill, Peter, and I put a paper up on the Center's web site explaining this in detail, but to go into it very briefly, it's just a deeply misleading classic bait and switch argument.

First, the bait. The \$10 trillion figure itself is very misleading. I think it's worth quoting a letter from the American Academy of Actuaries in full, because it really explains it in detail. It says that this number \$10 trillion provides little if any useful information about the program's long-term finances and indeed is likely to mislead anyone lacking technical expertise in demographic, economic, and actuarial aspects of the program's finances into believing that the program is in far worse financial shape than is actually indicated.

So this is a number which is designed to mislead people, according to the actuaries. Here are a few of the reasons why. First of all, it's important to stress that the \$10 trillion is over an infinite horizon; that is not the traditional way in which people examine Social Security. Traditionally people look at the imbalance in Social Security over the next 75 years. Just to put that in perspective, if the tax cuts passed in 2001 and 2003 are extended and are not eroded by the Alternative Minimum Tax, they would total \$18 trillion in present value over that same period.

If you just look at Social Security over a 75-year period, the imbalance is \$3.7 trillion. That's 0.7 percent of GDP. According to the Congressional Budget Office the imbalance is 0.4 percent of

GDP. That's definitely a challenge, but it's a manageable challenge and it's smaller than the challenge that's been created by the fiscal hole created by the President's tax cut, which was on the order of 2 percent of GDP — three to five times larger than the cost of saving Social Security for the next 75 years. Therefore, the first problem with the \$10 trillion argument is that the \$10 trillion, the bait itself, is misleading.

An even more fundamental problem, though, is the switch, which is that the \$2 trillion you borrow for individual accounts over the next ten years doesn't do anything to help you solve the \$10 trillion dollar problem. In fact, borrowing that \$2 trillion just adds another \$2 trillion to the problem, because now you don't just need to close the gap in Social Security, you also need to repay the \$2 trillion dollars for individual accounts.

In Model 2 from the [President's Social Security] Commission, you pay back most of the individual accounts with one set of benefit reductions, and then you pay back the remaining costs of the individual accounts plus bring the system into balance through a deeper benefit cut that's implemented by switching from wage indexing to price indexing. In the Ferrara-Ryan-Sununu plan, you transfer \$7 trillion to Social Security and that's how you extend its life, but borrowing the \$2 trillion does nothing by itself to solve Social Security's imbalance and actually hurts it.

In terms of the other paper Peter, Bill, and I did, Alan did an excellent job of hitting on most of the key points; I just wanted to highlight a few things. The question we set out to ask, as Alan said, was not whether individual accounts are a good idea or a bad idea. Nor was it the deeper question of whether we should do accrual budget or generational accounts when we do our budget, or how we should measure the budget.

The question that's before us is a very simple one: we have a unified budget right now; should we make an exception to that? Would that lead to better policy making or worse policy making? Our answer, resoundingly, is that whether you agree or disagree with individual accounts, making an exception to the unified budget would lead to substantially worse policy making.

First, let's step back and remember that raising national savings was one of the primary goals of Social Security reform; it was unanimously endorsed by the Advisory Council in 1994-96 and endorsed by the President's Commission as well. If you pay for individual accounts by borrowing the money, the individual accounts have done nothing to increase national savings. And if you haven't increased national savings, then you're not increasing investment, you're not increasing the capital stock, and you're not putting us in a better position to meet our obligations in the future.

In fact, if you pay for individual accounts by borrowing, that's likely to decrease national savings, because people see the money accumulating in their individual accounts and they assume that they don't need to save as much in their IRA's and 401(k)'s. So likely on balance to a first approximation you've just rearranged money, while to a second approximation you've probably discouraged people from saving on their own and reduced national savings.

The only way that the individual accounts portion of the plan can lead to higher national savings is if those individual accounts are funded by higher payroll taxes, by cutting other government spending, or by repealing some form of tax cuts and putting the money into the individual accounts. If you borrow for the accounts they won't increase savings; they'll probably decrease it.

That brings me to my second point, which is that there are a number of “free lunch” Social Security plans floating around, as well as plans like Model 2 from the Commission, which has a very substantial “free lunch” component in the form of large general revenue transfers and unfunded individual accounts combined with benefit cuts well into the future. Those types of “free lunch” plans thrive in an environment where you don’t have to count the cost of borrowing over the next decade and where you can make the accounts as large as possible (in the Ferrara-Ryan-Sununu plan, for example) to exploit the fact that the Social Security actuaries don’t incorporate any cost of risk associated with investing in the stock market into their analysis. The more borrowing you can do in that way of accounting, the more you can leverage yourself up, not take account of the risk in the stock market, and do something like a “free lunch” plan.

The third reason that making this one exception to the way that we do budget scoring would lead to worse policy is the one that Alan described very well. He said that in theory, shifting from the implicit debt we have now — the \$10 trillion over an infinite period or \$3.7 trillion over the next 75 years — into explicit debt that we borrow from the public and that we have to pay interest on each year would have no effect, but that in *practice*, it would have an effect. I agree with him that in practice it would. In theory, it would only have no effect if you believed every one of the parameters of the model. But a lot of the benefit cuts that are paying for the up-front borrowing are very backloaded; there’s a decent chance they won’t occur. Also, if the stock market goes down, there would likely be a bailout, so there’s some implicit costs you’d want to price in. Once you take all of those factors into account, plus the fact that no one right now expects that the implicit liability really is as high as \$10 trillion (because they expect eventually some adjustments will be made), then even in theory you would have financial market effects up front.

