A conference hosted by

The Center for Strategic and International Studies
&
The Concord Coalition

SOCIAL SECURITY REFORM:
Is There a Bipartisan Solution?

June 30, 2005
8:00 AM to 2:00 PM

at the
The Center for Strategic and International Studies
1800 K Street, NW, Washington, DC
B1 Conference Level

Welcome

Richard Jackson
Senior Fellow and Director, CSIS Global Aging Initiative

Robert Bixby
Executive Director, The Concord Coalition

Richard Jackson: Good morning. Welcome to the joint CSIS-Concord Coalition conference on Social Security reform. I'm Richard Jackson. I direct the Global Aging Initiative at CSIS. My co-host today is Bob Bixby, the Executive Director of the Concord Coalition. We've decided to team up on this issue and host this event today because we think that Social Security reform is one of the great challenges facing America in the 21st Century and because we're concerned that the opportunity for a meaningful solution is slipping away.

The problem with Social Security is first and foremost a fiscal problem. Social Security is the cornerstone of the retirement system. Millions of people depend on it for all or most of their income in retirement, yet as currently structured and financed over the long run, the Social Security program isn't sustainable.

Some try to minimize the problem by focusing on the Trust Fund, which has sufficient assets to pay full benefits until sometime in the early 2040s, but the Trust Fund does not consist of financial assets invested in the real economy. Rather, it's a promise by Congress that they'll raise my children's taxes.

Others try to minimize the problem by pointing out that Medicare is growing even faster than Social Security, which is certainly true, but to say that because Medicare is an even bigger problem we don't need to address the Social Security problem isn't really an argument that makes a lot of sense to me. In fact, it suggests just the opposite—that Social Security reform may be even more important to the extent that Medicare is such a daunting challenge.

The problem is a fiscal problem but it isn't only a fiscal problem. There's a substantial consensus among economists that Social Security's pay-as-you-go structure depresses private savings. The system offers younger workers a poor and declining return on their contributions, and yet, despite its large and rising cost, it leaves millions of elders in poverty.

This is a national challenge, and with a national challenge, an enduring solution must be a bipartisan solution—which brings us back to the purpose of today's meeting.

Let me now turn it over to Bob who will say a few words about what it is we hope to accomplish today. Thank you.

Robert Bixby: Thank you very much, Richard.

As they say in Congress, I would like to be associated with the remarks of my distinguished colleague. I'd also like to join him in welcoming all of you to our forum today and to thank CSIS for being such a good host and providing all that great food. The only free lunch you'll get is today.

We've titled today's conference "Social Security Reform: Is There a Bipartisan Solution?" The implicit answer is that there had better be. But looking at some of the ideas that we sometimes see we might have been more precise and titled the conference, "Is there a bipartisan solution that is meaningful?"

The Concord Coalition co-chair Bob Kerrey sometimes likes to say that there is indeed a bipartisan plan. It's called a "do nothing" plan, and it has about 500 co-sponsors. Of course very few people actually propose doing nothing, but very few actually propose plans that would deal with the kind of issues that Richard has articulated.

As he mentioned, from some we hear that there really isn't much of a problem because the Trust Fund is solvent for 40 years or so; and from others we hear that there is a more immediate problem but it's one that can be cured by establishing personal accounts that don't require anybody to give up anything.

A meaningful solution needs to get beyond these comfortable partisan points and grapple with some of the more difficult tradeoffs, so let me be the first to say and reiterate that there is no free lunch in Social Security reform.

Ultimately a package of reforms is going to have to do some of the tough choices like reducing promised benefits or raising new contributions for the system. These things obviously involve short-term political pain for long-term substantive and policy gain, and that is precisely why any solution ought to be bipartisan.

Paul Tsongas, our founding co-chairman, used to say that there aren't many kamikaze pilots in the Congress. What he meant by that is that difficult choices like this are unlikely to be made in the absence of bipartisan negotiations, and in matters like this Democrats and Republicans, oddly enough, find themselves needing each other. And even assuming that we did have some sort of one-party solution, we would have little confidence that it would hold up over time, as Richard mentioned. If both parties have a stake in the ultimate solution as they did in the 1983 reforms, then both will see to it, or try to see to it anyway, that the reforms are not unraveled at the next election.

Obviously, with Social Security reforms that need to be phased in over time and need to be sustained over time, you want to make sure that they won't simply disappear.

A bipartisan approach will help convince the public that these hard choices need to be made. It demonstrates the seriousness of both sides. And let me quote the President, "We dare not let this disintegrate into a partisan, rhetorical battle. Senior citizens are going to be Republican and Democrats and Independents. They're going to come from all walks of life, from all income backgrounds, from every region of the country, and therefore so will their children and grandchildren. This is an American challenge and we have to meet it together."

That, by the way, was President Bill Clinton who was speaking at a Concord Coalition--AARP Forum in 1998.

It's an important fact to note that the last two Presidents—one a Democrat and one a Republican—have chosen to make an initiative of Social Security reform. It's also instrumental, by the way they both chose to do it in their second term when they didn't have to run for reelection. That's another reason this has to be bipartisan.

Today, in that spirit we'll hear from people who reject the “free lunch” approach and who have different perspectives on how the solution should come about. We're hopeful that the thoughtful ideas that will be put on the table today are the kinds of ideas that will eventually lead to a solution that is both meaningful and bipartisan. It might not happen as soon as some of us would like, but whenever it does happen we hope that the types of ideas today will help lay the groundwork for that eventual deal.

With that uncharacteristically optimistic note, let me now introduce our first speaker who will set the stage today by giving us an outline of the challenges ahead.

He is David Walker, the Comptroller General of the United States. I first got to know Dave when he was public trustee of the Social Security and Medicare systems in the mid 1990s. I was always impressed with the way he articulated these issues when he testified before Congress. He did so in a fair, non-partisan, and understandable way. That's no small feat. Of course, no good deed goes unpunished. So in 1998 when the Concord Coalition and AARP were asked to do a series of national forums, we were looking for people that could help explain this out on the stump. Both organizations agreed that David Walker would be a perfect person to do this. So we tasked him to take part in those forums, which he did. Of course that good deed didn't go unpunished either because later in the year he was appointed Comptroller General of the United States.

He continues to be a source of excellent, non-partisan information on this issue. The GAO puts out some terrific information on this. I'd like to commend the entire GAO for the great work that they do.

Dave travels around the country with this message, something I hope we'll be able to give him an opportunity to do more of in the coming year. If anybody wants to talk to me about that and help in that effort, see me during the program.

It's my pleasure now to introduce the Comptroller General of the United States, David Walker.

Introductory Address

David Walker
Comptroller General of the United States, Government Accountability Office

David Walker: Thank you very much. It's good to be back at CSIS.

In the interest of full and fair disclosure, I have been a member of the Concord Coalition for many years—a dues-paying member. I also was a member of CSIS' Social Security Retirement Commission. I was pleased to have an opportunity to be involved in that as well, and as Bob mentioned, I was a trustee of Social Security/Medicare from 1990 until 1995.

What I'd like to do this morning is to provide some non-partisan facts which hopefully will provide a foundation to achieve bipartisan solutions with regard to Social Security.

I think it's of critical importance that we keep Social Security in its proper context. Social Security is a subset of our nation's economic security and retirement challenges, and those are a subset of our nation's fiscal and other policy challenges. Whatever we do in one area has a ripple effect on others. So we need to view and approach our challenges from the big picture perspective. We also need to understand how individual reform efforts—whether focused on Social Security, private pensions, tax reform, et cetera—interrelate, and how they will either contribute to or detract from the need to address our broader challenge.

Let's start first by looking back. In 1964, almost half the federal budget was for defense. Fast forward 40 years to last year, when only 20 percent was defense. It would have been 17-18 but for Iraq and Afghanistan.

Where did the money go? It went from defense to Social Security, Medicare and Medicaid.

Look at 1964. You won't see anything in the red portion because Medicare and Medicaid didn't exist. Therefore, you can see that that has grown the most rapidly since 1964.

Seven percent of the budget was for interest on the federal debt in '64. It was the same thing in 2004, but not for long because we're adding debt at record rates and over time interest rates will rise.

Another way to look at it is that in 1964, when Congress came to town, they got to decide how two-thirds of the federal budget would be spent. Only a third was on auto-pilot.

Fast forward 40 years to 2004—now 61 percent is on auto-pilot and Congress only gets to decide on 39 percent. And it's going down every year. The past cannot be prologue.

By the way, what's in discretionary spending? You might be surprised. National security, homeland security, the judicial system, education, the environment, transportation, GAO—obviously critically important. So the fact is, the past cannot be prologue.

How we keep score in Washington, both from a financial reporting as well as a budgetary standpoint does not provide a full and fair view of where we are and where we're headed. You're hearing this from the audit partner on the audit of the consolidated financial statements of the U.S. government. We issued our audit report in December of 2004, available on our web site at www.gao.gov, and I would recommend it to you. When you read that audit report you'll find something interesting. For the eighth year in a row, we disclaimed an opinion on the financial statements of the U.S. government, for several reasons—-largely because the Department of Defense still has not gotten its act together with regard to financial management.

Secondly, you'll also find that even though we disclaimed an opinion on the financial statements of the U.S. government, we issued something that may be unprecedented. It was a paragraph in our audit report that basically said the United States has a broken business model, and that we are in an imprudent and unsustainable fiscal path. That tough choices must be made or else our economy, our national security, and potentially our republic is at risk in the coming decades.

One of the things that we also drew attention to is that while people in the press are encouraged to report the unified budget deficit of $412 billion, with a little bit of looking under the hood you find that the real on-budget deficit last year was $567 billion or almost five percent of our economy. Why? Because we spent every dime of the Social Security and other temporary

surpluses—and they're exactly that, *temporary* surpluses—on other government operations, and we replaced them with bonds backed by the full faith and credit of the United States government, guaranteed as to principle and interest, that have legal, political and moral significance but no economic significance whatsoever. I'll be happy to take questions on that.

So the bottom line is—our deficit situation is worse than advertised. This is the trend on the on-budget versus off-budget activity. The on-budget is ex-Social Security or excluding Social Security. The off-budget is primarily Social Security. You'll see the trend is not positive within the last several years.

Now keep in mind, if you went back and looked at my testimony before the House and the Senate in 2002 about what were we going to do with this huge surplus, we were in danger of paying off all federal debt. This was something that was really going to be a problem.

I reminded the Congress that, number one, these were temporary surpluses. Even in the days of current surpluses, we knew we faced large and growing structural deficits due primarily to known demographic trends and rising health care costs.

Secondly, I reminded them that these were projected deficits, which might or might not become reality, and that, as our mothers taught us, we must not let this burn a hole in our pocket. Be prudent with regard to what you do with this temporary surplus, I urged them, and suggested using a portfolio risk management approach. Unfortunately, the advice was not taken.

Since the beginning of the republic in 1789, and as of the end of last year, we had run up about $7.4 trillion in debt. But if you add unfunded promises for Social Security and Medicare and certain other commitments—civilian and military pensions, et cetera—you will find that the total liabilities in unfunded commitments of the United States as of the end of last fiscal year were about $43.5 trillion. That's a T (on the slide). Twelve zeros go behind trillions.

That's about $155,000 per American. That's what I call a birth burden. As somebody said recently, no wonder babies cry.

Secondly, it's about $365,000 per full time worker, and it's growing every day. By the way, that $43.5 trillion is now up to over $45 trillion since then.

And by the way, in 2004 if the deficit wasn't bad enough, we increased liabilities and unfunded commitments in one year by over $13 trillion.

Now compare that to the $7.4 trillion in total debt outstanding since the beginning of the republic. It was a very bad year, possibly the worst in our history from the fiscal standpoint.

What about how we look at it from a budget standpoint because this is, frankly, as big a problem, or bigger?

I'm going to get a show of hands. How many of you believe the following: There will be no new laws passed in the next ten years?

How many of you believe that over the next indefinite period of time, that discretionary spending will grow by the rate of inflation?

How many of you believe that all tax cuts will sunset?

How many of you believe that we won't do anything about the growing pinch of the alternative minimum tax?

Well, we're all in agreement. So if you agree with all of those assumptions, then you should be making your decisions based upon how Congress is making its decisions.

Now obviously, you look at this and you see gee, we've got a growing problem in the out years, but most people sit back here and say I'm not going to be alive then so I'm not going to worry about it; or it's so far out I'm not going to be in Congress; or we'll grow our way out of it.

There's an alternative scenario. Only two differences between this scenario and the first one: discretionary spending grows by the rate of the economy, and all tax cuts are made permanent. This is an Argentina scenario—not a desirable outcome.

There are those who say, "Let's look at the Trust Funds of Social Security. They're okay until 2041." The fact of the matter is Social Security is less than ten percent of our long-range fiscal imbalance and we could have a much greater fiscal challenge in 2041 than Social Security's Trust Funds if we don't get serious soon and recognize that we're on an imprudent and unsustainable fiscal path.

I would acknowledge, as the front PowerPoint numbers did, that Medicare is seven to eight times greater a problem than Social Security. But the difference is Medicare is a subset of our overall health care challenge. We're going to have to reform our entire health care system in installments over a number of years. People don't seem to have found the way forward on that yet and we need to develop a way forward and start dealing with it. We're doing work on that at GAO to try to help get that going, but in the case of Social Security, there are ways to reform Social Security and exceed the expectations of every generation of Americans. Everybody can get more than they think they're going to get. Not necessarily more than they've been promised, but more than they think they're going to get. I call that a win. If we can do that and solve almost ten percent of our long-range problem, that's a good down payment to try to deal with our long-range structural imbalance. It helps to give us credibility that we're willing to deal with some of our known and long-range problems. It helps to instill confidence that we hopefully can use to get to address tougher challenges.

So the bottom line is we are on a burning platform fiscally. The status quo is unacceptable and unsustainable. Faster economic growth can help, but we're not going to grow our way out of this problem. The math doesn't work. The numbers just don't add up.

The sooner we get started the better, because when you're a debtor, debt on debt is not good, and we are a huge debtor.

So we need to change how we keep score for accounting and reporting. We need to change our budget control mechanisms and provide discipline on both sides of the ledger. When you're trying to get control of the bottom line, you can't exempt one half of the ledger. You've got to look at both the spending side and the tax side because they both affect the bottom line.

We need to understand what the long-term affordability and sustainability of both tax and spending proposals are before they're enacted into law. We should have known that the Medicare Prescription Drug Bill was going to cost $8.1 trillion in discounted present value dollar terms before that bill was voted on.

We need different metrics and measures to understand where we are and where we're headed as a nation based on an outcome-based indicator. Because in the absence of these measures, people assume that if we want to do more we spend more money, or we give another tax preference. Spending more money or giving another tax preference does not necessarily result in additional positive outcomes. Plus, quite frankly, we're already in a hole and the first rule of holes is you stop digging.

We need to reexamine the base of the entire federal government. I'm going to point to this document which is on our web site, "Reexamining the Base of the Federal Government, 21st Century Challenges." The federal government's programs—including Social Security, Disability, a number of tax preferences, our organizational structure, and certain aspects of our defense posture—are based upon conditions that existed in the United States and the world in the 1950s and the 1960s. They need to be fundamentally reviewed and revised.

Now here's Social Security and Medicare's cash flows. Medicare already has a negative cash flow in 2004. Social Security turns a negative cash flow in 2017. But starting in 2009, the surplus starts to go down. That's going to be withdrawal pains on the rest of the federal budget because, keep in mind, we've been spending all that every year.

This is the demographic tidal wave. Unlike most tidal waves which recede, this one never will. This is the percentage of the elderly population as to the overall U.S. population. This bump-up is the tidal wave. This is my generation, the baby boom generation. A permanent change in our workforce or at least indefinite change in our workforce will have profound budget, economic, workforce, and other implications. And unlike other assumptions, these people are alive.

This is what's happening with regard to our labor force growth. It's slowing considerably. It's going to flatten out. We're in a knowledge-based economy. We need skilled and knowledgeable workers in adequate numbers in order to be able to fuel economic growth, in order to compete based on innovation, productivity, quality, et cetera.

These are the key dates for Social Security. Cash surplus begins to decline in 2009; benefit costs exceed cash revenue in 2017; the Trust Fund ceases to grow in 2027; and then those who say

we don't have a problem, the Trust Fund doesn't go dry until 2041.

You saw the scenario where we have bigger issues we have to deal with. Do not take solace in the Trust Fund. It is an accounting device. It is not a trust fund.

Look at Webster's dictionary. It does not meet the definition. It is a sub-account of the general ledger.

Look in the financial statements of the U.S. government. You will not find a liability to the Social Security and Medicare Trust Funds. It isn't there. Why? Because the left hand owes the right hand. Now that needs to change. I believe that needs to change because we took the people's money, we spent the people's money, and therefore I believe we need to change that, as well as having more transparency over what's going on with regard to restricted revenues.

What are the discounted present value dollar numbers based on the latest trustees' report? Four trillion is what we'd have to have today, invested at Treasury rates, to deliver on the promise for the next 75 years; 11.1 trillion if you want to solve the problem in perpetuity. Why? Because every year we drop a surplus year and we add an increasingly bad deficit year, primarily due to these known demographic trends.

We need to keep in mind that Social Security is a subset of our economic security and retirement challenge. It's Social Security, pensions, savings, and for a growing number of Americans, earnings from continued employment, full time or part time. It's Medicare. It's retiree health care. And long term care, which is a hybrid. Ultimately we're going to have to address all these dimensions, but Social Security can be a huge win and a huge confidence builder if we just face facts.

When we've done work at GAO we've analyzed Social Security reform proposals based upon three primary criteria: Do they achieve sustainable solvency? Do they balance adequacy and equity? What are the administrative challenges associated with it, especially if it involves individual accounts?

I think you'd have to add another one now, and that is what do they do to our overall fiscal posture? Because some people evidently believe there is a free lunch, and there is no free lunch.

In the presentation I have about five pages designed to separate assertions from facts. People are loose with regard to description of where we are and where we're headed as it relates to Social Security.

If you look at Webster's dictionary, Social Security will be insolvent in 2041. It will never go bust because even in 2041 it will have about 73 cents in revenues for every dollar of promised benefits. Now it would be fundamentally imprudent to allow ourselves to get to that point, especially given that this is less than ten percent of our problem.

I think we also have to keep in mind that if you want to throw more money at Social Security—tax revenues or otherwise—that's money you're not going to have to throw at something else. This is less than ten percent of our problem. And one area where you're likely to have to have additional revenues over time will be health care, which is a much bigger issue.

So with that, I want to thank you for your time and attention. I have a few minutes to answer questions if anybody should have any.

Thank you very much. [Applause]

Question: What percent of the gross national product has Social Security been in other years in the past? Which is the highest?