Finally, I think Alan did a very good job of saying that even if you think that changing this accounting rule is a good idea for Social Security (and we think it’s an overwhelmingly bad idea for Social Security), it would set a precedent and send you down a slippery slope. To give you one example of the type of thing you could justify by it, we could cut taxes in half today and pay for those with a law that said discretionary spending would be eliminated starting 30 years from now. Starting 30 years from now you’re going to have zero spending on education, etc. The Congressional Budget Office scores budget caps, so it would score that in present value terms, allowing you to argue that the future discretionary spending cuts would fully pay for the enormous tax cut today and that this should therefore have no cost in terms of the budget.

But I think anyone looking at a proposal like that would say that that was not only deeply irresponsible, but that the future cuts to pay for the today’s benefits are likely never to materialize. By the way, we’ve seen this happen several times before, where Congress has passed things like tax cuts to be paid for by future Medicare cuts and then delayed or rejected the Medicare cuts because they are too painful. So it would open up the door to that type of budget gimmickry, and it could justify any manner of deficit-worsening proposal.

ROBERT GREENSTEIN: Thank you Jason. Now, Peter Orszag.

PETER ORSZAG: I just want to underscore two key points. The first is that trading implicit debt for explicit debt in the real world is not inconsequential; there is a substantial difference between a benefit promise in 40 or 50 years (or even revenue changes in 40 or 50 years) and explicit debt today. Basically, you don’t have to sell your implicit debt to financial markets. You do have to sell your *explicit* debt to financial markets.

I am not aware of any country that has gotten into trouble with large implicit debt. I'm aware of many, many countries that have gotten into trouble with large explicit debt.

We do need to address the nation's large implicit debt, but it is of a different nature and provides more flexibility to the government than explicit debt does. Another way of putting the same point is that you can reduce implicit debt through future policy changes — in fact, that's the sound way of addressing implicit debt, by a phased-in set of adjustments on both the benefit and revenue sides to reduce the implicit debt. If you get in trouble with your explicit debt, by contrast, you're forced to make often wrenching, immediate changes. You can't just change future policy if you're having trouble rolling over your explicit debt, so there is an important difference.

My second point is a reminder that this vision that somehow we have only a decade of transition costs and then the plan will start to reduce costs is just wrong. Alan mentioned that with regard to Model 2, which is I think the leading plan from the President's Commission, it took 60 years for there to be a net savings in terms of public debt. Just think about that for a moment. That would be like if we enacted Model 2 at the end of World War II, and even if we implemented all of the benefit reductions that the plan entails (which as Jason has noted might not be easy), we would only now be experiencing any net reduction in debt from that plan relative to doing nothing. Basically, 60 years in fiscal policy is an eternity. This is not just a short-term cost that then very quickly produces savings; there is an extended cost.

I guess I'm going to a third point: we don't need to be incurring that debt. Even if you favor individual accounts, Senator Lindsay Graham is now stepping forward with ways of trying to finance some of the accounts. Ned Gramlich from the mid-1990s had a plan that financed individual accounts. You do not need to borrow the money to finance the accounts, and you undermine the potential macroeconomic benefits associated with accounts by borrowing the money.

ROBERT GREENSTEIN: Thank you Peter. We're going to go to your questions.

QUESTION: Yeah. Whom have you spoke with on Capitol Hill about your ideas?

ALAN BLINDER: I spoke the other day to a meeting of the House Democratic Caucus. There were quite a few people there.

PETER ORSZAG: I think it's safe to say we all have a lot of interaction with policymakers.

QUESTION: Is there a feeling from your interactions with policymakers that the Administration is dead set against tweaking the system — say, increasing payroll taxes, or changing from a wage index to an inflation index? Are they dead set against changes like this and intent only on borrowing?

PETER ORSZAG: Two of the President's principles, when you actually combine them, necessarily implicate certain outcomes. In particular, he's said no increase in the payroll tax, and I believe a fair reading of the rather confusing press conference his spokesman gave also means no increase in the maximum taxable earnings threshold or other ways of getting additional revenue. Once you rule out additional revenue for the system, fundamentally that means you will have to rely on very large benefit reductions to close the underlying deficit in Social Security.

That's one implication. Since borrowing is not ultimately sustainable, you need to ultimately address the problem on the benefit side or the revenue side, and if you completely rule out the revenue side you're putting a lot of pressure on the benefit side. That is what the so-called "price indexing" proposal would do: it would very dramatically scale back Social Security benefits in terms of replacing the wages that you had before retirement. Whether the Administration owns up to this implication or not is a different question.

The second thing the President has said is that he wants to allow workers to divert part of their existing payroll taxes into individual accounts. If that's combined with a policy of no additional revenue, you wind up borrowing the money, because most of the dollars that are going to go into those accounts are already spoken for — they go to pay current beneficiaries. So unless you're going to cut off grandma, which he has also ruled out, you have to come up with the money somewhere. And if you're not going to come up with it on the revenue side, you have to borrow the money.