David Walker: I don't have the numbers off the top of my head. I have a longer presentation that has all that information in it. I would respectfully suggest you might want to go to our web site.

It is increasing as a percent, but not nearly to the extent that Medicare and Medicaid are. Those are the ones that are growing rapidly as a percentage, not only of the economy but as a percentage of the federal budget.

By the way, if I can, let me also familiarize you, with this Social Security primer that GAO came out with within the last month which I would recommend to you as well. This is also available

on our web site at www.gao.gov.

Question: Your comments about the Social Security Trust Fund and its effects on the federal budget. I just wanted to try to delve a little bit into that.

The effects of the Social Security surplus depend in particular on what offsetting behavior it triggers in the rest of the budget, and we don't know that just by observing the fact that there's a deficit outside of Social Security. That doesn't answer the analytical question. So should I infer from your comments that you all have done analytical work that causes you to conclude that the Social Security surpluses have triggered offsetting behavior in the rest of the budget that lead you to believe that the surpluses have been dissipated? Because the mere observation that there's a deficit outside of Social Security doesn't really tell us anything.

David Walker: I understand that. I guess my point is this: I think we need more transparency as to what actually is going on. And what actually is going on is that our on-budget deficits are much worse than people want to admit.

You know as well as I do that you have to do more in depth analysis in order to be able to determine correlations here, but you also know as well as I do that spending has not been constrained in recent years. So in theory, if you said, “gee, let's take this Social Security surplus, let's put it in a lock box,” how is that going to affect your behavior with regard to the balance of the federal budget? Because merely doing that doesn't necessarily solve our problem. There are some proposals that are out there right now that are along those lines, but they don't really solve Social Security's problems, if you will.

Question: There are a number of proposals under consideration right now that would address Social Security's financing problem by creating individual accounts but without generating new revenues to go into those accounts. Is this going to have any real, practical effect on the financing of these, especially the baby boomers' claims on this system?

David Walker: As you know, individual accounts by themselves will not solve the problem. My personal view is that they should be considered as part of a comprehensive Social Security reform proposal.

There are pluses and minuses to individual accounts. I think one of the things that people need to keep in mind is only about half of the workforce is covered by private pension and savings plans. If, for example, Congress decided that they were going to have individual accounts, let's say as an add-on rather than as a carve-out, that could provide a mechanism to allow those individuals who do not have a private pension or savings plan to save on a payroll deduction basis, get the economies of scale, get limited investment options, and get some limited investment education which I think could be potentially another plus that people don't think about.

But my personal view is that it is highly unlikely that you're going to see Congress passing an individual account plan that does not have additional revenues. And by additional revenues, I mean either additional tax revenues or mandatory savings.

But I would also respectfully suggest that mandatory savings are not the same as a tax increase, because if it's your money in your account and you own it and your heirs will own it, it might be forced savings. It might reduce discretionary income, but it's not a tax increase because it's your money.

Question: I have an accounting definition question that I think GAO is probably in the perfect spot to help me out with.

Back to the federal spending and the discretionary programs and those pie charts that are so alarming, you talked about the broken business model. I can't help but think that past assumptions on programs, structural spending, are not being challenged. What goes into those mandatory programs? Is it pay? Is it building maintenance? What is in there that we might possibly be able to

challenge as far as our future model goes?

David Walker: For one thing, mandatory spending includes Social Security, Medicare, and civilian and military pensions. It basically includes items for which the only way that you're going to change the spending is if you change the law.

In this particular diagram, the yellow is discretionary. Every year Congress decides how much money they're going to provide to those different programs and related departments and agencies to try to achieve public policy objectives.

I believe that one of our challenges has been that we don't have enough transparency over these long-term, unfunded obligations and commitments. And in fact one of the things that I'm fighting for, in addition to trying to increase transparency with regard to the Trust Funds, and in addition to recognizing the liability for the money we've spent from the Social Security surpluses, is to come up with a new burden statement for the government, adding up not only the liabilities but also the unfunded commitments and coming up with a total number that would have per capita numbers per full-time worker, and that would show intergenerational aspects. Because what's going on to a great extent is we are putting a situation where our children and our grandchildren are going to bear some unbelievable burdens because of the failure of people to act today and that needs to be more transparent and more well-known. Ironically, the people who are least politically active are the ones that are going to pay the biggest price for failure to act.

Thank you for your time and attention. [Applause]

Richard Jackson: Thank you very much, Dave. It's hard to imagine a more compelling presentation of long-term fiscal challenge than the one we've just heard from Dave Walker. I'm grateful that he was able to join us to do that this morning.

Panel 1: The Dimensions of the Problem—and the Possible Solutions

Rudy Penner
Senior Fellow, Urban Institute

Elizabeth Robinson
Deputy Director, CBO

Eugene Steuerle
Senior Fellow, Urban Institute

Peter Orszag
Senior Fellow, The Brookings Institute

Sylvester Schieber
Vice President and Director, Watson Wyatt Worldwide

Estelle James
International Consultant on Pension Reform

Rudy Penner: Welcome to this panel. We're going to resolve this pesky Social Security problem once and for all. Our panelists, to use the old cliché, certainly don't need any introduction and I'm not going to give them any. [Laughter] So let us begin with Beth Robinson, the Deputy Director of the Congressional Budget Office.

Elizabeth Robinson: Good morning. How are you all?

I took as my job this morning to talk about some of the areas where I think there's actually agreement about the Social Security issue and I want to talk about that in three areas. The first area has to do with the dimensions of the problem, including how we measure it; the second has to do with the things we've learned about potential fixes; and then finally, what kind of information policymakers want and need in order to make the decisions they're going to have to make in the future.

First, let's talk about the dimensions of the problem. People do have different conceptions of this. The first is the problem, the Social Security program itself. And as you can see, this is a graph of outlays for the Social Security program versus revenues on a cash flow basis going forward 100 years. CBO loves to have a little hubris and go out 100 years, so please forgive us since I'm sure this will all be wrong.

But the basic dynamic of the program is that right now outlays are less than revenues, so the program's finances are bringing in money to the government. Over time, though, that's going to diminish as the baby boomer retires and then outlays for the baby boom are going to go up. As we well know, the baby boom is not a single phenomenon. It's actually the herald, the beginning of a demographic transition for the entire populace because the baby boomers were the first generation in which women, such as myself, did not have more babies to reproduce our family. The aging of the American populace is going to cause it to make the transition a permanent one. The working age population is going to be permanently smaller when compared to those who have retired.

So what we see is that the Social Security program has authority to pay benefits until somewhere around 2040. And at that point the program loses the ability to pay more than the revenues coming in and there is an automatic benefit cut. We're estimating that that's about 20-25 percent, and that's perfectly in line with the Social Security program's estimates as well. At that point, by law, outlays have to equal revenues of the program does come into balance.

But the promised benefits would otherwise continue and actually drift upward over time. So

there is a difference between the promises that are made in terms of benefits and what the program will actually be able to pay after the cliff of the Trust Fund runs out, which means that the program has to stop pulling money from the rest of the government to fund benefits.

That's one version of the problem: the Social Security Trust Fund is going to go broke; there's going to be this automatic benefit cut which no one wants; and that's what we need to fix.

Another version of the problem starts much earlier: the surpluses that we're now running, because the revenues are higher than the benefits going out, are going to start to become smaller.

In several years the surplus is going to start decreasing and eventually cross over, and the program is going to start having to pull money from the rest of government to fund all of these benefits.

We already have a federal government that's in deficit. At this time the Medicare and Medicaid programs are going to start pulling on the federal government as well, and the question is: where are we going to find the money to pay for these things?

That's another version of the problem. It's one that comes in much earlier and has to do really with the impact of the program on the rest of the budget, not on the program itself.

So the question that we're facing right now is which problem is Congress going to try to fix? Or are they going to try to fix both of them? And an indicator of that will be what measurement of success are they going to pick for solving the problem?

If they're confining it to the Social Security system I think you'll see actuarial measures, you'll see Trust Fund measures. If they are thinking more broadly you're going to see measures having to do with the deficit and with national savings.

Cash flow measures such as this are sustainable and show sustainability in a fairly clear manner. However, it's not a gold measure of success. It's not a number that Congress is striving for. It's a very difficult concept over time. So it's perhaps one that's not satisfying for the policy process going forward. I think that's not the only reason, but one of the reasons that actuarial measures are of interest to the Congress, because they are things to strive for.

The problem with actuarial measures is that they collapse this entire behavior into one number and that's not a bad thing, but it's a difficult thing for policymakers to deal with because there are timing issues involved. Also if you pick any period to study, 75 years for example, then the question is always what comes afterward? I think GAO, SSA, and others, have tried to develop a suite of actuarial numbers to constrain this, to get the good of a few numbers and yet make sure that you have a sustainable system in the end. But as we know, actuarial measures are very difficult to handle and I'll just say that the policy process as one has seen in the MMA or in tax cuts when you're striving for a specific number, over a specific time, it tends to lead to strange behavior such as sunsets or other things in order to hit numbers.

So the question then is: what measure of success will Congress pick? As we look at the potential fixes and what we've learned about those fixes, let's talk about them in terms of these kinds of measures.

The first is accounts. We've already had a question about accounts and personal accounts. I think there is broad consensus that personal accounts do not help the Social Security system, at least early on. They take a very long time to start compounding their benefits and for beneficiaries who take them up to actually be in a position to draw from them. So especially for 75-year actuarial measures, accounts really only hit very late in the process.

Also associated with accounts is the issue of risk. Whatever you believe about risk and how the government should portray it, it is a very difficult issue to discuss. You have accounts that are invested in stocks, bonds and other things. You're comparing that to a Social Security annuity and a promise, and it is very difficult to quantify for policymakers and the policymaking environment what that risk really means and, particularly for beneficiaries, what choices they are really being given. They hear a lot about 6.8 percent on stock returns, and they hear about trying to predict stock returns over a long period of time, and they also hear about how you do risk discounting. All those things are just very difficult to talk about in a policy environment.

I think we've also learned that some of the simple measures that have been talked about for a long time aren't big enough to work at this point. In particular, increasing the retirement age. If that

was your sole solution you would have to increase the retirement age a lot and very quickly in order to solve the problem.

But we've also learned that CPI indexing is a very strong policy tool and in fact it's overkill in many circumstances. And we've learned that progressive indexing can work. It can be a middle ground that can bring benefits down, strongly enough and quickly enough to solve the problem on a cash flow basis and also on an actuarial basis. So those are the kinds of things I think we've already learned about fixes.

But what do policymakers need in order to make a decision? Well, policymakers have asked for a metric of success and I think they're still working on that. And in fact we've seen the struggle that the lack of one has caused. Whenever a proposal comes out, there are always competing claims about it, about what it does to the deficit, about what it does to the Trust Funds, about what it does to the Social Security system, about what it does to a number of things. It's a very difficult environment for policymakers to sort out when they aren't quite sure what they're striving at.

We do need to look at the effect of the program and the budget as a whole. We need to be able to quantify risk, and if we have measures or policy proposals that introduce more risk into the system we need to be able to explain that and show what that means to beneficiaries.

Finally, we need to talk about distributional outcomes. We have the computational power, both SSA and others including CBO, can look at what this means for different kinds of beneficiaries, and that's the game in Social Security. We already have a system which has a strong distributional component to it. Any proposal is going to change that. That’s of strong interest to policymakers and we need to be able to show them what happens to different segments of society.

So I think that's where we are in terms of what we agree on in Social Security and moving forward, and I look forward to hearing the rest of the comments. [Applause]

Rudy Penner: Thank you very much, Beth. Gene Steuerle from the Urban Institute.

Eugene Steuerle: It's an honor to be on the panel with my colleagues and friends here from a variety of walks of life.

My talk is largely driven by one major concern and it's an attempt, if you will, to take Social Security into the broader context in which I think it really belongs. Every year, we spend larger and larger shares of our budget in areas where needs in many ways have declined—declined because we're living longer, our health care is getting better, but then we claim we don't have enough money left over for our children, for young adult men, for others whose real needs are growing or remaining unattended.

Right now if you're a baby boomer and you happen to be sitting in this room, our legacy to our children is pretty much a government whose sole purpose is our consumption in retirement. We have voted ourselves tax cut after tax cut; benefit increase after benefit increase that we have not paid for. And I don't care whether you're a conservative or a liberal, the notion of good government being a government that's almost entirely devoted to us and our retirement seems to me not to be much of a legacy.

I want to address fairly quickly four major issues that I think must be addressed in Social Security reform, either near-term or long-term, and I think have largely been neglected.

The first one is that the Social Security issue, the numbers that Beth just showed you, is largely a labor force issue. We can debate in terms of trust funds and we can debate in terms of individual accounts. That's the tendency of economists, always to convert things into nice financial present value terms. This is a labor force issue. The drop from three workers per retiree to two workers per retiree—actually more than three to less than two—is a labor force issue, and it affects not just Social Security but also the rest of the budget. Because among other things, it affects the revenues that are going to be available to pay for other programs.

Just think of some of the statistics. Close to one-third of the adult population is soon scheduled to be on Social Security. Add to that the number of those among the non-elderly who might be dependent upon the government because they really do have needs, and you come up to a population of perhaps close to one-half of the population being significantly dependent upon

government for their transfers. That's neither a progressive society—if we're trying to take care of everybody, we're not taking care of anybody well—nor is it a conservative society because of its large expenses and the lack of output that we're producing.

Think also in terms of how long people retire now. People now retire already for close to one-third of their adult lives. Males have a life expectancy of about 17 years, females about 20 years when they retire at 62. The typical annuity of Social Security lasts 25 years. When I used to do public finance there used to be a notion that you would examine programs of government and try to decide where the greatest needs were, try to determine how you allocated resources. And I challenge anybody here in this room to say their 17th, 18th, or 20th year of retirement is the national priority on how we should spend additional resources, that that represents the greatest need of society.

By the way, I have some figures which show that, if you take the average age at which people retired when Social Security was first created, that was age 68. If people today were to retire for the same number of years of life expectancy, they'd be retiring at about age 74. And if they were to retire in another 40 years for the same number of years of life expectancy, they'd be retiring at about age 78.

So what we've done is we've basically managed to morph the Social Security system into a middle-age retirement system. We can afford it for one major reason. That's because the women entered the labor force more rapidly than the men came out. Over the post-war period, we had a significant increase in the percent of adults who actually worked even though we had this vast increase in retirees.

Now we're not only headed in the opposite direction, but if you were to calculate this as an equivalent increase in the unemployment rate, assuming you retire as we do now, we're scheduling something like an increase in the unemployment rate of about 4/10ths of one percent of the employed labor force. An increase in that rate of increased unemployment, every year for about 20 years running. We have never as an economy gone through that type of adjustment and we don't even know fully what it's going to need.

So issue number one, this program has morphed into a middle-age retirement system. We need to adjust the retirement ages. That includes the early, not just the normal retirement age, because an increase of the normal retirement age is nothing more than a benefit, across the board benefit cut that hits the very old who aren't going to work more as much as the young.

Other adjustments we can make along these ways are to backload benefits. We can take the same present valued benefits, concentrate it more in the last 12 years of life expectancy, lower the benefit in the first years of life expectancy for everybody perhaps but for the low income, and we could also provide a major labor force incentive in that manner.

Nobody disagrees with the second major concern I have in Social Security. I've raised this in conference after conference and it really bothers me that almost all proposals that I've seen with some rare exceptions such as Syl Schieber's and John Shoven's, do not address this issue. When I ask these people why they don't address the issue, well, it's too politically difficult. That is the enormous inequity in the system in terms of the family structure.

We know, for instance, that a single head of household who works, makes $20,000 a year, pays taxes, pays into Social Security for 40 years, will get about $95,000 in Social Security benefits. Meanwhile, someone who marries someone who's rich who doesn't work, doesn't raise children, doesn't pay taxes is going to get something like $250,000 in benefits. That is an enormous inequity.

There are also inequities between two-earner and one-earner couples and divorced people who divorce with less than ten years of marriage—they can really get totally messed up by this system.

Everybody agrees it's a problem. All I hear from the left and the right is, “Hey, but that's difficult to deal with. I don't want to deal with it.”

I think as analysts we have an obligation to first put forward what's wrong with the system and propose how to fix it and then let the politics decide how much they can deal with.

A third approach to reform that Rudy Penner and I have suggested in a pamphlet that's just come out is that for systems like Social Security, and for any system that's scheduled forever to grow faster than GDP, we have to change the defaults. As a matter of budget policy, it just doesn't make

sense to have systems that grow faster than GDP automatically by default.

So if Congress is not willing to make these other reforms, we have to change the default in the system. One way to change the default is simply to make automatic adjustments. Whenever Social Security or CBO or whoever you wants makes actuarial projections year after year that the systems' out of balance, we can require that there be some adjustment in the retirement age or some adjustment in the wage-versus-price indexing, mainly perhaps for higher and middle income taxpayers. That adjustment takes place in those years that it's out of balance. If it goes back into balance because some people claim the economy gets better or other things happen or the birth rate goes up, then fine, you don't have to make that adjustment. We need to change the defaults and policy. We should not be addressing policies that always by default grow faster than GDP and we're always coming in the back door to try to reform them, on top of which these policies then always take a preference in the budget over other programs such as those for children.

A final set of proposals, and I have this in a Ways and Means testimony that's in your packet, is I think we need to address the issues that I think were raised by proposals for personal accounts but then were not addressed and those are largely issues of private saving and private pensions. Whether we call something a personal account or focus on getting more people into 401K accounts, this is mainly, in my view, a private pension issue, one which we have to have additional resources. I suggest several. I suggest that it might be possible to actually provide some incentive for plans that are much more portable, and cover a lot more workers. For instance, by actually giving them—and this would be a slight cost—the Social Security tax benefit that defined benefit plans already have.

But I also propose a number of savings proposals including the fact that you and I and most taxpayers are perfectly capable of taking interest deductions on one side of the ledger, in the tax system at the very time that we're getting all these tax exempt benefits or tax excluded benefits on the other side. We're basically over-charging the system even though we're often not saving.

So that combination of five proposals—dealing with the retirement age, dealing with the increase in the labor force that we have to deal with, dealing with family benefits, removing the current default and changing the default in the system so it's not forever going out of balance, and engaging in some private pension reforms—are among the many reforms that I would suggest. Thank you. [Applause]

Rudy Penner: Thank you very much, Gene.

The next speaker is Peter Orszag from Brookings.

Peter Orszag: I'm going to be brief so that we leave more time for discussion, and I just want to make a few key points.