So the President's principles have effectively guaranteed that when we really get down to the heart of the matter, you're going to combine very large reductions in traditional benefits with very large borrowing.

QUESTION: Privatization seems to me to be a deliberate and even radical undermining of the long-term future of Social Security and a lot of other New Deal and Great Society programs. What else can be done to reform Social Security to cover its unfunded liability for baby boomers' retirement?

PETER ORSZAG: I want to talk for a moment just about accounts first and then turn to Social Security because I think it's very important to emphasize that I am very much in favor of individual accounts. We already have them: they're called 401(k)'s and IRA's. There's a growing body of evidence on what works to make them work better, and that is where we should be taking risk and promoting ownership.

Individual accounts make sense above the core foundation of financial security. They do not make sense *within* the core tier. The average Social Security benefit is only about \$1,000 a month. Social Security is supposed to provide a base layer; it's not supposed to do everything, and in that core foundation, accounts just don't make any sense.

With regard to the core foundation, you want a benefit that lasts as long as your life, that's protected against inflation, and that doesn't decline when the stock market declines. To shore up that system and continue to provide that kind of protection as a foundation, there are lots of changes that we can make. One promising idea that's included in the book that I wrote with Peter Diamond is that instead of repealing the estate tax we should reform it, retain its 2009 parameters and dedicate that revenue to Social Security. Simply doing that (which would affect well under 0.5 percent of estates each year) would solve between 25 and 40 percent of the Social Security deficit over the next 75 years, depending on whose assumptions you use. That would be a very good first step.

Beyond that, there are a whole bunch of other things that we could be talking about. I'll give you one example. Life expectancy is going up for everyone, but it's going up really fast at the top of the income distribution. That is to say, the gap in life expectancy between higher earners and lower earners is increasing markedly — by more than a half a year during the 1990s alone, which is a very big change over that kind of time period. In my view, that justifies some benefit reductions that occur at the very top of the benefit formula that only affect the top 10 to 15

percent of beneficiaries, to offset the fact that they're increasingly living longer than everyone else and collecting their benefits over a longer period of time than everyone else. In our book we lay out a whole series of options.

The analogy I like to draw is that Social Security is like a car with a flat tire. We should fix the tire, not replace the car. I guess I now need to extend that analogy to say we should fix the flat tire and not *borrow* the money to buy a car.

QUESTION: The proponents of private accounts have been able to simplify their arguments in a way that is very easy and very compelling for people to understand. Is there a way for opponents to frame their arguments in language that is as easy and compelling?

ALAN BLINDER: You ask a very good and very tough question. It's an example of how somebody with a good polemical touch can put the side of truth and justice, so to speak, on the defensive.

One thing you can talk about is that you don't borrow your way into prosperity. Another is the nature of this gimmick I was describing: once you allow this gimmick, you can allow almost anything to happen. A third is, there's a basic principle of finance that says you get higher returns by bearing more risk; privatization is being sold as a way to get higher returns on Social Security accounts, which it might, but you only get that by bearing more risk, and of course the key word in "Social Security" is "security." The program was meant to protect people from risk, not to expose them to risk.

JASON FURMAN: A lot of what the other side does is exploit confusion and complexity. For example, you will see a column saying that higher returns from the stock market solve the problems in these individual accounts plans, and that's decidedly not the case. First of all there's the extra risk that Alan just talked about, but second of all, what solves the problem in these plans is massive borrowing on a scale that would solve the problem even without individual accounts or deep benefit cuts. So there's a lot of bait and switch kinds of arguments in which proponents talk about how great individual accounts are, when really it's other elements of the plan that are doing the work.

QUESTION: Imagine a similar proposal regarding borrowing and accounting being used in the corporate sector: what kind of descriptions would you give to the kind of corporate thievery you seem to be describing?

ALAN BLINDER: The answer is, you'd go straight to jail, and deservedly so.

JASON FURMAN: Someone described this as Enron accounting and I think that's a fair description. There was a rejoinder to this phrase arguing that it shows Democrats are hostile to stock markets. That's not the case. What they're hostile to is the idea that you can use 100 percent leverage, borrowing trillions and trillions of dollars in the bond market by the government having individuals invest that in the stock market, and think that that solves the problem. What Enron accounting refers to is not individual accounts themselves but financing individual accounts by borrowing and pretending there's no cost to it.

QUESTION: Let's assume for sake of argument that a move to private accounts becomes inevitable. Is there any way to make that transition that's fiscally honest and responsible?

PETER ORSZAG: You pay for them. I don't think it's desirable, but if you were going to go this route, you raise revenue or make other changes in the budget to actually pay those costs. That is what Lindsey Graham seems to be edging towards, and it's what Ned Gramlich basically proposed as part of his plan during the 1990s. It is not necessary to have individual accounts in order to solve Social Security's problems, but even if you have the accounts, it's not necessary to borrow the money.

QUESTION: You'd have to be raising more revenue than you would otherwise, would you not? How could you plausibly raise that revenue without either having a tax increase that you wouldn't really want to do politically (or maybe even economically) and/or budget cuts that you don't think you could do politically or economically?

JASON FURMAN: That's a question really for them. Right now the Social Security problem as it's classically measured is that there's a deficit in Social Security over the next 75 years of nearly 2 percent of payroll, so you could raise payroll taxes by 2 percent and you would fully solve the 75-year problem. If you do individual accounts that cost 2 percent of payroll, you in effect have to solve the existing 2 percent problem and also pay for your new 2 percent individual accounts; so as you correctly noted, you would actually have to do twice as much as you have to do under current law to pay for them. I think that's part of the reason why a lot of us on the call think that it's not a good idea to have individual accounts.

PETER ORSZAG: If the accounts are really as attractive and as popular as their advocates are making them seem, then paying for them should not be a particularly high hurdle, even from a narrow political perspective, let alone from an economic perspective. In other words, you're really not accomplishing anything if you borrow the money for individual accounts. Arguably you're actually setting things backwards, because you may well be reducing national savings. So of course it's always easier to borrow the money rather than to honestly finance something from a political perspective, but if this were truly as attractive as the advocates suggest, paying for it shouldn't be a high hurdle.

Another thing that I would say is that when you're forced to directly pay for something, it does force you to more question whether it's worth the money. We ultimately have to pay regardless; that credit card bill ultimately does come due. Paying for it now just brings the question home more directly in terms of whether it's worth it.

QUESTION: As I understand it, the White House wants to borrow a lot of money now on the promise that this will save money later. Has anyone calculated how much Social Security benefits would have to be cut in the future for a given hypothetical worker in order to repay \$2 trillion of borrowing now? Also, can you give me an analogy in household accounting that would be comparable to what they're proposing?

ALAN BLINDER: An analogy would be, you borrow a lot of money from your neighbor and invest it in the stock market, hoping that you'll turn a profit on the deal. Which you might. On the other hand, you might not, which will leave you with a very big bill to pay. That's what this amounts to.

JASON FURMAN: If you look at the Congressional Budget Office analysis of Model 2, people born in the 1970s would see a 23 percent cut in their benefits. People born in the 2000s would see a 45 percent cut in their benefits. I should note in fairness that these cuts not only pay back the \$2 trillion but also close the Social Security shortfall, so you could reduce them somewhat and still pay the money back. But these are very, very dramatic changes in the program.

QUESTION: Could I ask someone to step back a bit from these details and talk about what a retired America looks like with a combination of individual accounts and benefit cuts. Are we going back to another era of a large underclass of destitute elderly?

ALAN BLINDER: The one-liner I used the other day is that under these changes, Social Security would be neither social nor provide security. This is exactly a piece of a program which exposes people to more and more risk.

Now some people — upper-income people who are financially sophisticated — can get along in a system like that very nicely, thank you. If my Social Security were completely taken away from me and they just gave me back my payroll taxes, that's fine. But there are tens of millions of Americans for whom that's not fine. They rely on Social Security and they have no desire or ability to gamble in the financial markets; they shouldn't be pushed to do so.

PETER ORSZAG: Financial planners and others suggest that if you want to live quasi-comfortably in retirement you need about 70 percent of what you had been earning before retirement; that reduction reflects the fact that you don't have work-related expenses and a few other things, but you need basically 70 percent of what you had before. Today for the average earner who claims benefits at age 62 (which is the most common age for claiming benefits), Social Security replaces about 30 percent of your previous wages. So you've got another 40 percent to make up on top of Social Security. That's where the account part comes in — 401(k)'s and IRA's. You need to be doing that on top of Social Security.

If we take that 30 percent and scale it back to 20 percent or even less, over time you're just providing too thin a cushion for even middle-income Americans. For the vast bulk of the population this is a critical foundation upon which one should be building a comfortable retirement. But to take that bottom tier and introduce more risk into it just doesn't make any sense. You should be taking risks on top of this, this core foundation, not within it.

ROBERT GREENSTEIN: As all three speakers have noted, the borrowing of the \$2 trillion isn't what makes the long-term deficit go away under plans like the Commission's Model 2 plan; it's substantial benefit cuts down the road that erase the shortfall. Also: Medicare premiums are subtracted from Social Security benefits and are rising faster than Social Security benefits because of the greater rise in health care costs. Jason or Peter, how much would be left of an actual cash benefit after the Medicare premium is subtracted if one makes the kinds of benefit cuts reflected in the Commission plan?

JASON FURMAN: I don't have the year off the top of my head, but sometime in the next 75 years, if you implemented Commission Model 2, your entire Social Security benefit would be used up by your Medicare premium and your Medicare payments. You would be spending all of it on that portion of health care.

QUESTION: About the point on the explicit debt versus implicit debt and the implications for interest rates, obviously we've added a lot of debt in the last few years, and the Administration would argue that we have not seen the [upward] movement in interest rates that people would've predicted. Why would this be different? Also, what do you think might happen to interest rates if we did in fact pass a plan that would add \$2 or \$2.5 trillion in new debt over the next decade?