First, the obvious one, that we can't be talking about Social Security in the absence of an understanding that it's part of a retirement package. Social Security provides about 33 percent or 35 percent—depending in how you do the calculation—of previous wages for an average earner. Financial planners say you need 70 to 80 percent of pre-retirement wages to live comfortably in retirement. That means you need to make up another, let's call it 35 percent on top of Social Security. Both tiers of that retirement system have problems. The core tier provided through Social Security faces a long-term imbalance. The upper tier faces the problem that we don't have enough people accumulating the required assets to meet that additional 35 percent. And in addition, there is frankly no good product that exists today—and I'm including, unfortunately, life annuities that are available—on the private market that allows families in the middle of the income distribution to transform whatever balances they have accumulated into something that lasts as long as they're alive. I'm going to come back to both parts of that.

In terms of goals for reform, I'm not going to go over them because I think they've been adequately covered before, and anyone who's gone through at least two of these sessions in Washington, D.C. hears the same thing over and over again. So I'm going to just skip that and hop to the things that we agree on.

I think we agree on at least two sets of proposals. The first is that in undertaking reforms for Social Security we should protect the most vulnerable. The President's Commission to strengthen

Social Security had provisions that did take steps in that direction. The administration has expressed support for those kinds of notions. Those on the left side of the political aisle certainly agree with that, so what are we talking about there? We're talking about things like someone who works at relatively low wages over an entire career should not live in poverty during old age, so there should be some low-earner enhanced benefit. The reduction in living standards that occurs when women, in particular, become widows, is unacceptably large. Therefore we should have some improvement in survivor benefits that could perhaps be done on a revenue-neutral basis. Disabled workers, which are an important component of the program, should not be treated in the same way as retired workers are, and so there may be special protections that are needed for disabled workers and young survivors. I think there's a significant amount of agreement in that area, that in moving towards reform we should make sure that we actually strengthen social insurance for those who are most vulnerable.

Another area of agreement is that on top of Social Security there's a lot that we can do to fill in that additional 35 percent, and I highlighted, in particular, simply changing the defaults in our savings behavior so that you're basically saving, if you don't think about it, rather than having to exert a lot of effort in order to save. The evidence here is overwhelming that defaults matter, and what happens to people who don't decide makes all the difference in the world.

If you're a new employee in a 401K plan, unless you opt out, you get the kinds of red bar take-up rates, 80 percent take-up rate, even with workers in under $20,000 in earnings. If you have to exert effort in order to save, take-up rates are much, much lower. That same concept can be applied outside of the 401K system. We should be making it much easier to save, and for families to navigate the pension system with saving happening automatically, with increasing savings rates over time unless you opt out, with funds invested in diversified index or life cycle fund automatically, and a whole variety of auto-pilot features that should make it a lot easier for busy families to do the right thing without having to study a big binder of material over the weekend when they'd rather be playing with their kids.

So those are the things we agree on. Of course that's not the hard part. The hard part is the stuff that we don't agree on and I think there are there key issues. One is how much of the solvency adjustment should be done on the benefit side and how much on the revenue side; how much of the burden should be born at different parts of the income distribution, regardless of whether the decision on the benefit and revenue side; and then should we have individual accounts as part of Social Security.

On the first point, two things I think are worth noting. One is all of the evidence I've seen from the American public in terms of what the public prefers. I'll just give you one example from Alan Blinder and Alan Krueger. There's gallop and other public opinion research on this point, suggesting that if forced to choose, the American public prefers doing more of the adjustment on the revenue side than on the benefit side. That is diametrically opposite from the leading proposals including price indexing and others in terms of where the adjustment occurs.

Now just because the American public wants, it doesn't mean that it's the right thing to do. But I would also argue that I think we are substantially undervaluing the benefit of social insurance, not just to individuals, but for economic performance. I think a whole generation of economists and policymakers have been taught to focus exclusively on the moral hazard and distortions that come from social insurance programs. Those are there and we need to worry about how they're structured and their effects. But there is a corresponding effect that we are running a significant risk of going too far in the other direction. In particular, if we don't have the kinds of social insurance and other protections for families to take the risks that allow us to invest in education, to move to new places, to take risks in a variety of ways, we will not get the economic performance that helps to make us all better off. In other words, social insurance really has two aspects. One is the distortion effects that can impair economic growth, and that's what everyone seems to focus on. But there's another perspective, which is that by limiting downside risk, social insurance and other insurance products can help you undertake the risks in investments that lead to economic growth, and there's a balance between those two. The discussion about the programs has become completely dominated by the adverse effects and has not paid enough attention to the potential benefit in terms of economic

performance from having risk management tools and insurance products that are available to households.

In terms of the second question, the distributional burdens that should be borne, there actually does seem to be some agreement, coming back to my former point, that lower earners should be spared at least the proportionate burden, that they should be cushioned to some degree. I think there are a variety of reasons to be looking towards higher earners for a disproportionate share of the adjustment, and I've highlighted, in particular, the second one. We are experiencing what I think is—an explosion might be just a little bit of an exaggeration—but a very substantial increase in the gap in life expectancy between higher earners, better educated workers and lower earners. Life expectancy is increasing, but it's increasing particularly rapidly at the top of the income and education distribution. If you look at a variety of factors, whether it's a concentration of smoking, the concentration of obesity, at least for women, the fact that a lot of the fancy genetic-based technologies will not filter down the income distribution immediately.

My favorite little anecdote there is that, to the extent that cord blood does have potential benefits in fighting future disease, and to the extent that your own cord blood is a much better match than any public storage bank ever could be, the fact that a very small percentage of American households which are disproportionately at the very top of the income distribution are now paying the $1,000 fee for setup and the couple of hundred dollar maintenance fee each year to have private cord blood storage of their children's own umbilical cord blood—suggests that in 40 or 50 years, if this technology bears fruit, we could be facing a situation in which a very small percentage of the American public has a very substantial advantage in terms of fighting a variety of diseases relative to everyone else. That's just one anecdotal example.

I think this trend towards an increasing spread in life expectancy will continue. In my mind that justifies a deeper burden placed on higher earners compared to lower earners because the higher earners are increasingly living longer than everyone else and therefore enjoying their benefits over a longer period of time.

I'm not going to talk about the individual account debate because I'm sure we can get into that during the question and answer period. Suffice it to say that I think individual accounts belong in that second tier and not in the first tier, and that's partly because of a realistic expectation about how people will behave and the political pressures that will come to bear on a system of individual accounts. They just seem inappropriate to me for the first tier, and there's a lot we can be doing to boost accounts in the second tier, and we should do that first.

What about reform plans and how to move forward? Obviously there's one reform plan I like which is the one that I wrote with Peter Diamond. I'm not going to go over and over on that. But let me just raise two, and actually I'm going to add another one.

One is there's a lot of discussion about indexing the system to life expectancy whether through the normal retirement age or through benefits and revenue. I think an interesting idea that should be further explored is instead, to index the system to the dependency ratio. In other words, to take into account both life expectancy and the fertility rate in one summary measure and index the system to that.

In constructing things that we're going to index the system to, or thinking about them, it is crucially important to realize that, as has already been noted, we're going to be wrong in one direction or the other about the future, with all due respect to CBO, SSA, or GAO. You can do a great job in coming up with those projections, but they will be wrong. I'm virtually certain of it, in one direction or the other.

Therefore, in indexing the system to something we need to think very hard about whether we're indexing it to something that's sensible. So, when the forecast errors occur, the system responds in a sensible way. Price indexing from that perspective does terribly because it responds in exactly the wrong way to future forecast areas. If real productivity growth is faster than currently expected, the overall fiscal gap facing the nation is smaller than currently expected, and yet the benefit reductions compared to the current benefit formula are larger, not smaller, under price indexing. Exactly the opposite of what you'd want. That same point holds with regard to progressive price indexing.

Instead, we should be indexing the system to an underlying driver of its cost, or a cost/revenue balance which is the dependency ratio. I think there are ways of doing that As far as I know, no one has actually proposed it, and it seems to me worthy of exploration.

The second thing is there are lots of things in terms of labor compensation that are currently not included in the FICA tax base that arguably should be. For example, just to throw out some ideas, employees' health care benefits are excluded from the FICA tax base. Obviously they are a form of labor compensation. Including them would have a variety of benefits, including broadening the tax base and perhaps facilitating an actual reduction in the payroll tax rate. There are lots of questions about exactly how that could be implemented, but it seems worthy of exploration.

A final point which I hinted at before doesn't have to do with Security reform, but does have to do with the challenge that's facing households who do manage to save amounts on top of Social Security. Let's say all this opt-out stuff happens and we've made it easier for families to save, we've increased the incentives for them to do so. Families accumulate $50,000 or $100,000. You're a 65-year-old woman with $50,000 or $100,000 sitting in a 401K. Currently, your life expectancy is about 20 years, so you think you might live to age 85, but you have a 30 percent chance of living past age 90. You have almost a 15 percent chance of living past age 95. What do you do with your $50,000 or $100,000? You could buy a life annuity on the private market, the individual market, but the research shows that because life insurance firms have to price to the pool of annuitants rather than the typical American, you pay a cost that's about 15 or 20 percent in expected value for doing that.

It seems to me like the federal government has a role that could be played in providing a benchmark here for annuities, basically to provide some product that for the typical American is actuarially fair. You could take the tables that Steve Goss generates or others generate and effectively sell an annuity directly from the federal government to provide an actuarially fair annuity for that typical American.

This is something that Peter Fisher floated when he was Under Secretary of the Treasury. It apparently didn't get very far, but I think we're going to be coming back to products like that, which help families manage that second tier very soon.

With those perhaps less talked about ideas, I will close. Thank you. [Applause]

Rudy Penner: Thank you. Syl Schieber from Watson Wyatt.

Sylvester Schieber: Good morning.

Like most everybody else up here or several other people up here, I have had a Social Security plan for quite a number of years. It includes individual accounts. I have been of the mindset that our retirement system is underfunded at least for the kinds of behavior that we have today in terms of retirement for the kinds of reasons that Gene Steuerle has put on the table and others you're all aware of, and have always thought if we were in the process of reform, unless we're willing to change our retirement behavior significantly, we need more money in the system.

Having said that, I'm not going to spend as much time talking about a specific plan today as I am about what it is we're doing, and how we might think about what we're doing in guiding what we might consider in terms of reform.

Our Social Security system provides a number of insurance protections for our society. On a pre-retirement basis, I believe it provides essentially four kinds of protection. With people who die and leave juvenile children, they are protected because of the loss of income for that parent. The system provides disability insurance for people who have misfortune during their working career and can no longer work. It provides redistributive insurance, what I characterize as insurance against bad labor market outcomes. It's unseemly for a society like ours to see people who have toiled throughout what we consider to be a normal working life to have a retirement period with no income or inadequate income. And then it also provides insurance to all of us who may not realize early enough in our careers when we need to start laying aside a portion of our earnings in order to provide our own retirement security when we can no longer work.

In retirement there's a variety of insurance protections. It provides longevity insurance through the form of an annuity. It's an inflation protected annuity. There are spouse and survivor

benefits. And I think we need to focus on what it is we're doing when we start to consider how it is we might modify the system in order to deal with the financing issues that we're facing.

In the early days of the program, there was a lot of discussion about the insurance nature of the system, and I think maybe we ought to return to that insurance discussion as we consider our current dilemma. What is insurance? It's a pooling of risks.

If you live in a community where, let’s say, there are a thousand houses and each of these houses is worth $100,000 and one of these houses burns down every year. There are two different ways you can deal with that problem. One, everybody can pay a $100 premium and then whoever in the community's house burns down is secured for their loss. Alternatively, we could let people do this on their own and one individual in the community each year would face a $100,000 loss and everyone else would be well-off.

In terms of our Social Security system, at least for elements of the system, the former is the situation.

When we look at the incidents of disability under OASDI by age, the probability of incurring a disability is extremely low, the sort of model that I talked about in this community will work.

The cumulative probabilities of dying are extremely low. Again, this model would seem to work fairly well.

Peter Orszag was talking about the redistributive characteristics of the program. It is clear that the probability of having a very low income during a working career is not randomly distributed. We can decide what an adequate income might be, but we could probably use the same sort of model to provide protections for people who have these bad labor market outcomes, and in fact that's the way the system works now.

When we look, though, at the probability of people actually receiving a retirement income, what we see is that by the time people get into their 60s, the probability of receiving a Social Security benefit in our society is around 90 percent. It gets a little bit higher as people move on into their 60s. If you subtract the people who never participate in the system because they're still covered under state and local systems, or who never get into the labor market, the overwhelming majority of people that enter the labor force in our society end up drawing a benefit.

Now, if you were in our society of a thousand houses, and there was a certainty at some point in your lifetime that your house was going to burn down, everybody in the society's house was going to burn down, would you necessarily use the same insurance mechanism that you do to deal with the other contingency? And I believe the answer to that is probably not.

Now, in certain circumstances you can use that same model. Paul Samuelson looked at the demographics and economics that are needed to make pay as you go systems actually operate quite efficiently. The problem is we no longer have those characteristics.

I believe that the way we need to provide for the contingency of retirement needs for the vast majority of people, and it's not these other insurance protections I'm talking about. It's by actually accruing from people's income during their working careers and laying that aside to actually fund the benefit.

For the individual worker today in our society that's actually the way Social Security works. People start to contribute to the system early in their career and they develop an entitlement to a benefit that's going to be paid during their retirement. For the individual worker, this system is an asset. It's an asset in their retirement portfolio.

We have talked a lot—there was actually some intimation of that discussion here this morning—about whether or not the surpluses that are accumulating in the Social Security Trust Funds are savings. People look at how much we have that we've been accruing in the Trust Fund since the early 1980s. The argument is that during this period we've been running federal deficits and we really haven't saved the money. Some people believe we have. Peter asked this morning whether we really know how much the government would have spent had we not had these surpluses, and whether it's having a positive effect. I think this is the wrong discussion to have.

Consider the case of a worker. Here's a set of assumptions. I'm not going to talk about these assumptions. They're in the handout if you want to look at them. I want to look at how we save on new alternative regimes in terms of accumulating retirement wealth.

If you're in a funded system, this worker would be contributing to his or her retirement account over the working career. With return on assets, they would gradually accumulate. When he or she reached retirement, they would begin to spend down. Under my assumptions, they run out of money and die at age 81. [Laughter] It was for simplifying purposes. [Laughter] But this is the way a funded system works.

On the other hand, the worker contributes into the Social Security system over his or her working career. They are earning a benefit right by making these contributions, but the money is paid right back out to finance the consumption of current retirees.

In this regard, it's what Paul Samuelson characterized as a consumption loan. I'm giving up some of my consumption during my working career by contributing to Social Security, but it's really a loan that I'm making to the system that the next generation has to pay back. As Gene Steuerle has suggested, the loan is going to be fairly dear for the next generation to pay.

I would suggest in this system you're not generating nearly the savings in a macro context that you are in a funded system. What you're generating is long term obligations.

In this context, when we think about the accumulation of the Trust Fund, it may have some effect on the overall net effects of the operation of the system, but the overwhelming majority of the obligations are still being financed on the basis of these consumption loans rather than actual funding.

The actuaries actually estimate the accrued liabilities under Social Security each year. Nobody talks very much about these accrued liabilities. We talk a lot about the ongoing liability. We talk about the $4 trillion, the $11 trillion, what have you. I'd like to focus on the accrued obligation—how much we owe ourselves based on service under the program to date. That tells us what we have stuck in our personal portfolios, all the workers that are living in this society, that we expect to make a claim on going forward.

The Trust Fund in the system since the mid 1990s is that green line, that line that's slightly sloping upward here in this graphic. The bottom line is the unfunded obligations—the obligations that we're accruing in our retirement portfolio for which no money has been laid aside. I think if we really want to meaningfully talk about how we're going to solve this issue, we need to think about beginning to fund these obligations as we're accruing them, at least for the retirement element of the system.

When you look at the net savings of the system—the accruing obligations minus what we're putting into the Trust Fund—it seems to me that it's very difficult for us to make an argument that we're actually saving anything in terms of laying aside these Trust Fund monies. We're creating ever-larger obligations for a future generation.

Many people say that Social Security really isn't a retirement system. We cannot think about Social Security in terms of traditional retirement plan financing. In fact, I was at a lunch yesterday and an attorney who works for an investment house started to make this argument with me. For many people, maybe it is not a retirement system in the context of a save during your working career. For some people it is.

Olivia Mitchell and James Moore at Wharton several years ago did a paper. They looked at the people participating in the health and retirement survey. This survey was based on a sample of people who were between 52 and 62 in the early 1990s. So these were people that were just on the cusp of reaching retirement. They looked at the components of their wealth. They considered housing, which I have taken out of the equation for reasons I'd be happy to discuss. They looked at personal assets—these are financial assets people held outside the form of retirement plans. They looked at Social Security and personal wealth.

When I looked at the tenth percentile of the wealth distribution and how people at this level held their assets, the overwhelming majority of it was held in the form of Social Security wealth. Even as we moved up to the one-third point in the distribution, still almost two-thirds of their wealth is concentrated in Social Security. At the two-thirds point, still over a third of their assets are held in the form of Social Security. This is a retirement program for a very substantial number of people in our society. I think we ought to consider it in the context of it being a retirement program, and we ought to think about it in the rational context of the insurance protections that we're trying to provide.

If we are trying to protect people against their own myopia, their own ability to figure out how much they ought to be laying aside in order to meet their needs, then we ought to think about it in the context of a mandatory savings program and there ought to be real savings associated with what it is that we're doing. I think if we start to think about it in that context, it can instruct the discussions about what we want to do in terms of changing current policy, and it is one of the fundamental reasons that I have always believed in order to solve our systemic problems because the system is underfunded, and nobody wants to talk about raising the retirement age, that we need to get people to put more money in and the only way we can get them to do that is if they're putting it into an account in their own name. Then we can make the argument over whether or not this is savings or not.

Some people are not going to want to make additional contributions. Those are probably in many cases the people that are going to want to retire the earliest. We need to balance some of these arguments. But I really do think we need to go back to fundamental principles when we're discussing this issue because it helps instruct where we want to go.

Thank you. [Applause]

Rudy Penner: Thank you very much.

The last speaker is Estelle James who was formerly with the World Bank and also for a time a colleague at the Urban Institute.

Estelle James: Thanks.

I'll also skip over the objectives of Social Security reform except to emphasize two things that I think we have to keep in mind. Both the financial side—which, of course, gets most attention in the newspaper—and the real side. That is, we want the Social Security system to be financially sustainable, but we also need to increase the amount of labor, particularly labor of older workers, and labor productivity. Otherwise, as the proportion of inactive people in the population rises relative to the proportion of active people, our standard of living will fall. Then we won't have old age security or young age security. So, that's a very important intrinsic part of the old age security problem.

The second thing to bear in mind is the importance of building-in automatic stabilizers because the future is always different from what you expect, and the other speakers have emphasized that.

Just to put the reform picture into the international context which is where I come from, our current mandatory contribution rate and our target replacement rate are among the lowest in the world. We know that it's low by OECD standards. Our target replacement rate and expenditures in old age securities are even low relative to other countries such as Chile, which is sometimes used as an example of what we might do here.