PETER ORSZAG: The key question is whether we reach a situation in which we face difficulties in rolling over our public debt, servicing the interest on it. If you combine Commission Model 2 with a fairly conservative estimate of the budget scenario from the Congressional Budget Office by 2030 you are looking at publicly held debt that is almost 100 percent of gross domestic product. Under some of the other alternative plans that are being discussed, it's well over 100 percent of GDP. At those levels, the danger that the nation may lose the confidence of its creditors — especially its foreign creditors — becomes a much deeper concern even than it is today.

Can we say with certainty that that's going to cause a collapse tomorrow? No. Can we say that that entails risk that it doesn't make sense to be running? Yes. So I can't tell you for sure that this would, this would be the factor that sparked a fiscal crisis, but I think we have to ask why we are running that risk, since the consequences of getting into that kind of trouble are so adverse (as we've seen in other countries).

QUESTION: Do you think people would feel this in their mortgages and in their interest rates if congress approves a plan that says we're going to borrow another \$2 trillion over the next decade?

PETER ORSZAG: Let me answer that by referencing what Bob Rubin has said about this, which is basically that in the very short term it's hard to know how financial markets react to particular events. Over longer periods of time, though, markets do kind of come back to the underlying fundamentals, and here the underlying issue is that we do have this much larger level of explicit debt coupled with very backloaded promises of reducing Social Security benefits to pay for that explicit debt (and again, those backloaded changes may not occur).

So in my view the market could well become unsettled. I can't say that immediately something would happen, but again, I think we're running the risk of shaking confidence. We are already very, very dependent on the confidence of the nation's foreign creditors in financing our large budget deficit and our large current account deficit. At a time when we are already exposed, it seems quite imprudent to be running a grand fiscal experiment in which one's arguing that implicit debt and explicit debt are the same when actually they're not and when markets may not concur with your view. Conducting that kind of experiment at this time seems particularly unwise.

QUESTION: I'm wondering if any of you have seen proposals from lawmakers on the Democratic side that are worth exploring. In particular I'm struck by what Peter Orszag said earlier about how this is just a flat tire problem; you could make a few fixes to fix your flat and the car could drive on. Are there any particular bills out there or ideas that have been embraced by senators or representatives that you think are worth exploring to fix the flat?

PETER ORSZAG: I have two comments on that. One is, the alternative plans that are being proposed are disproportionately "free lunch" approaches, so my own view is that some policymakers are reluctant to be putting forward plans that actually fix the flat tire while the opposition is still pretending that you can do this all for free. Beyond that, though, you do see some examples. Rep. David Obey, for example, has a plan that involves a couple of the steps that I've described, like dedicating the estate tax revenue to Social Security. I think that's a great place to start and I am hopeful that we're going to see more proposals like that that are actively debated, because in my opinion they are much more realistic and attractive.

ROBERT GREENSTEIN: The Obey plan was designed by Bob Ball, who was the Commissioner of Social Security under Presidents Kennedy, Johnson, and Nixon. Ball also was one of the prime architects of the '83 Greenspan Commission proposals and like those proposals, his plan, which Rep. Obey introduced, is a series of changes on both the benefit and the revenue side, plus the transfer of the estate tax revenue that Peter described.

QUESTION: Could you talk a little bit about the risk of inflation? Someone was talking earlier about the risk that investors and foreign investors would lose confidence. That's based on the fact that when countries have gotten themselves in over their head with debt, often the solution has been to inflate the currency, right?

ALAN BLINDER: That is right as a generalization around the world. But given the independent Federal Reserve, it's most unlikely this kind of debt explosion would manifest itself to people in the form of higher inflation. If the Fed keeps the lid on money and credit, the likely recipe is much more for higher interest rates and devaluation of the dollar than it is for inflation. But if you're talking about Argentina, that's one of the ways it got into trouble, and that's a whole different story.

PETER ORSZAG: It is worth noting that Argentina's an interesting example in which implicit debt was turned into explicit debt, and arguably, the additional explicit debt associated with their Social Security reform was one of the key ingredients in their fiscal crisis, demonstrating that implicit and explicit debt are not the same thing.

QUESTION: Right now Social Security's running a surplus and there's money in a lockbox somewhere, right?

ALAN BLINDER: Yes, there is money in the so-called lockbox — the Social Security trust fund has money dedicated to it that isn't going to be taken away under any circumstances. But it's not enough. There needs to be more put into the trust fund one way or another over the next 75 years to make the system actuarially sound.

QUESTION: But if they sell \$2 trillion in bonds, would they use some of it to redeem what's in the lockbox?

ALAN BLINDER: No, I don't think so.

QUESTION: Okay. Because in practical terms we still have to go out onto the market and borrow some of that money too, right?

ALAN BLINDER: Exactly.

QUESTION: It seems that the President keeps talking about an ownership society versus the social insurance nature of the Social Security program, and Alan, you mentioned that this is neither social nor security. I wanted to ask you a little bit about that in light of the President's talking about the ownership society.

ALAN BLINDER: What you have is now is a compulsory system to which everybody contributes; everybody has an entitlement benefit. That's a social aspect. Also, the investing is socially done (and it's invested, by the way, in extremely safe government securities, as we know).

In addition to that, a forgotten aspect of Social Security is that it's redistributive, in the following sense. Lower wage earners get a higher rate of return on their Social Security "investments" than upper-bracket people do. That's deliberate, and it compensates for their inferior longevity. If you're a poor person in America, you don't live as long, and therefore you don't collect your Social Security annuity as long as a rich person.

Private accounts cannot work that way. Nobody can — the Dreyfus fund, the Vanguard funds, Fidelity, etc. can't run on the principle of giving better returns to poorer persons. You don't run a private business that way, and therefore private accounts cannot be run that way. So as we shift over from public accounts to private accounts, you lose that aspect of socialization of risk.

QUESTION: Given the long-term costs of privatization through massive borrowing, why do you feel the Administration is so adamant about pursuing this strategy for solving the solvency problem?

ALAN BLINDER: I think this is ideologically driven; it's part and parcel of a long-run objective that will continue after the Bush Administration, which is to repeal the social insurance system that we've been putting in since the New Deal.

PETER ORSZAG: I'm going to add just one more part to that, which has to do with the borrowing aspect. If you look at the common theme of economic policy during this Administration, it has basically been to impose no costs on any current voters. You're imposing massive costs on future generations by borrowing so heavily, but those future generations don't speak at the polls right now, so the borrowing aspect of this is similar in the sense that there's just an aversion to imposing any pain whatsoever on current generations. Of course the problem is the pain isn't avoided, it's just delayed. That raises a fundamentally moral question about the type of legacy that we're leaving to future generations.

QUESTION: It seems like some of the proponents of private accounts would argue that diverting some of the payroll taxes into accounts would work as something of a tax cut, since people would view that money as their own and that might spur an increase in savings on top of that. Do you think that there is anything to back up that argument?

ALAN BLINDER: First of all, there's no evidence at all that higher rates of return on saving actually encourage more saving. It sounds sensible, it ought to be, but when you actually try to study this empirically it doesn't seem to be the case (and by the way, not only in the United States). The other point is something that Jason mentioned briefly in his opening remarks, which is that if you give people a sense of ownership that now they have an asset, a new individual account that they didn't have before, the empirical studies suggest that they will save *less* in other forms. So more than likely it's a reduction in other forms of savings.

PETER ORSZAG: I think that the rhetoric surrounding these accounts will lead to a variety of pressures that reduce savings. For example, the accounts are being sold as an ownership thing, but many people don't know that these plans assume that you won't be able to access the accounts before you retire. So no pre-retirement withdrawals. Given the way that they've been sold, if you own the account and you want a new television, your car's broken, the kid's sick, whatever the need is, what we've seen with 401(k)'s and IRA's is a lot of pressure for access to those funds before retirement. That may well make sense depending on the family's circumstances, but it does mean that you're reducing your saving. It also means that the funds are not there for retirement.

QUESTION: What will the economic impact be when the first of these savers will start to access their distributions? Will they be subject to minimum distribution rules?

PETER ORSZAG: I am on a National Academy of Social Insurance panel chaired by Michel Gratz from Yale and Ken Apfel from the University of Texas at Austin (who's a former Social Security commissioner), a bipartisan panel that's looking at exactly that question. There's been very little work on what would happen at retirement, and our report is intended to address that gap.

The panel examines the questions you would need to answer about how the payout stage would work if we have the accounts as part of Social Security. Our report will be released in the middle of January so I don't want to scoop it, but I do think the report represents the first attempt to deal with the complications that are involved in a comprehensive manner. There are both difficult dilemmas that one faces in trying to arrange things at retirement or during the payout phase and a lot of problems that have not been addressed in the plans that have been put forward thus far.

QUESTION: Given the fear among some economists that the current account deficit is dangerously high and is dangerously highly financed by foreign banks, is there a situation in which the dollar will decline so much that this plan would be infeasible to even contemplate?

ALAN BLINDER: That's conceivable, but I rather doubt it. The dollar's a real currency; it's not something that people will say they don't want at any price. The question is, what will the price be? How far will the dollar have to fall to accommodate all the debt that needs to be landed someplace in foreign portfolios? I don't think we want to test that limit. I'm not personally very worried that there's no answer to that question.

QUESTION: You talked early on about the Administration's willingness or unwillingness to raise the maximum taxable earnings threshold. The AP does report that the threshold will rise very slightly, from \$87,900 to \$90,000.

PETER ORSZAG: That happens automatically under the current system: just as wages and the economy go up, that threshold goes up. So that's not a policy change; it's an automatic feature of the system. It's similar in some ways to the fact that the tax system is indexed to the consumer price index, so the thresholds and deductions and everything in the income tax system evolve from one year to the next even without any policy change.

QUESTION: There was some concern when these plans came out in 2001 that younger workers were going to have to pay the burden of the transition costs. If I'm a younger worker, I'm thinking at least I don't have to pay for it, but this plan to borrow the funds needed for the transition doesn't sound very good either because I'm young enough that I'm going to pay for it at some point anyway. How would borrowing these funds affect the additional burden that would be put on younger workers who do divert money into their personal accounts?

ALAN BLINDER: The obvious point is that there's interest to be paid on these borrowings. You may not call them borrowing, but there's going to be interest to be paid, and a fair amount of that is going to foreign holders.