So I think we need to keep this relative perspective in mind when we think about where we go from here.

We have the richest elderly, but we also have the highest old age poverty rate, among the highest within OECD.

Employer-sponsored plans cover the upper half of our workforce, but for the bottom half, access and participation are unreliable.

Net wages for the bottom two-thirds of workers are likely to stagnate. We know that we've had a polarization of income and I would guess that polarization will continue over the next 30 years due to the fact that health insurance will take an increasing share of the growth rate, and even more so we're going to have an absorption of many Chinese and Indians, a billion Chinese and Indians into the global labor market. This is going to happen gradually. It's going to happen over the next 30 to 50 years, but I think it's going to happen. It's going to raise the labor capital ratio. There will be winners and losers and I would guess that the wages of the bottom two-thirds will stagnate and gainers will be the upper 20 percent and that has implications for the kinds of policies, the kinds of distributions of benefits and costs that we want to impose in a long-term program such as old age security.

Finally, I think we all agree in this room that it's important not to raise the public debt which

just passes the burden onto our children and grandchildren and, since much of the debt is held abroad, makes us vulnerable to foreign economic and political decisions.

So a key question that we have to answer in this discussion is: do we want to maintain the kinds of benefit schedules that we've projected for the future, or do we want to maintain the revenues, the tax stream that we've projected? Maintaining the scheduled benefits will simply require more revenues. The other speakers have talked about that. With or without individual accounts.

Now I happen to favor using individual accounts as part of the program, but that's not going to solve this basic question of the tradeoff between revenues and benefits. And this is a value judgment that people will disagree on.

So my own judgment is that we should try to maintain as much as possible the current ratio of average benefit to average wage, for the reasons that I've given. That it's already quite modest. That means extra money is needed, and the question is where does the money come from and where does it go?

I think here's where the issue about individual accounts arises. I would argue that it's going to be more efficient if we put the extra money into the account rather than putting it into the Social Security Trust Fund. Why? For a number of reasons that I've listed here. This list really I would say sets forth in a nutshell what I would like to see happen in Social Security reform. I think by putting some of the money into individual accounts you diversify the income sources of retirees, particularly of retirees who don't have access to the 401K plans. The extra money is less likely to be regarded as a tax, more likely to be regarded as mandatory savings. If done correctly, this can be used to increase national savings, productive investment, therefore productivity which is the real side of the picture, but only if done correctly.

If this money goes into the Trust Fund I believe there's a danger that it will increase Treasury borrowing. Now Peter raised the question about this earlier, and of course this is a key question. We don't really have firm analytic evidence about whether Treasury borrowing has increased, will increase as a result of extra money in the Trust Fund. We have a little bit of econometric evidence.

In the absence of firm evidence, what do we do? I think we all have to look at our interpretation of what we have seen happen. And my own interpretation is that if money is sitting there in the Trust Fund and the Treasury gets exclusive access to it and the money that they borrow does not appear as part of the publicly held debt, I just think it's difficult for politicians to keep their hands off that money and it's likely to result in increased Treasury borrowing. That is more spending while tax cuts are made simultaneously.

This is not for sure. Different people may disagree on their interpretation of that, but we all have to make our guesses about what the impact will be, and that's my guess, and for that reason I think we're better off putting the money into individual accounts where it's less likely to have this impact and therefore more likely to result in increased national savings.

Some people think that we can escape this problem by allowing the trustees of Social Security to invest that money in the stock market so Treasury doesn't have exclusive access, and I think that just opens the door to a whole slew of other issues regarding political manipulation, political pressures, conflicts of interest, and so forth.

I think this is a dividing line. People stand on one side versus the other. In fact when I go on to suggest how I would cut down on the traditional benefit to make it solvent and supplement that with, largely with an add-on to an individual account, my suggestion about how to make the traditional system solvent in some ways are not very different from the proposals that Peter Orszag and Peter Diamond came up with in their work, except that I wouldn't put a lot of additional revenue in there. I would put the additional revenue into the accounts for these reasons. So I think this is a key issue that we have to be debated.

How to achieve solvency? We've put a lot of emphasis on increasing the retirement age which is politically very unpopular. Whether this will end up being part of a political solution, I don't know. But, from the economic point of view as Gene emphasized, having people work longer has to be part of the solution as people are living longer and longer.

You can achieve this by linking the retirement age to longevity or benefits to longevity. I would choose linking retirement age because that sends a very direct signal that this is what we

would like to achieve. So that would be an important part of my solution.

I would slow down the benefit growth for workers above the median. This could be done by gradually reducing the third factor. Or it could be done by some kind of progressive indexation that starts at the median wage which is approximately where the third factor kicks in. But this stems from the fact that people above the median are likely to have other sources of retirement income, and that's where the disparity in incomes is going to be growing.

I would stabilize the percentage of the total wage bill tax at 90 percent. We all know that's been the percentage that the total wage bill tax has been falling. It's likely to continue falling, in my opinion. And I think this is one of the automatic stabilizers that we should build in.

I completely agree with Gene that in some way we should reevaluate the way we treat families, the way we treat spouses and survivors.

Now I think the survivor's benefit is very important, but it's very hard to justify the current system that we have regarding spouses and survivors. Some of the things that I would consider doing, capping the spousal benefit at 50 percent of the average benefit so that basically the workers above the median don't get a larger benefit for their spouses.

Reducing the husband's benefit to finance the survivor's benefit, which is the way joint annuities would work in the private market. Basically this means that you're cutting the family income when both partners are alive in order to finance the survivor's benefit.

And I would allow widows to keep their own benefit in addition to survivor's benefit. This would accomplish a couple of things. It would mean that women who work in the marketplace don't have to choose between the two. They don't lose their own benefit because they've received the survivor's benefit since the survivor's benefit is now finance by their husband, there would be no reason to expect them to give that up. It would increase the total income of elderly women which everyone recognizes is one of the sore spots in our current system.

Finally, I would add some kind of minimum benefit for low earners linked to years of work.

I should say I don't know whether this exact plan will achieve balancing. This hasn't been put through Steve Goss' machine, but I think it would get you to the right ball park.

At the same time, I would have not a voluntary add-on, but a mandatory add-on, small, perhaps around 1.5 percent of wages. I would match that from payroll taxes with a match targeted towards low earners. I would do this in part because the add-on is simply going to be more binding for low earners. We know that, for high earners, they'll be able to do an offset with their other savings if they want to. Low earners won't be able to do that because they don't have other savings. I would also do this because it's a way of keeping total costs low.

For example, you could match it with a 1.5 percent carve out, but with a maximum of say $300 which would automatically mean that it was targeted at low earners and phased out for high earners.

In the long run, my rough calculation is that, even though this would be a very small account, it would provide about 30 percent of the total Social Security benefit for low earners and close to 50 percent for high earners, partly because of the rate of return that we assume in the accounts, and partly because of the fact that the traditional system is continuing to face the legacy debt. Even though it's a small account, it would provide in relative terms a substantial benefit.

To cover that financing, I would designate a source something like a small estate tax or a surtax on wages above the taxable ceiling. This stems directly from my expectation that it's the higher earners whose incomes will be growing over the next 30 to 50 years. Therefore it's appropriate for them to cover the financing gap.

But I'm assuming that the cost of this would be relatively small. That is because I also see all the other looming needs out there including Medicare and Medicaid. I wouldn't want this to take a huge amount of the total revenues that we're going to need for these other purposes.

Basically, the money from the accounts would allow people to continue to retire somewhat earlier than they would on the basis of the traditional system alone, or to offset other benefit adjustments in the traditional system.

I would just say this is better than putting more money into the Trust Fund for the reasons that I've already given. Syl Schieber at other times has advocated a larger individual account. I could

go for a larger individual account, except I don't think the money will be there for it. I don't think people will want to add-on. I don't think that we'll have the money to finance a larger transition.

So this is really a plan for making Social Security solvent, for maintaining scheduled benefits very close to the currently scheduled levels, for building in work incentives, increasing national saving, and incorporating built-in stabilizers.

We were asked to comment on the political feasibility. This could be a bipartisan plan because it really contains something for everyone. That is, I think, it meets a lot of the objectives that many different groups want, but I'm not sure that the parties want a bipartisan solution.

I'll close there. [Applause]

Rudy Penner: Thank you very much.

I have a feeling we don't have quite enough time for questions given the stimulating nature of this conversation, but why don't we start with the audience, and could I ask you to identify yourself and wait for the microphone before you ask your questions.

Question: Joe Minarik from the Committee for Economic Development.

One question for Beth and one for Peter. Beth, the chart you used would show, in the 2040s the decline from scheduled benefits to payable benefits. For perspective, my understanding is that that decline assumes a reduction in benefits of 20 to 25 percent. Not only for new retirees, but also for all pre-existing retirees.

Elizabeth Robinson: Yes.

Question: Including those of lower economic well-being. Just to put that number in perspective. And I understand if you restricted it to new retirees you would probably need a reduction of about twice that magnitude or so.

Elizabeth Robinson: Or more. There's quite a lot of debate about what the administrator of the system would face in terms of their ability to actually administer the cut, and the thought is now that it would have to be across the board, but we're trying to predict the law and all that 40 years from now so that's sort of difficult.

Question: And Peter, I think you raised an interesting negative aspect of the idea on the table to switch from wage to price index and benefits. Is it possible that there's one additional downside to switching from wage to price indexing, whether it be across the board or of a progressive nature? Which is that as Beth noted earlier, a switch to price indexing tends towards overkill including in the long run. And if one were to assume that policymakers at some future hour, observing perhaps that the future is more kind to us than current projections suggest, or upon reaching the point where price indexing tends toward overkill, were they simply to choose to turn the policy off and to revert to wage indexing, then within one Social Security generation we'd be back with the problem we started with.

Doesn't that suggest that it would make more sense to use, as I think Estelle suggested, a conversion in the PIA formula of equivalent magnitude which if you discovered at some future hour you had overestimated the size of the problem, you could simply turn it off and you would then -- [Microphone problems]

Peter Orszag: Let me answer it this way. Frankly, I think there is very close to zero probability that if we employed price indexing or progressive price indexing, that we would actually stick with it for 75 years, 100 years, or what have you. Given that, I think it has the same flaw, a different dimension but the same flaw as doing a 75 year solvency package that doesn't address the cliquier(????) effect. It makes no sense to be setting up something that we know doesn't really sort of make sense and is not sustainable. Rather than doing that and this just exacerbates the point

about forecast error. I would respectfully disagree with those who argue that we should on purpose build in something that we know we will reverse in the future, because in certain areas retirement plans in particular, and I would frankly include the estate tax in this too. I don't think we should be making lots of changes to things that take a long time to develop and upon which households base retirement plans.

So, I don't think it is sensible to think that we would on purpose build in something that is ratcheted lower than what we expect. I think we should basically design the system so that it has the kind of automatic stabilizers that Estelle talks about, step up to the plate, fix it, and then have it respond sensibly to future forecast errors and have it be something that actually makes sense and that we would all be happy living with for 75, 100, or 150 years.

Of course the system will have to change, but we shouldn't sort of adopt reform now knowing that we'll have to change it. That doesn't make a lot of sense.

Question: So are you saying that on that criterion price indexing does not make sense?

Peter Orszag: On that and several other criteria. I have a very hard time other than as a convenient excuse for a specific set of specified benefit reductions based on Steve's projections as of today, seeing the logic for price indexing.

Question: My name is Nathaniel Preston. I'm a retired educator and lawyer.

What is the rationale for having the income level [inaudible], and also would it be worth considering applying these same taxes to unearned income?

Eugene Steuerle: The rationale for capping it is that, it is a mandatory social insurance scheme if you basically have what you're arguing essentially for an income tax to pay for it, then you're into a different type of system. You're basically into a redistributive scheme. And I'm not saying that Social Security doesn't have a lot of redistribution in it, and that you might not want to do this. In fact, Medicare does that in a large way. But to the extent you think social insurance involves mandates, that you have some notion you'll get something back for your mandate, we can debate that a little.

I would say there's a lot of agreement on this panel, and we just haven't had the chance to say it, and your question raises one of those areas of agreement. In my testimony, I noticed that we could easily raise the wage base for Social Security which tends to be favored a little more by the Democrats, at the same time cap the things like employee benefits which tends to be favored by Republicans in part because in areas like health insurance, it actually probably would help reduce the number of uninsured, or at least not have the incentives of the current system which actually tends to, for reasons I could go into elsewhere, increase the number of health uninsured.

So, especially for those of you who might be from congressional staff, that's an area of very possible compromise over the years. Not necessarily eliminate the wage base, which you suggest, but to raise the wage base both with respect to the percent of earnings that are subject to tax, but also the percent of compensation that's subject to tax at the same time.

Peter Orszag: If I can just quickly add one thing, which is that I think if we did literally uncap and apply the full 12.4 percent payroll tax just on earnings all the way up, we would not come close to generating the type of revenue that current projections suggest. I do think, especially at the upper earnings levels, there is substantial scope for altering the type of income, the form in which it's taken. So in other words, and I'm not advocating this, but if one were to eliminate the tax base, I think you'd have to apply the tax to all forms of income and not just earnings because it's the easiest thing in the world to transform wage income flowing through an S Corporation into dividends.

Question: That's why I asked the two questions together.

Peter Orszag: Right. Thank you.

Question: I'm Ricardo Martinez. I was responsible for the [inaudible] program in the Spanish government, and it's really interesting to see how you try to face these challenges.

In Spain, we tried to introduce some specific measures. I do agree with you that there is a set of different ideas we have to introduce. One of them is that you have to consider that people have their financial wealth, real estate wealth, and also the saving capacity. During their life cycle, they put their savings not only in those financial assets but also buying their own homes, and here in the United States, 80 percent of the people own their own homes.

So this is my question. Does it make sense to introduce some incentives upon their retirement to convert this real estate wealth into more liquid assets, to have their own private capacity, and to help solve these type of challenges?

Sylvester Schieber: Certainly you can introduce incentives. The experience here has been that, at least early in the retirement period, people are very reluctant to sell off their homes, enter reverse mortgages and that sort.

There's an interesting undercurrent here in all of this discussion. We're talking about figuring out how to tax away resources from higher income people to solve what in essence is largely a middle class retirement savings problem. I think people ought to be encouraged to save during their working careers for the retirement benefit if we provide the other sort of protections I talked about. There are definitely financial risks that people face. We provide protections, but you can go back to the establishment of this program and Franklin Roosevelt's opening comments when he signed the bill. He said we're trying to protect people from the vicissitudes of life, but we realize that we can't protect them from all the vicissitudes of life. So we need to find reasonable mechanisms to allow them to accumulate the wealth they need during their working careers and the home maybe as part of it, but right now I don't see that as a solution that anyone here is very seriously talking about tapping.

Peter Orszag: But just very briefly, the other thing we should be doing in encouraging middle and lower income households to save for retirement, the most counter-productive thing in the world is that we impose heavy, implicit taxes on those who actually do save because we disqualify them from Medicaid, supplemental security income, and food stamps. Those rules were written 30 or 40 years ago when 401Ks and IRAs basically didn't exist. They've never been revisited and they don't make any sense.

So the first step that we need to take in order to be encouraging saving is to get rid of the impediments that hit people over the head if they actually do save.

Sylvester Schieber: And we've actually privatized this by penalizing them when their children apply for educational assistance and those kinds of things as well.

Question: A question on the issue of [inaudible] more or less that we have too long a retirement, and then a comment by others that really went in the direction of under-funding retirement. I think this is a little bit of the crux of the matter here, which is we want to get into a discussion about long-term entitlement but the first thing out of the box, [inaudible]. And I see that as sort of a bad first step. The first step ought to be a discussion about how we commit our society to [inaudible] retirement, and [inaudible] agenda before we talk about add-ons, higher payroll taxes, et cetera.

Eugene Steuerle: That's a good question for all of us to end up on so we can all have a final quick comment.

I think the issue is primarily a labor force issue. I don't think there's any way on this green earth we can save our way out of the problem. So as soon as we turn to trying to finance the

problem with more taxes—as soon as we talk about trust funds, I think we confuse that issue and we duck that issue of middle age retirement, what I consider to be a major issue for our economy. And it's far beyond Social Security. It's the revenues that's financing everything in government—Medicare, children's programs, income taxes, state taxes, on down the line.

Having said that, I can't disagree that we save inadequately. We already spend more on employer incentives for retirement than our entire personal saving rate. So we don't even allocate our current savings well which argues for some private pension reform. And I tend to agree, I don't know whether Peter's quite there, but I tend to agree with Estelle and Syl a little bit that to the extent you're going to finance some retirement, there is a case that seems to be made for us as a society to debate whether we should have some mandatory saving. At least mandatory saving is the least sort of distorted of the types of taxes. If I'm going to raise taxes to redistribute, I don't want to so more for us in this room who are already promised $700,000, $800,000 in combined Social Security and Medicare benefits. That's not, to me, how I want to raise taxes for that type of redistribution. If we have to save more, then we should be mandated to save more. That's sort of the hind of the dog, not the torso or the main dog that I would address.

Rudy Penner: Let me raise what I think is a pretty fundamental question and that involves risk. The whole purpose of social insurance is really to reduce risk and in that sense our system is a bit peculiar because Social Security benefits themselves have a quite enormous amount of uncertainty in them, even forgetting the uncertainty related to reform. How they're taxed, family status as Gene said and so on. I don't think many 40 year olds really have a very good idea of their replacement rate.

I think the fundamental question is, is it as important to reduce the risk of the more affluent as much as you do the lower groups? And Peter has already hinted that our floor in the system is really faulty. The SSI has all kinds of problems related to it, asset testing, one of the most important. But most countries have a much more generous floor and maybe Estelle, you could comment on the kind of guarantees you see in places like Chile, and maybe others could comment on whether that makes individual accounts more acceptable to have that sort of thing, and maybe somebody can tell me why it's not more of the debate in this country.

Estelle James: Internationally that's usually a debate. There are all sorts of guarantees, some of which might make you shudder, but besides the quote. But one thing I discovered when I recently looked over the individual account, the countries that have adopted individual accounts, each one of them has a minimum pension of some sort. It may be a minimum pension guarantee that tops up the accounts of people who fall below a certain level. It may be a flat benefit that goes to every old person, it may be a broad based means tested benefit that most old people qualify for. But it was striking to me and it was a little surprising to me actually, how universal this was out of every country I looked at. They each had it. The levels varied a lot but I would say there's a concentration between 20 and 30 percent of the average wage.

That's pretty high relative to our average benefit which is an indication of the fact that we're starting from a low point, relatively speaking, and I think that is one problem. Because our average benefit is low, to say nothing of the actions of a reasonable minimum, there's very little there to cushion the risk and that's part of why the issue of risk does keep coming up and it's difficult to figure out how to address that.