The main thing that economists emphasize is that when the government runs huge amounts of debt, it impedes private capital formation by raising interest rates. Therefore, as younger workers grow up to be middle-aged and older workers, they wind up living in an economy that's

less productive because it doesn't have as much capital. This is just a basic argument not to run excessive amounts of debt that we've been talking about in this country for 25 years. Borrowing for privatizations would simply make that situation worse.

QUESTION: We talked a lot about private accounts and how the markets might react to such a thing. How do the financial services industry feel about that? They would reap the benefits of servicing them to some degree, but there would also be a lot of risk in the amount of debt that's out there. Any idea how they feel overall?

ALAN BLINDER: You have a lot of people in the retail brokerage ends of that business that are salivating at the idea of having tens of millions of additional accounts on which to gain commissions. They may be disappointed in how profitable those are, but that's neither here nor there. There's a lot of support for it.

When I talk to people in the bond market, most of those that have focused on this at all (which is not that many) haven't thought about the implicit debt, but when they think about it, it sends a shudder up their spines to consider what this might do to bond prices.

PETER ORSZAG: To keep administrative costs low, many of these plans assume that the accounts would actually be held effectively with a government agency, or with a centralized entity that would do a lot of the accounting and investment functions; it would *not* be, for example, that you could hold your account at your local brokerage or financial services firm. But if you own the account and you want to hold it at, say, Firm A and invest it in Stock B rather than some broadly diversified index fund, will it be sustainable for the government to say that you can't do that?

As soon as you start going to the retail model, with people holding accounts at lots of different firms and being able to invest in lots of different things, administrative costs go way up. What we have learned from the United Kingdom (which has voluntary individual accounts) is that if you do this in a decentralized way, where you can hold the accounts wherever you want, you wind up with really high administrative costs. In fact, the United Kingdom has stepped in to regulate the fees that can be charged on accounts because the fees have been too high. No one in the United States yet is talking about fee regulation, but if we did adopt the decentralized retail approach and the fees started to be as high as they were in the United Kingdom, I think that would quickly move onto the agenda.

QUESTION: I read what you've written and I've heard what you said about the inadvisability of changing the budget rules to score something over 30 years, but if they scored everything in the budget over 30 years, including the cost of tax cut extensions and so forth, would you be less opposed? Is some of your opposition because they're just picking out one thing to score over 30 years?

JASON FURMAN: You just hit an excellent point, which is that when they want to do things that have costs *outside* of the ten-year window — like backloaded repeal of the estate tax — you don't hear an awful lot about net present values in the second ten years and all of that. If looked at over a longer horizon, some of the Administration's proposals would have been curtailed.

But we're asking a specific question, which is whether making this one exception to the rules is going to lead to better policy or worse policy. We conclude, worse policy.

Second, this is particularly pernicious because they try to take something that is a cost over 10, 20, 30, 40, and some of the plans 50, 60, 70 years, and claim that it's actually a benefit. So it's not that they're trying to minimize the cost of something; they're trying to reverse the sign and claim that borrowing trillions of dollars is actually *saving* money, which is simply not the case over any reasonable horizon.

PETER ORSZAG: Providing information about the full time path of the budget deficit, year by year and going out over a long period of time, is helpful whether it's used in the formal budget process or not. It's helpful information for people to know and I want to make it clear that I don't think there's any problem in providing that information. In fact, I spend a lot of my time generating those kinds of numbers.

Secondly, it makes no sense to be using different time periods in the same budget presentation for different parts of the budget. That is just not consistent with any reasonable way of approaching the problem. So to do this longer time horizon perspective for individual accounts but not for other provisions is completely unsound.

Finally, I would just note you had mentioned 30 years. Under almost all of these plans, if you go out "only" 30 years, you're still not generally getting savings. So I would be delighted if they showed the full 30-year effect for Model 2, for example, because it demonstrates that you're still experiencing very large cost increases. Going up to 30 years on many of these plans would vividly demonstrate very, very large costs if you honestly presented the numbers.

ROBERT GREENSTEIN: It would seem to me that the ultimate in gimmickry, and perhaps in hypocrisy as well, would be a budget that said for Social Security we want to use a budget period that extends into infinity — what is called an "infinite horizon" — even though the American Academy of Actuaries has said that infinite horizon figures are misleading and shouldn't be used in policy discussions, while at the same time actually doing not even a ten-year budget resolution but rather only a five-year budget resolution, because you don't want to show the costs of making the tax cuts permanent in the sixth, seventh, eighth, ninth, and tenth years. If that is done, you could simultaneously hear arguments that it's too uncertain to show the costs of tax cuts in the sixth through tenth years but it's fine to effectively assume Social Security costs for centuries into the future.

QUESTION: Will there be an impact on stock prices with having this much Social Security money going in? And won't that be helpful for stock prices at a time when the baby boom generation will be withdrawing money from the stock market as they draw down on their 401(k)'s?

PETER ORSZAG: There've been some studies done on the effect on stock prices. It's possible that there would be some increase in the level of the stock market, but most of the studies suggest it's relatively modest. Even if it were not modest, trying to artificially stoke stock prices by effectively having the government borrow money and then (even if it's indirectly through individual accounts) invest it in the stock market is extremely unsound fiscal policy. That is inconsistent with the rhetoric that one hears from the proponents of individual accounts, that we should leave things up to the market.