In Chile, the minimum pension guarantee is price indexed by legislation, but de facto it's been raised on par with wages since the system began. It's about 25 percent of the average wage. It goes up when you reach age 70, it goes up again when you reach age 75. So it's about 28, 29 percent of the average wage person in their 70s. That just gives you an example of how other countries have handled this.

Sylvester Schieber: I think the real problem is that we are hell-bent that we're going to have this progressive benefit structure, where we peg the bottom, the slope of the benefit structure

has to go up from there. And if you start to raise the floor and you can't bring down the top, then it starts costing more money.

There has not been a significant appetite to talk about programs that will in fact flatten the benefit structure.

I have two well-developed proposals, Steve Goss at the advisory counsel back in the mid 1990s spent a lot of time costing out such a proposal. In fact in some regards the progressive indexing just mimics what we were doing on a different time scale in terms of the internal benefit.

I think we're caught in our own knitting and until we're willing to talk about having some kind of foundation of protection and really making it that for everybody, and then worrying about how we finance the structure of benefits above that, we're not going to get to answering the question.

Estelle James: For example the Netherlands has a flat benefit.

Sylvester Schieber: So does Canada and Australia.

Estelle James: And then private plans provide the earnings-related component.

Eugene Steuerle: A lot of people want to argue against things like increasing the retirement age because they say if you and I get 25 years of retirement and that's reduced to 23, our reduction in benefits isn't as much as somebody who has 15 years because they have a shorter life expectancy and it gets reduced to 13. If you bump up something like a minimum benefit on a lifetime basis you can compensate these lower income people. We could create a minimum benefit. We could almost all be utterly out of poverty. By the way, the additional money we're spending on Social Security, and it is additional amounts every year because of this wage indexing and more years of retirement, could be spent, we could wipe out poverty among the elderly. We could debate on what that floor is. We could really do a good job at the bottom to try to base and solve a lot of these risk problems you're talking about for people at the bottom.

I do want to make two points clear on that, however. Most of the minimums that have been suggested including the one by the Advisory Council basically are nothing. The reason they cost nothing is because they do nothing in the long run. If you create a minimum benefit you've got to at least wage index it. I don't know, Joe, that I'd necessarily believe you have to wage index everything.

Male Voice: The Advisory Council is supposed to wage index.

Eugene Steuerle: For whatever reason, my understanding is that it cost almost nothing and the reason it cost almost nothing is because it did almost nothing.

Male Voice: Are you talking about the Bush Commission? That's not the Advisory Council.

Eugene Steuerle: What we need are estimates on how these things would work. We need different estimates so we can actually examine them regardless of which one we might think theoretically is right by design off the top of our heads. We need to look at the analysis on how to do this.

The second point I want to make quickly here is you don't want to do it in the form of a guarantee against individual accounts because that encourages all sorts of game play. It encourages, for instance, you take very risky measures with your accounts. You basically need to set up a minimum in the time benefit system and let your individual accounts be the additional risk that we think middle and higher income people can have on the side.

Rudy Penner: Beth, you get the last word.

Elizabeth Robinson: I was just going to make a very similar point about the presence of guarantees and the presence of individual accounts. Even if you take out the behavioral effects that we would all have, I think, if we had an individual account in the presence of a guarantee, we would definitely put them all in stocks, right? But even if we took that out and we were only allowed to do a certain kind of investment strategies, whether or not it's thrift savings or something like that, guarantees are incredibly expensive. One of the sneaky things about budgets is that when times go down for the government, that's when times go down also for individuals. That's when they'll be needing the guarantee. These costs snowball and guarantees are very expensive in the presence of individual accounts.

Estelle James: And I might add that most of the countries that have these guarantees have not cost them out. [Laughter]

Rudy Penner: I'm sorry, I will have to close it now. I guess we're going to have a very brief break right now so I'd like to thank the panel very much. [Applause]

Panel 2: Fashioning a Grand Compromise

Warren Rudman
Former U.S. Senator and Co-Chairman, The Concord Coalition

Don Nickles
Former U.S. Senator (R-OK)

Tim Penny
Former U.S. Representative (D-MN)

Charles Stenholm
Former U.S. Representative (D-TX)

Robert Bixby: In the previous panel, we heard an extremely high-minded and substantive discussion of the hard choices that could be made in order to repair the Social Security system and make it sustainable. The political reality, however, is that in order to enact these good ideas, we need to put them through our democratic (i.e., Democratic and Republican) processes. To that bipartisan end, we thought we would assemble a second panel today that has particular expertise in this area and has been working on it for some time.

I will turn things over to Warren Rudman, our Concord Coalition Co-Chairman, who will be the Moderator for this panel on whether or not we can get some sort of political consensus on the hard choices for Social Security reform.

Senator Rudman?

Warren Rudman: Thank you, Bob, and thank you all for being here.

You all have in your packets the biographical information on all of the panelists so I'm not going to go into a lot of detail except to say they've all been friends of mine for a long time and have all been in the very forefront of budget battles and battles of entitlements, and as far as I'm concerned they've been on the right side of all of the issues. Unfortunately they have all too often also been in the minority when the votes were counted.

Charlie Stenholm from Texas recently left Congress. He had a very distinguished time there and I think his name was well known amongst those who had the interest of fiscal stability and responsibility.

Tim Penny has been a member of the Concord Board since he left Congress, right out in front on a lot of very important legislation that had to do with fiscal and entitlement issues.

Don Nickles on my right, came to the Senate with me. I will have to say that Don -- [Inaudible]

Don Nickles: [Inaudible]

Warren Rudman: Yeah, unfortunately. I was going to say, Don, that you have precisely twice as much patience and twice as much endurance as I ever had. Don just left the Senate after 24 extremely distinguished years. I served half of that, 12 years. We came together in 1980 at the time of the Reagan Revolution, and he's been a dear friend; I for one, am really delighted that you could make it here Don.

Unfortunately, Bob Bennett, who has been in the forefront of this fight with his proposal, is tied up on the Floor of the Senate, and we all understand that. The recess is going to start tomorrow, so he called us and let us know that unfortunately he couldn't be here.

Our luncheon speaker, the President of the Concord Coalition, Peter Peterson, got on an airplane in New York this morning and his flight was promptly canceled. He's now on a helicopter in-bound for Dulles Airport and we hope he's here for lunch, which will start somewhere around 12:45.

What I intend to do this morning is to have each of my friends here make brief opening remarks about whether there is a fundamental grand compromise feasible in this situation.. The politics surrounding this issue are very interesting. Everybody seems to recognize the problem but not a lot of people agree on the solution. So I'm going to start off by having Charlie Stenholm, Tim Penny and Don Nickles give some brief comments. Then we'll have some discussions will hopefully have a substantial amount of time for Q&A.

Charlie, it's yours.

Charles Stenholm: Thank you, Warren. I'm delighted to be here. I want to take just a few moments to do what we were asked here-- talk about the politics of this issue. We've heard the solutions this morning, but how do you get from here to there?

For 26 years I worked on the fiscal side of the question. For the last 10 years I've been working on the fiscal and the Social Security side. I came to be affiliated with Jim Colby, Senator Breaux and Senator Greg right here with CSIS in a commission about ten years ago. We've heard from four of the people who gave us the ideas that I have espoused, with political success, until last year. And Social Security had very little to do with my defeat last year. Gene Steuerle, Estelle James, Rudy Penner and David Walker were part of that commission. We spent a lot of time on it, and I don't think we even called it a commission. I don't know what it was called, but it was designed to put together a solution that could get bipartisan support.

The result has been the Colby/Boyd Bill. It's the only bill that still can claim to have bipartisan, bicameral support, and right now it's on life support. [Laughter]. People say “how come you're called the Blue Dog Democrats?” I've always answered in a jovial way “You know what a Yellow Dog Democrat is? There was one in Texas that would literally vote for a yellow dog if it was on the right side of the ticket -- or left, depending on your political perspective. A Blue Dog is a Yellow Dog that's been choked nigh to death. [Laughter].

Well, the Blue Dogs in the House are now on life support because bipartisanship in the House is almost non-existent. That's the challenge we have to work against now.

Now I've been working with Tim Penny on the group called “For Our Grandchildren.” That's why I have stayed, and continue to stay, as involved in the answering of the question of what do we do for Social Security. I have three reasons. Cindy and I have three reasons -- our three grandsons aged ten, seven and two. And when the first one was born, really got involved and started talking about it constantly.

The problem hasn't gone away. If there is one thing that there is political agreement on in the House and Senate, in the country and in this room, it’s that we've got a problem. What we haven’t agreed to yet is a compromise of how to solve it.

I try to never criticize anybody, and I ask everybody involved to not criticize somebody when they put an idea out there. That's the best way to not get anything done, and we've been doing that real regularly.

It's unfortunate that the political climate has deteriorated to the place that it is, because it makes it very difficult to see the possibility of bipartisan support. I think in the Senate right now, Senator DeMint and Senator Bennett are putting together two ideas separately; but together have the formula or recipe for doing something. In the House I'm glad to see somebody talking about doing something, even if they're not going to talk about solvency. At least we're getting started.

So let me now end on a positive note from the standpoint of offering a solution as to how we're going to get there. We’re going to get there by working on the “For Our Grandchildren Group” and working with folks like Senator Lindsey Graham -who has just done a wonderful job of trying - and Senator Ben Nelson, as well as others in the Senate, trying to find some bipartisan ways to deal with the issue.

I've avoided calling for another commission because we've commissioned this thing to death, but I'm of the opinion today that the only way we're really going to get any kind of bipartisan solution is a commission not appointed by the House and Senate and the administration. Other than just agreeing that the people on it know something about the subject, and something patterned after what got me as involved as I am, and put together something that I've never had to apologize for,

individual accounts make eminent good sense for the future of Social Security for my grandchildren. But the President made a mistake when he led with them, because, when you start with David Walker's proposal, and look at what we're going to hear from Pete Peterson, you'll see that solvency is the critical part of how we deal with this. Therefore, if you deal with solvency first, and deal with the tough medicine you've got to take there, then individual accounts make sense. As for how we get back to that, I think what we need is a commission patterned after the BRAC Commission, in which we basically have an up and down vote scheduled on the House and Senate Floor for one of the better ideas that can be put together by men and women who have some idea of what they're talking about. And if that doesn't pass, then we go back to the drawing board and try something else.

Warren Rudman: Tim?

Tim Penny: Thank you, and thank you Charlie for those observations about the politics of this issue.

I want to speak specifically about bringing Democrats to the table. What I'm going to offer won't be new to this audience, and probably isn't unknown to most Democrats on the Hill. It seems to me that if we could move away from the politics and towards a policy discussion that these policy considerations ought to bring Democrats to the table, because the policy implications really bump up against values and policies and programs that are vitally important to any self-respecting Democrat in Congress.

The first is just this whole question of how much of the government do we want to devote to entitlements. We sort of debate everything on Capital Hill on its individual merit, and everything has individual merit; but these relative claims on the federal budget are important. As David Walker and others have pointed out this morning, this pie keeps growing and growing with each passing year in terms of the degree to which we are devoting the commitments of the government to an entitlement agenda. We've gone from about a third of the government being devoted to entitlement programs back in the 1960s to about 50 percent today. By the year 2020 it will be about two-thirds of the federal budget that's committed in this direction. It leaves very little left, and of course for Democrats who may not be as enamored with the Pentagon budget as they are with the domestic discretionary agenda, there's still a lot in that domestic discretionary agenda that is going to come under increasing pressure as we allow entitlement growth, Medicare and Social Security, to eat up a larger and larger share as time goes by.

Related to this is what happens when we begin repaying the Trust Fund. Under law, the Trust Fund will have a first claim on the rest of the budget. That's what it means to invest these Social Security surpluses in Treasury Bills, special issue Treasury Bills. So unless we change the law to redefine how we intend to honor those Treasury Bill obligations, they do become a first claim. Today, interest on the debt is the first dollar we spend every year before we consider anything else; similarly, these Trust Fund repayments would become a first claim on everything else.

What does that really mean? It means that before we can talk about anything else in the budget, starting in the year 2018, these Trust Fund commitments will have to be paid out, and those commitments grow from about $20 billion in the first year to $200 billion within six or seven years, to $300 billion within ten or twelve years. These are not insignificant obligations that will have to be paid out.

If you want to look at the equivalency, what is it the equivalent of? Well, in probably the third year of Trust Fund repayments we would have to eliminate the equivalent of Headstart, Student Financial Aid, the WIC program, Foodstamps, and the Department of the Interior. That's just within a few short years. That's the equivalency of these costs.

So you would think Democrats would look at that and the competition that these Trust Fund repayments are going to place on the rest of the budget, and it might cause them to think more seriously about doing something now to avoid that eventuality later.

The other thing that I would think should bring Democrats to the table is this whole intergenerational aspect. It's been highlighted frequently that we have about an 8:1 ratio right now in terms of federal spending on those over 65 as opposed to those 18 and under. It doesn't strike me

that that's really where Democrats as a party want to be, that they want to have a federal government that's investing far more in those of us who are toward the end of life as opposed to those of us that have our entire lives ahead of us.

Related to this is what kind of a burden do we put on each succeeding generation? In order to finance these obligations for the elderly as opposed to either constraining those obligations or pre-funding those obligations in a more sensible, fiscal way, we have a pay as you go system that essentially means each passing generation of Americans, or each new generation of Americans, ends up paying more with the prospect that they will get less.

One example of this is how we patched up Social Security back in 1983. We essentially said to the working generation at that time that they would get lower benefits out of the system because we were going to raise the retirement age in the timeframe between their employment and their retirement, while at the same time accelerating payroll tax increases to get more money in the system. So you pay more, and the tradeoff is that you have benefits less generous than the generation preceding you.

This intergenerational argument, I think, is one that Democrats ought to take more seriously than they seem to be taking today, and that ought to bring them to the table.

The third thing I think Democrats ought to consider is that we can't do this all on the tax side. I think we should look at that in two ways. One is this payroll tax equivalency, and I don't suggest that we're going to do this all with payroll taxes, but I think it is worth noting that in past years when we've run into a problem here we have raised the payroll tax. We've raised it repeatedly in order to accommodate the higher and higher promises that were being made toward the Social Security system. And if we continue down that path, the increase becomes rather sizeable. As others pointed out earlier today, if we were to raise the payroll tax immediately on the presumption that we could somehow save this money and accumulate interest over time, you'd have to raise it anywhere between two and four percent, beginning now. And then somehow honestly save it, and that alone is a sizeable payroll tax hike for younger generations of workers, and it compounds the problem that we've created in previous years by essentially telling each succeeding generation “pay a little more but don't necessarily get more back.”

If, however, we wait until the crisis hits and then we resort to payroll taxes to fill the void as opposed to a general fund transfer, you're looking within about a 20 year timeframe of something in the neighborhood of a 50 percent increase in payroll taxes. So this is the magnitude of the burden that we're talking about on the tax front, if we use payroll taxes.

If, however, we throw out the old canard that we can just tax the rich to take care of this, I think the question Democrats need to face is does that really fix the gap we face? Even if you apply a tax increase to all of the wealthy it's not sufficient to create a permanent fix for the Social Security problem. It buys you a few more years of solvency, but then we're in trouble again.

Now you can probably tax them more and not give them additional benefits based on those higher taxes, but you're still going to reach a point well before the 75 year window in which we're right back into the ditch again.

So the taxes don't in and of themselves fix this problem. And you can't tax the wealthy for everything. I mean, I hear Democrats saying we're going to essentially tax the wealthy to balance the budget. We're going to tax the wealthy to fix Social Security. We're going to tax the wealthy to provide universal health care. You can do it once. You can soak these folks once for one of these purposes, but you can't do it for all three purposes. At some point that canard sort of runs out of steam.

So it seems to me this whole notion, even if you want to tax the wealthy, you want to spend all of that simply on this problem or might there be other ways that we can approach this issue?

The last thing I would say from the standpoint of why Democrats ought to come to the table, is just straight up politics. This has to do with wining elections now and in the future. And as you look at the younger generation of Americans, they are increasingly convinced that this program is broke, and that they are - pardon my vernacular - screwed, and they're fundamentally right.

Any party that is perceived as being blind to that fact is a party that's not going to sell very well among younger generations of Americans who have come to believe that this is a system that

just doesn't hold up over time, and that something has to be done sooner rather than later or they're going to have a worse and worse return on their investment.

The other thing is, even if you look at the elderly population, those that are at or near retirement, in the past two elections in which Social Security reform was highlighted in attack ads in all of the key battleground states, the President ended up with 50 percent of the elderly vote. President Bush, who talked about reforming Social Security, ended up with 50 percent of the vote as opposed to a Democrat who was trying to frighten seniors into voting for the Democratic ticket by asserting that the President was out to destroy their Social Security. So even among the elderly, we're doing no better than splitting the vote by demagoging this issue.

For all those reasons I think Democrats ought to think twice about staying away from the table, because I don't think their agenda, in terms of domestic programs in the future, (i.e., investing in the future as opposed to investing increasing amounts of our largesse in the retirement population) or in terms of votes at the ballot box on election day, is being well served by a strategy that simply defends the status quo.

Warren Rudman: Thank you, Tim. Don Nickles.

Don Nickles: Warren, thank you very much. I'm delighted to be with my former colleague Warren Rudman because we did have a lot of enjoyable years together in the early '80s and '90s and also to join Congressmen Penny and Stenholm. I've had the pleasure of working with them and I wish there were more people like them serving on the Democrat side in Congress and in the Senate.

I participated in a discussion with Terry McAuliffe Monday before a big, large business group in Colorado Springs and somehow we got onto Social Security, a topic in which I happen to be very interested. I will also admit my bias. I'm co-chair of *Compass,* a group that's trying to reform Social Security and provide for personal savings accounts, defined contribution portion. And so the question came up on Social Security. I went into a little spiel about how important it was, it needs to be reformed, I complimented the President, the first President in a long time that's ever had the guts to lead on it. A lot of his advisors told him don't do it. Nobody else is behind you. Congress doesn't really want to do it and people say "hey, wait a minute, they don't want to do it until there's a problem that hits them right between the eyes. They don't listen to David Walker and Don Nickles and others, they want to wait or they're just not quite attuned to it."

And we don't have the Democrats, at least in the Senate. I had the pleasure of serving on the Finance Committee with Pat Moynihan, John Breaux, Bob Kerrey. They were Democrat who were willing to wrestle with the big, tough issues, and willing to say "we need to actually do some of these things." There's no one like that now. None. I wish that was not the case, and maybe I'm wrong, I hope that I'm wrong, but I look at statements that my very good friend Harry Reid and others have made, and they don't want to touch it. Terry Mcauliffe's comments when I started talking about reform were indicative of exactly what I'm talking about. I said, we need to address it and do it now, that demographically, if we do it now it's a whole lot better than trying to do it when it hits you right between the eyes 13 years from now. Terry McAuliffe's response was really funny. He said, I'll tell you want I think about that. It's dead.

D-E-A-D. I want on about how irresponsible it was, but the Democrats aren't offering any solutions, all they're doing is saying no, no, and Terry says, D-E-A-D. It was funny, but it's not funny. This is too big of a problem.

Charlie said the reason he wants to do something on this is for his grandkids. I have four grandkids. It's unconscionable to think we're going to leave them this present system.

Frankly, Social Security's not a very good system -- I'm in the process right now, I started a new business so I'm putting together a 401K for all my employees. Could you imagine if I had told my employees, hey yes, I want you to put in 12.4 percent of your pay with after-tax dollars. Not pre-tax, not 401K dollars, but after-tax dollars. And incidentally, if you die and you don't have a surviving spouse and your kids are over 18, you get zero. They'd throw something at me. Really, they would say that's the crummiest system they've ever heard of. Think about that.

And so I'm just telling you, I think that really we need to have some reform. I'd venture to say

every person in this room has a defined contribution, a 401K, some type of system where you're putting in a percentage, maybe your employer is matching it or putting in some percentage as well, and you're letting it grow, and you're investing it in some way, shape or form. Every federal employee has that option and we all loved it. Loved it. All of our employees had it, all of them loved it, all of them had great returns in certain years and maybe not so good in other years, but they still love it. It's a great thing to do. And the entire private sector is moving away from unfunded defined benefit plans, but not the government. The entire private sector is moving into funded, personally owned and controlled defined contribution plans. Everybody is. And if they're not, they're behind the times and they're making a mistake. And their defined contribution plans have beneficiaries so when they pass away their kids will have something, so they're investing. They feel like they're creating equity. They can control the investment. All those things are in the private sector; but they're not in Social Security, and they should be.

So I compliment the President for saying we need to reform it. This group is being great in saying we need to reform and save it. We need to make it fiscally responsible. The President is on that wave length as well. He just didn't want say “here's the plan you have to do” and give his adversaries more rocks to throw. But frankly, there are a lot of things that can, could and should be done.

Social Security is the only retirement system that I know of in the country that's indexed on wages. There's not a private sector system in the country that's indexed on wages that I've found. It's over-indexed. It is not affordable.

Some people say oh, if you move the indexing and you move it to CPI or to price indexing or indexing that everybody else in the world uses, oh, that's cutting benefits. I don't think it is because we can't afford the benefits that are out there right now. We cannot afford it. It is not sustainable. I think that is an imminent good thing. It happens to fix about two-thirds of the problem. But it needs to be done now, not later. The sooner you do it the better off and more affordable the system will be. It needs to be done and we need to have responsible people that say hey, let's hold hands and do this together. It takes a bipartisan solution. You can't do Social Security with Republicans only. Maybe they can do it in the House. But you can't do it in the Senate. So we need to have responsible people say hey, we've got big problems.

Congressman Penny is exactly right. From the Democrats' perspective, hey, wait a minute. If you look at the growth of the entitlement programs it doesn't leave much for the other discretionary programs that a lot of members would like to spend more money on. This is going to gobble all the available money away. So can't we do this in somewhat of a painless way?

Every retirement system that the unions and everybody else has that are indexed, if they're indexed, are done so to CPI, not to wages. So couldn't we do this? And wouldn't it make sense? Absolutely it makes sense.

Can we get the votes? I was in the Senate for 24 years, as Warren mentioned, and I count votes pretty well. Right now unfortunately we haven't seen the votes. My very good friend Bob Bennett was here, and he's been advocating what is commonly called progressive indexing. I think we ought to have corrected indexing. Progressive indexing says we're going to continue over-indexing the low income people, i.e. no change; and then we'll have more correct indexing for upper income people. That's better than nothing. But frankly, we can't afford the system that's in there right now and I just make that point and hope that members of Congress will address it.

A couple of other points I want to make. Some people say “well, the real solution is we just need to increase the wage base.” I was one of the few members in '83 that voted against the Social Security package. I did because I saw an enormous increase in the base. I said that is an enormous tax increase. I look back on it now. The base back at that time was like $35,000. Today it's $90,000. So we've almost tripled, well we have tripled it because we also had some increase in the payroll tax as well.

The way that Social Security is financed doesn't work and doesn't make a whole lot of sense. Let me touch on it just a little bit. So you have an enormous increase in the base and some people want to increase the base further. I think that's a mistake. For two or three reasons. One, I don't give a whole lot of credibility to these super government funds that we say we're putting into a vault in

West Virginia. Those won't be redeemed, they will be reissued. We will issue more debt to pay those off. To pay off those bonds you either issue more bonds or you raise taxes or cut spending, and I've been around a little while. I think what we'll do is issue more debt; so enough of that. So the government will spend the difference. If you had an increase in the base right now, you're increasing the "surplus" theoretically going into the fund. You're increasing the amount of money the government will spend in other areas, and that doesn't make a lot of sense.

Another advantage of having individual accounts is that the government couldn't get their hands on any of it.

So I think that one of the worst things that Congress could do is increase the base or the premise on the way it's funded. Right now you're paying,$14,000; if you make $90,000, you're paying $14,000, and that's a lot. In '83 it was less than $5,000 so it's gone up dramatically in the last 20 years. But you have to pay that with after-tax dollars. So a person making $90,000, they pay $14,000 but they had to earn about $20,000 to pay the $14,00, that's pretty high and not a very good deal. Especially if they do that their entire life and they pass away with no surviving spouse or kids, and don't get anything. That's a pretty crummy system. If you're designing a system, like I said, that doesn't work very well. That won't sell.

So is there a better way to finance it? Surely there is.

I kind of appreciated the fact that Congressman Thomas said maybe we should look at Social Security reform in context with overall tax reform. It bothers me greatly to think that the highest marginal rate taxpayers in the country are people that are making, $60,000, $70,000, $80,000, and are self employed.

If you're self-employed and you and your spouse have a combined income of $50,000-some, you're in the 25 percent tax bracket, so that's 25 percent, and your Social Security and Medicare's 15.3, you're at 40.3. If you live in Virginia or most other states, average state income tax is about six percent, that's 46.3 percent in tax that you pay on every marginal dollar. That's higher than Bill Gates pays. Now what sense does that make?

Clearly there are a lot of inequities in the system. And the solution isn't to say well, let's just increase the base up a little more to 120 or to 150. Tim is exactly right. All that does is it theoretically buys you a couple years to put in more, issue more special bonds that will be in a bank. The government can go spend the money on something else and then when those bonds come due in not 40 years, but frankly, 2017 -- 12 years. then we have to issue more debt to pay them off. To me that's really not a very good solution, although I appreciate and respect people who are trying to offer viable alternatives.

I think that maybe we need to reconstruct things a little bit and ask how to pay for this? Can we pay for it in a different, more comprehensive way? If you're going to have a payroll tax you should have a defined contribution system. I feel that very strongly. If you're going to have a payroll tax method to do this you should have a confined contribution system. A lot of companies have combinations of defined benefit systems and defined contributions and my guess is we could work out something like that. You could keep a premise of a defined benefit, promise benefit coupled with a growing personalized defined contribution system. I think you could work on that. I think also you'd look at how we finance the overall system and maybe replace the idea of the payroll tax, which is a pretty regressive tax, with a different type of broader base tax to pay some of the benefits as well.

I compliment CSIS and Concord for bringing these issues up, and I wish I could be more optimistic.

I was in the gym this morning with some of our colleagues and told them I was going to be addressing it. I said why don't you give me some good news and tell me hey, we're going to mark up a bill. And Chairman Grassley, let me say, I don't concur with Terry McAuliffe when he says it's dead. I think this is too big of an issue. I know that Chuck Grassley's still working and he's a good legislator, so he's working. Chairman Thomas is a good legislator. So where a lot of people say hey, this is dead, you can't do it, there's no will behind it. I don't count the votes for getting it done, but I just think that's unfortunate. I think it's way too important. People need to wake up. They need to realize that this is just a vitally important thing for the future of our country. The sooner we act, the better off we'll be. The later we act, the more draconian the efforts will have to be to repair the ship.

That's tough, and it's not 44 years away from now, it's about 12 years from now.

Congress is going to be very hard-pressed to issue that extra couple of hundred billion dollars of debt in 20 years to keep this thing on a positive keel. That's going to be very difficult to do.

Anyway, it's a pleasure to join you.

Warren Rudman: Don, thank you, and thank you all.

I want to just pick up on something that you had just said and repeated about how this will eventually be financed. I think most of us who look at it have come to the conclusion that the unfortunate realities are that unless something is done and done fairly soon, it we'll end up just substituting new debt for old debt. And I want to address that and give some perspective and then ask you all to get into a specific discussion about pending proposals.

There's a very interesting article in one of the financial newspapers in the last week about the Chinese automobile industry. There was a number in there that was just staggering when it hit you because they are really gearing up now to produce incredible numbers of cars, not only for their own domestic use but for possible export.

It pointed out that the fully weighted average wage in the Chinese automobile industry was $1.50 an hour. And the average, fully weighted cost of United States automobile production was $55 an hour. Then you look at how much of our debt they've been buying, both in terms of our fiscal debt as well as our current account balance, which is something we're not even going to talk about today. If you put all that together, it seems to me that unless there are major changes in how currencies are valued, which doesn't appear to be imminent in the Chinese case, that you have to wonder how long there will be people out there willing to buy the amount of debt that they've been buying and at what point that doesn't put us in a geostrategic position that we don't want to be in, one in which we are worried about whether or not people will buy our debt and guide our foreign policy and to some extent our domestic policy in that way.

So with that general background let me ask the three of you a question. Our friend Bob Bennett from Utah caused quite a stir a couple of weeks ago, and I'm not really sure exactly what happened, but the press seemed to say that Bennett had made his proposal which did not include personal or private accounts, and that the White House somehow said that was okay. And then what the White House said later was no, we fully agree that from the solvency point of view Senator Bennett's proposal is a sound proposal, but we still believe that private accounts are very much required, following along the lines of the excellent presentation that Don Nickles made.

Looking at that whole exchange and knowing what's going on up there, I'd like each of you to comment on the following question. Will we get solvency reform without the personal accounts which have been a centerpiece of the President's plan, or are the two required to be done together to get anything done at all during this term of Congress?

Charlie, let me start with you.

Charles Stenholm: That's a tough question, and let me say I personally don't see how you get there in the general context we've heard expressed by the panels before us today and the context of the China question which you just briefly mentioned. But I would defer to what we'll hear regarding our overall fiscal position and our trade deficit at lunch today from Pete Peterson. And I've been wrong now for three or four years because I think we can't keep on this track, but I keep hearing every day we can. The basic economic plan of this country today as advocated by the majority party is that everything's going fine. That doesn't contribute to bipartisanship a whole lot when you happen to believe sincerely, as I do, that we need to make some changes.

To answer your question, if we're going to get to bipartisan on Social Security which we've got to do, there are only four things you can do for Social Security. You've got to cut benefits, raise taxes, grow the economy or borrow the money. That's it. Now how you get there. that's where the bipartisanship comes in.

To get there we've got to put everything on the table. We've got to be honest and fiscally responsible with the result we heard from those that were talking about solutions, and then absolutely protect the social insurance safety net for the most vulnerable. If you don't do those three

things, you don't have a prayer of getting there in the context that we're talking about.

And Republicans can't keep insisting that individual accounts must be part of the solution, but Democrats can't insist that they not be on the table. I associate myself with the words that Tim said regarding my party. Republicans need to be willing to put revenues on the table. And then sit down and work out these other difficult questions.

Warren Rudman: Tim?

Tim Penny: Two points that I would make in response to your question. I think that if Democrats look at solvency only, they're going to find themselves in a real bind because it sort of gets back to what we did in 1983 -- cut benefits, raise taxes. And none of that's easy, none of that's fun.

So to me, if you leave personal accounts off the table, you're leaving off the table the only option that changes the equation for the next generation of workers in a positive way. If the fix is simply tax increases and benefit cuts, it's all pain and no gain. If you leave personal accounts on the table, then for the next generation of workers you give them the opportunity to earn back what they may have to give up in these other areas because, as Charlie said, there really are only a few ways to deal with this. You can raise taxes, you can cut benefits or you can increase the earnings on the money that you're paying. You can either increase those earnings for the benefit of the system or you can increase those earnings for the benefit of the individual.

So I think taking them off the table and dealing only with solvency is a zero sum game. It's all pain and no gain for the succeeding generation.

The other point that I would make is that personal accounts are the only way to honestly save money over the long term. We raised taxes in 1983 and we've set them aside in a trust fund, but the trust fund is really a liability, not an asset. The only way you make it an asset is to put it in a real account that's owned by the individual.

If we had taken the surplus we created in 1983 and begun right away investing that surplus on a pro-rated basis in individual accounts, we'd be well on our way to a solution today. We wouldn't be looking at an increase in our unfunded liabilities to the tune of $600 billion with each passing year. We'd be looking at a decreasing unfunded liability in those out years.

So to me, you can either pre-fund in some fashion the decision to create these personal accounts and then obviate the long-term unfunded liability, or you can just stick with the current system and face this continuing burden of unfunded liabilities on into the future.

I think Mike Tanner at Cato Institute, and I don't subscribe to their Social Security reform plan, but I do want to identify myself with an analogy he uses: it's sort of like pay your credit card off now or pay the minimum forever. That's sort of what you're dealing with here.

To me, even if you're a Democrat that's leery of destroying the safety net and all of those legitimate concerns, there's a reason to come to the table and I think there's a reason to leave personal accounts on the table because it gives you one more piece to put into that puzzle and you may find that you end up with a better picture at the end of the day if that piece is in there as opposed to trying to put together the puzzle without it.

Warren Rudman: Don, I want to ask you the same question but let me add just one other dimension to it. That is, in the last several weeks we've heard a number of proposals designed to confront the issue of what to do about the gap? There's been talk about issuing Treasuries to these people who are going to be eligible for private accounts.

So if you could answer the basic question I asked Tim and to Charlie, and maybe talk about how we do fund that gap, because there will be a gap and the one thing you don't want to do, hopefully, is simply add to the fiscal deficit.

Don Nickles: A couple of comments. One, I'm not positive -- When we're referring to Senator Bennett's bill I think we're talking about progressive indexing.

Warren Rudman: Correct.

Don Nickles: I'm assuming -- I don't want to be saying that, and maybe there's something else, but I think progressive indexing is so much better than the total incorrect indexing that we have right now, that it's a giant step in the right direction. Some would say it means testing. So be it. To me it over-inflates indexing for the low income people and maybe that's a necessary prerogative to be able to pass it. Again, I know how to count votes, and so maybe that's necessary to have that happen, but it is over-indexing and I'm not sure we can afford any over-indexing but that's a whole lot better than over-indexing for everybody.

When we worked out the Medicare bill last year, we ended up passing a form of means testing on Part B Premiums. I was a sponsor of that. Frankly, I think we need to do it. I said we reduce the subsidy for upper income people. Call it means testing, I can't pass it. Say less subsidy for wealthier people, people said yes. So we could pass it.

Male Voice: You can call that affluence testing.

Don Nickles: You can call it any way you want it, but you and I are on the same wave length. You understand what we're trying to do.

Why in the world should you over-index people's benefits when you can't afford it? It makes no sense.

Part of Tim's comments was, "hey, can you just pass a bill that's just all pain?" That's what some people are saying, that this is all pain. I don't think it's painful to say "hey, we're going to have a correct index." I just think anybody in their mind would say "oh, I'm going to get a lot less than what I would get 30 years from now." And that's Hogwash, because with the present system you're not going to be able to get it. They're not going to be able to increase Social Security taxes 50 percent 20 years from now or 12 years from now. Now we did increase these taxes dramatically in '83, but keep in mind in '83 we were talking about a lot less tax. You were capping out on $30,000, so a lot of people weren't thinking that much about it. Now you have a lot of people thinking about it. Oh, yeah, I'm trying to put money in a 401K. Well look how much money you're putting into Social Security and what kind of return are you getting on that? You say whoa, this is not a very good deal.

Enough editorial commenting.

I desperately want private accounts to be in there. I may want a fix on the over-indexing every bit as bad because that has a direct relationship on whether or not my kids are going to be able to afford to pay this in the future.

I hate to think that if right now I'm complaining because the tax is $14,000 with after-tax dollars in this system, that my kids are going to have to be paying 50 percent more than that 15 years from now. That's just too big of a burden. If they're making $90,000 they're going to have to pay $24,000? We're going to take that big a percentage? That is unconscionable. I don't think it's affordable. I don't think it's doable. I think future Congress is going to back off and then they're going to say Warren Rudman, you're making too much money, you don't get any Social Security. They're going to have to really make tough decisions in the future if we don't start making more mild decisions --

This is a mild decision. This is saying "well wait a minute. Instead of having a COLA adjustment of 2.4 percent it might be 1.9 percent." That's not a lot, but granted, over 20 or 40 years it makes a lot of difference and it helps put the system back in a more solvent train.

Warren Rudman: Before we go to questions and discussion in the audience, I'm going to ask a very unfair question, but no one here currently holds office, so we'll try to get an answer.

I would like each of our panelists, and I'll give you my view at the end, to answer the following question, which is really the subject of the panel: Will we have a result during this Congress in the President's initiative? And what will it look like?

Charlie?

Charles Stenholm: I'm a farmer in real life. I'm the eternal optimist; the glass is always half full. This time it's half empty. It's going to be tough.

In the spirit of friendship, let me point out some of the difficulties of getting to bipartisanship. When Don talks about his views I find myself in substantial agreement with everything other than the fiscal side of the manner in which my friends on the other side of the aisle have handled the economy, and I've said so over and over, and it helped get me beat. They redrew the lines to where I wouldn't be there.

Well, let me say, I'm not bitter. The people spoke. Life is good on the other side of the desk, and I'm happy to be here now hoping to be a constructive part of working with the folks in this room and with Don and Warren and The Concord Coalition and CSIS for a solution. That's what we're after. But the rhetoric we get into is what's making it difficult.

It's difficult for me to have people walk up to me and say Charlie, how can you profess to be a Christian and a Democrat and mean it? Sincerely mean it. In Texas. In my district. Now that's part of this overall climate that we're having to work through, and it's difficult.

On Social Security per se, I hope we will have a solution this congressional session, because I know every year we wait to come up with a solution that's going to make it that much more difficult. We need to roll up our sleeves and do it, but it's difficult to do it in this climate. And I can't be overly critical of my party. I'm a little disappointed, but I can't be overly critical as Don can, because he's in the other party. I understand that. I believe in our two party system.