If raising stock prices were the motivation, that's a highly interventionist approach to public policy in which the government is trying in a sense to prop up stock prices somewhat artificially by borrowing money and then investing it in the stock market.

QUESTION: If you eliminate all the gimmickry and all the borrowing, then what beyond the increased risk in a system that was designed to be secure are the reasons that these private accounts would be a bad idea?

JASON FURMAN: You get the additional administrative costs and the risk to a lot of the ways in which Social Security is successful in terms of disability benefits, progressivity, etc. In general, the most honest argument on the positive side of the ledger for private accounts is that they can raise national savings. You can raise national savings *without* individual accounts — plans like the ones that Peter Orszag was talking about earlier would raise national savings — but individual accounts are one way to do it.

That's the only item on the positive side of the ledger, in my view. And if you pay for private accounts through borrowing, you don't even get that.

QUESTION: There are an awful lot of young people out there who think that Social Security won't be there when they retire, and they like the idea of having their money locked away in an account — the real lockbox, so to speak. Isn't that an advantage?

PETER ORSZAG: I've done a fair amount of talking to college students on this, and what's left out of that thought process is that Social Security was never intended to be more than a foundation, so you do need to be saving in individual accounts.

To repeat, you need 70 percent of pre-retirement income to live comfortably. Social Security currently is providing 30 percent. It's not going to provide any more than that, it's likely to provide less than that, so there's a lot that you need to be doing to save money on top of Social Security. But for those kinds of college students, you have to ask yourself whether accounts make sense on the bottom tier — whether you want to be taking risks with your food money, for example, as opposed to assuring a basic bare-bones level of survival first and then taking risks on top of that. It just strikes me that there's a place for accounts, and that's to fill in that 40 percent gap on top of Social Security; and there's a place where they don't belong, and that's within the core tier.

QUESTION: Are there any conspiracy theories among you or folks that you have talked to who think that the Administration is supporting personal accounts as a step toward the larger goal of decreasing the system of social programs?

PETER ORSZAG: Until now, what the President has been saying has just been pure rhetoric. What are you gonna do about Social Security? Individual accounts. And that of course is not an answer; that's a non sequitur.

What we're starting to see is the tensions that bubble up when you actually have to at least consider dealing with the underlying problem. We're seeing that in the back and forth between Lindsey Graham and the President, and in the statement by the President's chief economic adviser, Greg Mankiw, that there is no free lunch, and frankly charlatans like Peter Ferrara who are arguing that we can have it all and individual accounts are our salvation and they do solve the problem when that's just not correct. When you finally start to tackle this kind of problem seriously, the ruse of just using rhetoric about individual accounts doesn't work; we're starting to see the pressures that come from that rhetoric falling apart. How far we get along that road depends in part on how serious the Administration is on putting forward a real proposal.

QUESTION: Which of the three Moynihan Commission options is the least of three evils, and would the best long-term solution to this solvency problem come from COLA formula adjustments, higher retirement age, or raising the income threshold subject to the payroll tax?

PETER ORSZAG: I would say all three of the Commission plans had serious problems; they all entailed very substantial borrowing, for example. Model 2, which was the leading plan, also entailed very significant reductions in the defined benefit or traditional part of Social Security.

There are elements of the plans that are worthy of incorporation into a sound reform plan. Some of the ideas, such as targeted benefit improvements for the neediest beneficiaries (like people who have low earnings over a lifetime), are worthy of study. So while there's not a complete plan that's a good starting place, there are some ideas floating around in there that are sound.

In terms of what to do on the underlying deficit in Social Security, Peter Diamond and I have put forward a book that addresses that issue without any gimmickry at all. It's therefore not politically viable in the short term, because it deals with the problem completely honestly, but we have a variety of changes that are progressive that entail some modest sacrifices for average earners. I'll just quickly give you the bottom line: an average earner who's 35 years old would receive a 4.5 percent benefit reduction compared to what is promised under the current system. And we balance that with a modest revenue increase for average earners.

This problem can be tackled honestly through modest changes. We've put forward some, and Bob Ball and David Obey have put forward others. There are a wide variety of changes that are possible to address the flat tire here.

QUESTION: Given the cost experiences of in administering such plans, how much would individual investors have to outperform the market in order to match the market after costs, expenses, and fees are subtracted?

PETER ORSZAG: That basically comes down to the question of what the administrative costs are, and that depends on the kind of plan. The administrative costs that we've seen in many other countries are well over 100 basis points — that is to say 1 percent per year — which in terms of your account balance at retirement means a reduction of 20 percent or so compared to no fees. In the United Kingdom, before the government stepped in to regulate the fees the costs were even higher than that — well over 200 basis points, or 2 percent per year — which gives you some feeling of the part that's being eaten up by fees alone in many of the real-life account systems that we can see around the world.

ROBERT GREENSTEIN: Thanks everyone for joining us today, thanks to Peter and Jason and Alan Blinder. Please feel free to call any of them or to call us at the Center if you have follow-up questions, and a good holiday season to everyone. Thank you.