But we've got to learn to have disagreements without being as disagreeable as we are. And the House is different than the Senate. Very much different than the Senate today in our partisanship. But some how, some way we've got to find a positive answer, Warren, to your question. And right now, I, for the life of me can't see it, but I know it's out there. There's a pony in that pile somewhere.

Warren Rudman: All right. Good. Tim? Where's the pony?

Tim Penny: Well, I think the digging is going to be messy. That much I'll say.

I'd prefer to be an optimist partly because you cannot and should not underestimate the power of the presidency and this President will not relent. He's committed to Social Security reform.

I would like to think it will be done during this session of Congress, but odds are it won't done be this year. Slipping it into an election year is always difficult, but it also gives us more time to develop the debate and to try to get it off the partisan track and onto the policy track. And here are four quick observations as to how we might get this back on the policy track.

The first is that there might be some merit - and it might invite more Democratic participation - if we broaden this beyond simply Social Security to retirement security and look at some of the other pieces and the other policies related to 401Ks, IRAs, you name it, and make this part of a larger retirement security package. It might allow us then to do some things in Social Security that we otherwise might not do because we can see how it's going to be replaced or supplemented by some other retirement incentives. So I think that might be one way to do it.

Another issue is the trust factor, and this probably rests with the White House more than anyone else. How they treat Democrats on Capital Hill on one issue has a lot to do with how they will be treated by Democrats on other issues, and I think they sometimes approach these issues in isolation of one another, forgetting that poisoning the water here doesn't mean that the water doesn't trickle downstream, poisoning the water for the next debate.

Part of this is the way politics is played outside of the Beltway. It's one thing to lament the AARP airing demagogic and unfair advertisements in opposition to the President's plan, but you ought to be equally critical of groups like “Club for Growth” that go out and attack those that are trying to be part of the constructive debate. I think the White House can go a long way to build political trust by even-handedly condemning the sort of negative politics that are being played out there by groups that everyone knows are closely associated with one party or another.

One-on-one dialogue, there's nothing that substitutes for it, and the more the President can meet with legislators, including some in his own party that are very skittish about this issue, but

especially any and all Democrats that are at all gettable, the better for him. And anybody on Capital Hill -- Bennett and others -- that have the courage to be out front on this issue really ought to be spending perhaps the bulk of their time over the next several months in one-on-one confidential discussions with Democrats to try and figure out what it's going to take to get some of them to become part of the dialogue.

The last thing that I think can have some value between now and whenever this comes together, hopefully during this session of Congress, is the need to continue exposing the phony fixes.

I like Charlie's idea of bringing the do-nothing plan up to a vote. I think somebody ought to do that.

Back when Reagan was in the White House we would sometimes bring the Reagan budget to a vote before we'd then vote on the Republic budget, or the Black Caucus budget or the Democratic budget. Very often the President's budget would get 15 or 20 or 30 votes, but it was exposed as a budget that even most Republicans weren't going to vote for, and then it allowed us to kind of move on and have a more intelligent discussion about how to proceed.

I think a vote on the do-nothing plan would be great. It would smoke people out.

I think there is some merit to what DeMint has put forward, because you can either save the surplus in a trust fund or save it in personal accounts. I don't pretend that it's a comprehensive fix, but it at least sort of smokes people out and creates a debate about what is that trust fund?

And I think there is some value in some of these partial steps, just to kind of make the debate a bit more honest about what we're really facing.

I'm not here to suggest exactly what other ideas along the lines of the DeMint idea could be brought forward, but I think a series of votes of that nature could begin to sort of put people on record. And once you get them on record it's either going to cause them to be more realistic about what they're willing to support or it's going to expose their hypocrisy when they vote against all of this and then they don't vote for a solution either.

Don Nickles: A couple of comments. One, I was rather shocked to find out when I looked at the redistricting plans in Texas that Charlie's district was now in Oklahoma. [Laughter].

I really enjoy these conversations, and I wish we could get more of our colleagues engaged in these conversations. I agree with Tim.

Warren's question was what are the chances of doing it and I keep going back to Terry McAuliffe saying D-E-A-D. But the problem is just too great to ignore, and it needs to be addressed and we do have serious legislators. I have confidence in Chuck Grassley and Bill Thomas who will be spearheading the effort frankly in both houses, so I don't want to say it's D-E-A-D. It shouldn't be. I hope it can be addressed.

I want to make just a couple of editorial comments, though, because people say “wait a minute what about this surplus,” and “we have all this extra money,” and “if we raise taxes we'll have more surplus, and that will help fund it.” My experience tells me no, it's going to be spent some place else and we're just going to be increasing the IOUs. So as Tim said, it's not an asset, it's a liability. He's exactly right.

And I also want to throw water on the surplus. The total amount of money that's raised in Social Security and Medicare taxes, the total outlays exceed the total revenues today. There is no surplus.

Now on our accounting, David Walker will tell you “well, we show that there is,” but we don't count the fact that we subsidize Medicare through Part B subsidies. We pay three-fourths of that out of general revenues. So if you take that away and you don't give credit for this interest being earned in this bank account -- I'm just talking about cash flow - the total amount of money coming in in payroll taxes, that 15.3 percent that's raised on everybody's payroll up to $90,000, no limit on Medicare. Total amount of money coming in for all Medicare and all Social Security through the taxes and total amount of money going out for all Medicare and Social Security, outlays exceed revenues. There is no surplus, period.

So I made that comment a few times but people said “oh, no, we have a great big surplus

and we're stealing the surplus" and all this kind of stuff, and I say hey, if you just put it all together, it's not. And guess what? All the money goes into one pot for the federal government. All the money does. We write checks out of that same pot. And we borrow the difference if there's a shortfall. Period. That's Economics 101, but that's how we do it. I think a whole lot of people have this misconception of "oh, well, that's Social Security. That's different from income tax". But it's all put in the same pot and the checks are written in the same, then we put IOUs in sometimes, in different accounts, and those are actually liabilities instead of assets.

But to answer your question, I don't want to be so negative. I want something to happen. I want personal accounts to be in there. I want a more accurate CPI so we can have a system that our kids will be able to afford. And I'd like for our kids to be able to have a system that I can be proud of.

To leave them this present system bothers me a lot. It's not financially solid, and we can do so much better. This economic engine of our country is enormous and we could even help it greatly if we really did reform the system and moved away from the unfunded, defined benefit government promise, this pay go system, into a funded, capitalized, personally owned and controlled system. Even if at least part of our system was that way, I think it would be an enormous economic benefit to this country.

Warren Rudman: I served on the Budget Committee with Don, and he later became Chairman of the Budget Committee, and the information you find out on that committee is pretty amazing. For instance, a lot of people who are members of Congress don't understand what he explained in his little exposition on cash flow versus so-called surplus, and it's a very important point.

You look at the stark numbers; it's even more frightening than the numbers that you hear.

Let me give you a somewhat nuanced answer to my own question and then we'll have some Q&A.

I'll start off with this statement. In my view, the country is currently developing a negative opinion on the President regarding the whole question of the Iraq war; we don't talk about why or what or if it will change, but I believe that's true. I believe that, politics being what it is, that if that continues, (and we surely all hope that it doesn't, because if it turns it means things are going better in Iraq), politics will play itself out during this term. And Tim asked the question about connectivity of issues. They connect in lots of ways, and one of the ways they connect is unfortunately that if the President has serious problems with the American people on his Iraq policy, I don't think anything will happen with Social Security, because I don't think the Democrats will move in any way whatsoever. I think they will take full advantage of that and try to go into the '06 elections with that issue and the claim that the President was trying to "destroy Social Security", although in my view, he has shown enormous courage in moving ahead on his proposal. Whether you agree or disagree, he at least is a President that is willing to put his reputation on the line to try to fix the issue which I think is extraordinarily laudatory.

Now assuming that doesn't happen and things stay about what they are, I'm also an optimist. I think that unless there is a major, further erosion of the President's position with the American people, then I believe that we will have a solution during this term of Congress. I think the solution will be somewhere along the lines of changing the indexing, whether it's progressive indexing or something better than it is, and I sense that there will be some sort of a start to what has been referred to as "personal" or "private" accounts, either in the form that originally was proposed or the latest proposal which talks about issuing Treasuries, if you will, to people who make that choice.

But that only will happen, in my view, if the President's position with the American people on the question of Iraq does not erode further. If it does, I'm afraid we're in for a very nasty '06 congressional election, as nasty as we've seen in a long time.

Those are the views of the panel. We'll take some questions for the 15 minutes or so we have remaining.

Question: [Inaudible]

Warren Rudman: That's a very good question. I would just comment on my own personal

somewhat bitter experience shared by Don Nickles. We were elected in 1980 and as you all know from the period of 1981 through 1984 there were some tough votes on major issues cast mainly by Republicans in the Senate on what I thought were some very good, sound proposals. How many of our colleagues did we lose?

Don Nickles: About half.

Warren Rudman: We lost half. Half of the class was defeated. And rather than playing a constructive role, I have found both parties playing a destructive role in attempting to bring parties together. In fact it is the political parties themselves, and with all due respect to the consultants that are employed by those parties and the special interest groups that revolve around the parties, they are as much a part of the problem, and they've never been part of the solution.

Don Nickles: Let me add a little something to clarify.

I was talking about having correct indexing. In 1985 Warren Rudman and I and the majority of our colleagues voted to freeze all COLAs. A great vote. Remember we brought Pete Wilson --

Warren Rudman: I helped him up the steps, he was on a stretcher.

Don Nickles: We passed it. That wasn't saying correct indexing. That was saying freeze COLAs for a year.

Warren Rudman: One year.

Don Nickles: I was an advocate for it. The House declined to do it and then a whole bunch of people from our group lost and they blamed it on Social Security, because there were groups that were out there saying “hey, they voted to cut my Social Security.”

Warren Rudman: Fortunately, Don is from Oklahoma and I'm from New Hampshire where people obviously have good sense about what we did. [Laughter]. That was not the case for eight of our colleagues.

Don Nickles: I'm just trying to shave COLAs back a little bit. At that particular point in time we were trying to freeze all COLAs -- veterans, Social Security, and so on. A rather tough vote. In today's climate they act like you're trying to do away with something really bad if you have a CPI instead of a wage-based index. Wow. It's somewhat relative.

Part of the difference, though is that in the past, at least in the Finance Committee, where a lot of this is going to be done, we had some Democrats who were very good and responsible, as I mentioned before, Pat Moynihan, John Breaux, Bob Kerrey. Some were on these commissions that we've discussed, and they all recognized and realized the magnitude of the problem.

The Finance Committee today has been weighted more toward people who are less inclined to be independent thinking on long term, big issues.

Warren Rudman: Also I think you have to mention in that connection, Don, that what you saw at that time with Bob Dole and Pat Moynihan coming together -- I just don't see that happening today. The world is unfortunately changing. And as I pointed out earlier when I introduced Don, he had twice as much endurance as I had. He stayed there for 24 years. After 12 I decided I didn't want any more of that.

Tim? The question about parties and --

Tim Penny: I concur with your point about the role of interest groups. It's a piece of what has polarized the institution, but there's also this reapportionment piece that has, in the House, led to

a more polarized institution. There are far fewer moderates in either party today because there are far fewer competitive districts.

I always joked when I was in Congress representing southern Minnesota as a Democrat, “this is a district in which I was the first, last and only Democrat to represent that part of the state”. But I always thought it was to my great advantage and made me a better legislator because I had to go home every weekend and explain myself. That creates a different relationship with your constituency. It causes you to look at issues in a less partisan way because you just can't go home and spout the partisan path and get away with it. You've got to go home and reason with your constituents.

So I think there's something to be said for competitive districts, where the nominating process is essentially the general election. You get nominated, you're elected. But that's a bigger fix and I don't know what we do about that.

But even though there are fewer moderates on the Hill today than there were 10, 20, or 30 years ago, and Sarah Bender, a friend of mine at the Brookings Institute, is doing a study of the increasing polarization on Capital Hill, it doesn't mean that the remaining moderates should be let off the hook.

There's a price to pay when you do something like Gram/Rudman/Hollings, but these things have a huge effect. These bipartisan coalitions on issues like the deficit really do sort of threaten the status quo. And even if you lose, and Charlie and I were on the losing side more often than not, I think cumulatively you have an impact on the way these issues are viewed.

I think we got to a point in the Clinton Administration where he had to change his entire fiscal agenda after the election because we had spent ten years working on these issues in the Congress and he knew he couldn't just come to Capital Hill and expect the entire Democratic Caucus to embrace a return to the 1970s. So I think over time if there's some degree of bipartisanship that's consistent in challenging the status quo; you do create a climate that allows us to return to some sanity on these issues, and frankly, once in a while you win on these votes. So I think it's worth the effort. And I don't see in either chamber a group that's consistently raising these deficit issues in the way that they did while you were there, Charlie.

Charles Stenholm: I've voted, argued with Don and Warren for the same bill and thought it was the right thing to do at the time, and the record shows the rest of it.

But to answer your question: if you're looking for simple ones today, and there are no simple ones, this is the best one that I've seen come along, and it's now a Blue Dog position. It's got some bipartisan support and it has to do with redistricting, reapportionment.

If this country really wants good government, we've got to change the way in which we redraw the lines every ten years.

The first thing, there will be some in the audience saying well that's just sour grapes, Charlie, because that's what beat you, and I've said yeah. That's not what I'm talking about. When we Democrats controlled the Texas legislature we took care of all incumbents. The only difference in the redistricting this time was it was designed a little differently. But taking care of incumbents is bad government. If you really, really want to do something, take a look at the John Tanner bill. It's going to be a Blue Dog effort. The CEO of CSIS, John Hamre, made this comment in a little release that he did and I e-mailed him and said man, you're right on target.

If you're looking for things to do, and to make it specific, look at this: Martin Frost is one of my Texas colleagues that also was defeated last year. In the 1990 redistricting, Martin picked up three rural counties, and he asked me to help him, which I did. I said “you know what? The reason I'm willing to help you Martin, is that when you pick up three rural counties instead of just Dallas, you're going to be a better congressman when you get reelected.” And he was, because when you have a safe district, whether it's safe Republican or safe Democrat, it really pours gasoline on the fire of partisanship, which is the worst in the House of Representatives that I've seen in my 26 years and the ten before that when I was actively involved in rural issues up here. It is the worst. That's what makes it very difficult to get optimistic about solutions, because there are too many things in which we're fighting.

But Iowa's got it right, Arizona, California's about to ride on it, and if the organizations represented in this room see the same merit in that, I'd love to see us get a major political effort towards changing that in 2012.

Question: I have never read or heard any talk of having everybody account for putting funds in, of the 12.4 that we all are invested in the Social Security. It seems to me that if we don't need to have personal accounts because we don't want the money going down to our children; they're not old people. Instead we want the money to stay in the system. So we invest what we have now and what follows into the total stock market, and as a result we'll get the growth that is not occurring now in Social Security. That won't cover everything, but it might help.

Warren Rudman: Anybody want to respond to that?

Don Nickles: Was your comment that we should take the theoretical surplus and put it in the stock market?

Question: Part of it. One or two percent.

Don Nickles: I believe the Clinton Administration at one time suggested maybe they would do that and a lot of us were a reluctant to go through with it. With the sums involved, you could end up buying a lot of the Fortune 500 etc…. Anyway, I think a better solution would be to do it through the individuals so individuals can do it and own it and control it instead of having the federal government doing it.

Question: Greg Lashutka, Nationwide. Let me thank all four of you for your service, your vision and your leadership not only in public service, but right now.

Following upon Mia's question, which I think is longer term but worthy (as this will not change short term):. only second term Presidents recently have had the courage to raise this issue. What I have not heard in your observations as to how we should follow up on the ideas generated, is commentary on what actually did take place that one or many of you touched on, that is to say, the recent victory on the deficit spending in the '90s. All four of you were involved in a better look. There was a grass roots strategy of which The Concord Coalition was part of.

I've haven't heard any of you talk about a grass roots coalition, although grass tops has occurred with the President going out in controlled environments as well as within some discussion by trade groups.. Is that a possibility? If so, what would be your ideas on helping that so it's bottom up to force this issue by the American public who's pretty savvy, indeed caught up with the Iraq war in part, and maybe even more so. But this is huge for not only young people but for those of us who are grandparents. How would The Concord Coalition play into that, if at all?

Warren Rudman: I'll answer very briefly that of course The Concord Coalition is a nationwide organization with chapters in every state; we communicate with all of our members, and they hold forums around the country.

But let me point out that to do what you're talking about on a grand scale requires a huge amount of funding. Unfortunately, for whatever it's worth, there is a grass root movement out there, and it's called the AARP. And whether you want to agree or disagree with them, they are extremely effective and they have substantial money to spend on media and on contact and on grass roots organizations. They are obviously a very potent factor here and I must say that I think much of what they have said is inaccurate.

Don Nickles: You're talking about deficits as a big problem or challenge?

Question: [Inaudible] -- does the government work?

Don Nickles: Can we light a fire amongst the American people to try and contain the growth of some of the entitlements?

Question: And solve Social Security.

Don Nickles: And solve Social Security. Social Security and Medicare are the two biggest challenges we have. Demographically they're time bombs. They're not really affordable, sustainable for future generations under the present system so they have to be addressed and they need to be addressed sooner than later.

Can you build a constituency that's going to get really excited about doing it? The younger generations are the ones, to quote Tim Penny, that are really getting screwed. I said that very low. I hope nobody picked that up. I wouldn't use that language, but I did. Just kidding. [Laughter]. But they really are.

Can we mobilize that force? I compliment everybody here. This is part of the group that would be doing that. We need to save America for the future generations, and frankly we're bankrupting them if we don't try to get a handle on the growth of particularly those couple of programs and contain their growth, which will have some means tested elements of affluence testing or less subsidies for wealthier people. Those are going to have to be accelerated in the future in any way to be able to keep these things affordable for future generations.

Can we build that kind of a base? It will probably really take leadership from presidential candidates to make that happen.

Warren Rudman: I think we'll see if there are any other questions here, then I have one announcement to make. Are there any other wind-up comments anybody wants to make?

Any other questions in the group at all?

Charles Stenholm: I'd like to take a moment to answer to the question over here. I'm honored to serve on the Board of Concord. I'm honored to be on the Board of the Committee for a Responsible Federal Budget. I'm enjoying working for our grandchildren, trying to build grass roots, because we've got some efforts going on.

Now Centrus.org, a new little organization just getting started here that has a web site that is trying to put together some ideas that can be taken to the country in a progressive manner, in a bipartisan way. There are some other former members of Congress, from both sides of the aisle, who are getting very interested in trying to be a positive part of this.

I mentioned one example, the Tanner redistricting bill for folks to look at, and I'm going to try to get the organizations I work with to look at it and see if there can't be some grass roots. California's ahead of us on this right now with the Governor and bipartisanship.

There's one other. It's called Pay Go. It worked in 1990. One of the problems our party's got is spending more money is the answer to every problem out there. If you're going to spend more, you've got to cut something. If you're going to cut taxes you've got to cut spending first or raise other taxes so you end up doing no harm to the deficit. It worked in 1990, '93 and '97 in a bipartisan way. Why don't we have bipartisan support for that simple budget tool today that would work just as well in this Congress as it did in '90, '93, and '97? It's a legitimate question. But I would like to see some bipartisan, grass roots pressure on our former members to see what's wrong with that idea.

Warren Rudman: Any other questions at all?

Let me make a brief announcement. Pete Peterson is probably just on his way in from Dulles right now. He had to come down by an alternate mode of transportation since the shuttles were canceled. Helicopters aren't bad, and I assume he got here.

I think we're about done up here. I want to thank you all for your attention. I want to really thank my colleagues up here. It's been a very stimulating discussion, and three very interesting points of view. Thank you all

Luncheon Address

Peter G. Peterson
Chairman, the Blackstone Group and President, The Concord Coalition

Richard Jackson: Let me reconvene the conference here. Our luncheon speaker, Peter G. Peterson, Pete Peterson, has gone truly above and beyond the call of duty to get here. When his flight was canceled he got his helicopter out of the hangar and came down so that he could speak to us today.

It's really hard to know where to begin introducing Pete Peterson. He is, of course, the president of the Concord Coalition; Senior Chairman and co-founder of the Blackstone Group, a private investment bank in New York; Chairman of the Council of Foreign Relations; and former chairman of the Federal Reserve bank of New York. I could go on and on.

He's also a tireless advocate for fiscal sanity and an advocate for our children and grandchildren and the legacy that we're leaving them. He's the author of many, many books on the challenge of the aging of America, the long-term fiscal challenge, the long-term challenge of entitlements; most recently, Running on Empty: How the Democrats and Republicans are Bankrupting Our Future and What Americans Can Do About It; before that, a couple of years before that, Gray Dawn: How the Coming Age Wave Will Transform America and the World, which put the term global aging really on the map and brought that whole issue to the public's attention.

Of course, Pete is also, in addition to being the pre-eminent sort of elder statesman on the entitlements issue and the aging issue, a successful businessman. I am reminded, if I can tell a joke, we've worked together over the years on these issues and I remember one time up in the offices of the Blackstone Group where we were talking about entitlements in the federal budget over a breakfast meeting and you had to take a call. And I remember you excused yourself by saying that nobody ever made money writing about entitlements in the federal budget, but that was of course precisely what I was doing. [Laughter].

Pete Peterson has also been a public servant. He was Secretary of Commerce in the Nixon Administration. Newsweek, I believe it was, once referred to him as the most powerful Commerce Secretary since Herbert Hoover in the department of oxymorons.

So without further ado, I bring you the most powerful Commerce Secretary since Herbert Hoover.

Thank you so much. [Applause]

Peter G. Peterson: Thank you. If any of you in business are pretentious enough and presumptuous enough to write books, let me tell you that you have to be prepared for a lot of roasting, often from your best friends. My favorite roaster is Ted Sorenson. About Gray Dawn, he said, "Gray Dawn is a book that once you put it down you won't be able to pick it up." [Laughter].

About Running on Empty, he said, "Pete, when I saw the title, I had assumed it was an autobiography." [Laughter].

About this powerful Secretary of Commerce business: when I first read that, I think it was in Time, actually, and I burst out laughing on two scores. One, everyone knows what happened to Herbert Hoover and, secondly, I did start collecting oxymorons, because anybody that's had the job knows there's never been a powerful Secretary of Commerce. I've got about 50 of them I'd be glad to share with you, but my current favorite is the House Ethics Committee.

I have a bunch of charts for you, but let me first indicate a few caveats. This presentation is not about the short term, it's about the longer term. You get enough short-term forecasts.

Second, it's not about specific predictions because I think the kind of world we're living in, no one alive can make specific predictions about the longer term. One thing that makes the predictions unusually difficult is not only the unprecedented level of public debts, current account deficits and so forth, but also that we're leading a world with much more globalized capital markets with

extraordinary amounts of money coming from global savings, including emerging countries. And what makes the analysis particularly complicated is in some of these cases these investments are being made not for the classic risk and reward in financial terms, but often for political or domestic terms, like creating export jobs, for example.

I'll just give you one conundrum that Alan Greenspan talks about, namely, low interest rates. Why are they so low? And he says he has great trouble understanding, really, why they are lower than a year ago, even though the Fed has raised the Fed rate 200 basis points. When Alan Greenspan says he doesn't understand something, a mortal like me ought to just shut up about trying to understand it.

Having said that, I want to be sure you understand what I think I'm going to present are daunting issues. I don't want to come across as a Jeremiah on our own economic outlook. We have in this country some remarkable advantages that other countries do not have. In any event, Richard knows as well as anyone, their problems are more daunting than ours in several very important respects.

I am deeply grateful that we have the kind of labor mobility that we have in this country, which enables us to move much more responsibly than any other major country in the world. We have a much more deregulated economy, a much more entrepreneurial economy. We tend to have a very resilient economy. So with everything in mind, let me say I wouldn't, for a moment, trade our problems for theirs.

What I thought I would do today -- if we could have the first chart, Richard -- is try to put the deficits in the framework of what I call tri-debts: namely, the budget deficit, short, middle and longer term. The current account deficits that are to me very important are savings deficits and I think at least it's been helpful to me to think of them all together.

Let's start with the short term. I know I've heard all these projections that the five-year budget is going to be cut in half. I don't think I know of a single budget expert that believes that, the reason being that by the time you take defense and homeland defense and entitlements off the table, not to mention additional tax cuts, there's so little left that this would be an extraordinarily difficult phenomenon.

The next chart is on the mid term. The Concord Coalition, CED, Goldman Sachs, they are coalescing around an estimate of about $5 trillion. And I think it's important to remember that Social Security is going to be running a cash surplus over the next ten years of about $1 trillion. In other words, the ten-year budget deficit, if we were putting it off budget, would be at least $1 trillion bigger. But soon thereafter, of course, it runs in the other direction, from large surpluses to large deficits. For example, the current estimate for Social Security alone, without Medicare, is about $250 billion in 2030 in current dollars.

It's too bad that this is the case because given the boomer tsunami that is going to hit us, this should have been a decade of savings and surpluses; alas it is not.

Next chart, please.

On the deficits in the long term, it's obviously the entitlements, stupid. And for those of you who don't follow these numbers, using the same definition of unfunded liabilities that the Bush Administration is using, they're about $74 trillion, over $500,000 for every working American. If you want to look at it in terms of the increase projected in entitlement spending between now and 2040, the increase alone is about nine percent of GDP, which is, of course, nearly three times what we've been spending on defense.

To have one estimate, I asked Bob Bixby if he could try to project when entitlements and interest consumed the entire budget and he thought that was about 2020.

Now these staggering numbers ought to be related to something else, I guess. If you don't following this number, the net worth of the entire economy is about $42 trillion.

Now, given that we've had the Sarbanes-Oxley law, and given that we've had the ERISA law that requires funding of pensions in the private sector no more than 30 years, I've often wondered, what would that add to the annual budget deficit if we were to require similar funding?

If you take even the lower numbers that are thrown around on the unfunded liabilities, it would be at least a trillion and a half dollars a year. And if the CEOs and CFOs of America did their

accounting the way we do, of course, they'd be put in jail.

Now, a lot of proposals were made. One of them is why don't we just eliminate the Bush tax cuts? Notwithstanding the fact, of course, that nobody proposes getting rid of all of them, but even if you got rid of all of them, it's about one percent of the GDP we're talking about and the spending, of course, is nine percent of the GDP.

Next chart, please.

The Social Security Trust Fund is a fiscal oxymoron. It seems to me it is an oxymoron because it shouldn't be trusted and it's not funded and other than that it's a perfectly appropriate phrase. But I have often wondered what would happen if we said to our employees at a company we're going to print a lot of corporate bonds rather than using cash to provide you with liquidity for your pensions, so we're having a hard time confronting whether you have a trust fund or not. You still confront the same three tough choices: You're going to either have to try to borrow the money, increase taxes or cut the benefits.

Let's try alternative one, borrow the money. It seems to me that with the pay-as- you-go systems which these are, you should look at annual cash flows. So how much would we have to borrow? We're endlessly told, and I think it really harms the course of reform, that the system is "solvent" until the year 2042.

Bob Bixby tells me that between 2018, when the system starts going negative, and 2042 we would have to borrow \$5.4 trillion in today's dollars. So that doesn't meet my definition of solvency.

Secondly, we could talk about increasing taxes. This is the “increase in taxes that would be required to cover the cost of these programs and a seven percent increase in the case of Social Security” plan. Of course any payroll tax would fall very heavily on the middle class, which everyone asserts are paying too high a tax.

The next one is cut the benefits. Now, I am attracted, having proposed all kinds of other things in the past for reasons we can discuss if anybody is interested, to take a very serious look at the wage indexing phenomena which I find most Americans know nothing about.

In the first place, wage indexing makes it very difficult to grow out of the problem since the benefits go up with the growth of the economy. If you look at just how much wage indexing accounts for these outsize bills on Social Security, it's about 30 percent. Now, if we eliminated them totally, it turns out you get rid of all of the unfunded liabilities on Social Security. You actually end up with some surplus that I think could be used to buttress the program, which I'll get to in a moment, for the poor. It would have no effect on the current retirees, the kids and their parents would get the same benefits, and you would preserve the safety net.

This is what Margaret Thatcher did, as you perhaps know, in the '80s and as a result, as Richard knows, if you look at Britain's 20, 30-year outlook on Social Security, they're easily in the best shape of any developed country in the world.

Now, there are no free lunches here and quite obviously because wages rise faster than inflation by roughly one percent, if you eliminate wage indexing, it obviously means that the beneficiaries are going to get a smaller share of the retirement earnings.

Now, the administration, to its credit at least put something on the table in this progressive indexing proposal and, according to our calculations, it handles about 60 to 70 percent of the financing gap.

So if you want to solve the entire problem and you're going to go with progressive indexing, you're going to have to look at some other things like increasing the retirement age. If we ever get around to doing that, I hope we index it to longevity because if you look at some of the current forecasts on possible longevity, they make these numbers look very happy.

Next chart, please.

Now, what about the Bush proposal on private accounts? I think we have to ask some questions about it. First of all, are these accounts funded with new savings or with borrowed money? Under the latest and more gradual administration plan, Bob Bixby tells me we'd need to borrow about \$750 billion over the next decade. But if you look at the life of the next three decades following that, it totals about \$8 trillion.

I'm going to speak in a moment about the current account deficit which I think as a subject

deserves a lot of attention, but I can't imagine a signal that is less attractive to the financial markets than suggesting that a country that's already borrowing or importing about $6 billion of foreign capital is cavalier about adding another $8 trillion to the long-term requirements.

Also, it seems to me that there's a certain implausibility to this idea that we can just keep borrowing and borrowing and borrowing and "putting it into the accounts that are the ownership of society," because it implies that over the long term, stocks just automatically earn a lot more than bonds regardless of how much money we're borrowing.

Now, if that indeed were true, why do we restrict these private accounts that we're borrowing to a few hundred dollars or a few thousand dollars? Why don't we give everybody $1000 and make them very rich?

I think there's a case to be made, if I can, on the next one, because the second question I ask is what does it do to increased savings? This comes very slowly to a Republican like myself, but in the 1990s, I was asked by the White House and the Congress group that was setting up a bipartisan competitiveness council to get the best savings economists I could and explore what America could do to increase capital formation. So these gentlemen were left, right and center and I asked them to appraise some of the tax incentives that exist.

Much to my amusement and amazement, they were, I think, virtually unanimous that the tax incentives like 401Ks have very limited impact. And when you ask why, you say, well, because many of the people that shift to 401Ks would borrow anyway and therefore the net increase in national savings, after considering the cost, is limited. Also, poor people don't use these plans.

So I said, "What are you guys saying, then?"

They're saying if you want to increase savings, which for a lot of reasons we think we should be doing in this country, we're going to have to seriously consider mandatory savings, which is what Singapore, as you know, did many years ago, Chile has done now, Australia has done. So as counterintuitive as it may be, I have come to believe that that is a necessary aspect from the national standpoint.

Under my proposal, it would be two to three percent of pay. We'd have to figure out a subsidy for low wage earners. We have to be very concerned, not only about investor prudence and so forth, or imprudence, I should say, but I think it's very important that we consider the transaction costs.

Remember that many of these people that would be getting these accounts would have rather small amounts of money in the range for some time of $5000, $10,000, et cetera dollars and if you try to figure out the broker transaction costs, they would dramatically reduce the return. So I think some form of indexed options is one good way to go.

Now, my basic conclusions about Social Security are that I think whether we like to admit it or not, spending reductions are going to have to play a major role and while we're doing it we ought to seize the opportunity to increase personal savings, which I think is a critical national need.

The next chart is on Medicare. I don't know how many of you follow these numbers, but this is the big elephant in the boudoir. You may not know how big it is unless you look at the numbers. We're pretending as though it isn't there and we hope no one else is rude enough to point it out.

Earlier, I gave you the numbers on the total unfunded liabilities, but you might be interested in seeing that the Medicare unfunded liabilities are five times bigger than the Social Security.

Let's move on and say, all right, suppose you want to solve the Medicare problem with tax increases. You can see that the tax increase is much higher and, according to the Medicare and Social Security Administration, if you combine Social Security and Medicare, we're looking in not too many years in the future at about 38 percent of pay as a payroll tax, which I think is unthinkable.

Now, Medicare is not only in my view a much bigger fiscal problem, but our national discussion of health care costs in this country is so much in its infancy at this moment, I don't think many of us have spent much time thinking about what some of the issues are that we have to confront with Medicare reform.

The first question: how will an aging world make the tradeoff between health care and other health care priorities one; and other national priorities, two?

Now, let's look at what's going on in this country now. We have a health care problem that is obviously not limited to Medicare. General Motors is kind of the classic poster child at the moment

where the CEO was reputed to say he didn't realize when he got the job that he was going to be in the health care business rather than the automotive business. But let's just ponder a couple of questions that are rather difficult and painful for us: if we're saying that these costs are unaffordable, we're going to have to start making some choices.

One obvious choice is how much should we be spending in the last few months of life compared to health care for our children, which is ultimately an investment?

There are not only decisions to be made within the health care structure, but between health care and national priorities. For example, there is much discussion today, with good reason, about the long-term comparative advantages in the United States; our competitiveness, vis-à-vis countries like China and India that have educational systems that are improving dramatically. They have math and science scores that are better than ours, and in the case of China, they are producing about 220,000 engineers a year while we're producing about 60,000, and 20 percent of them go home.

Now, I think we ought to be having a discussion in this country about how much of our national resources should be devoted to education, research and development.

I think a second problem we have is that we've gotten very used to this fee-for- service, open ended or cost plus system and, as a result, the health care costs grow much faster than the economy, and this makes it, again, very difficult to grow out of this problem.

So among the very tough problems that we really aren't asking the American public to focus on is, and it's a brute problem, the fact that some people are going to have to give up some medical benefit that has some virtues. And the minute you say that, people say, my God, this damn fool is talking about rationing.

Well, I don't care what particular word you use, but that isn't a bad word to describe one element of health care reform. And for those of you who may have forgotten it, recall the experience in the Bush 1 administration when Oregon did a most interesting communitarian experiment. Because the states absorb 50 percent, as you probably know, of the Medicaid costs, they were going bankrupt and they had to do something about it and they got an extraordinary group of Oregonians -- priests, nurses, doctors, educators, labor unions, business executives, lawyers, et cetera -- and said what are we going to do?

And what they did was they took 715 or whatever it is so-called DRGs, diagnostic related groups, which define various kinds of ailments, and they actually ranked them and they said “we're going to spend x amount of money, and below this level if we run out of money we're not going to spend any more.” They sent it to the Bush Administration and the administration said, my God, these people are talking about rationing.

Hello. It seems to me that whatever the reforms are that we're talking about - and I'm aware of some of them - I hope that many of them, whether we're going to improve information technology, have budget caps, cost sharing or required gate keeping, somebody is going to have to give up some medical benefit that I say has some cost.

Next chart, please.

I tried to figure out, and you may have different theories, about how did our health care costs get this far out of control. I've mentioned that pre-Medicare, our costs were rather the same or nearly the same as the developed world and now, as you can see, they're nearly five percent of the GDP higher than the rest of the world.

I'll give you one theory, because this, perhaps coincidentally, ties in with the setting up of Medicare. If you study the history of that period -- and I've talked to some of the White House staff that were there -- LBJ was confronting a terrible choice because with his Brahman Ivy League friends he wanted to be in a position of launching some legacy-making domestic initiative and he decided health care, Medicare was what he wanted to do, but he was very weak politically, given the Vietnam War. So he had to make peace with the medical establishment, namely the American Medical Association, the American Hospital Association, who of course -- and I'm old enough to remember this and perhaps some of you are -- were shouting about socialized medicine and so forth.

So we ended up with this unique, really, open ended fee-for-service system and from that point forward at least, as I look at the numbers, our health care costs started taking off.

If you look at how much we're spending here, on a per capita basis you can see it's over twice as much, but if you ask the rather awkward question, are our health outcomes twice as good, I have not seen any evidence that supports that hypothesis.

So why is it so big? Well, clearly, we have an open ended system, and for those of you who don't follow these numbers, at least I've been stunned by them. I come out of corporate business life where we have something we call best practices and we try to figure out what is the best cost benefit practice we have and we try to apply it throughout the entire system. You may be surprised at the utterly stunning variation in certain medical treatments across the country. I have no reason to believe that the backs in Oregon are any more vulnerable than they are in Indiana, and yet Oregonians have over six times the back surgery that people in Indiana have. I have no reason to believe that the prostates in Georgia are much different than in Texas; we have six times the prostate removal in some areas in Georgia than we do in areas of Texas.

I have no particular reason to believe that people in the last months of their life vary across the country and yet in Miami, we have something like nine times as much time in intensive care units which are extraordinarily expensive, as we do elsewhere.

Fred Plum was the head of neurology at New York Hospital and he's a serious student of health care costs and I once asked him why was it that the costs, for example, in Great Britain were so much less than ours. So he said, "I'll tell you what I'm going to do, Pete. I'm going to give you a little case study and if you'll do this then you go and visit the intensive care units in the United States or in New York and I'll set up a visit for you in London."

Well, I was just astonished at the average age of the intensive care patient in New York Hospital and the proportion of people there who appeared to be in their eighties with what appeared to be a de minimis quality of life with heroic intervention and tubes and so forth. And when I went into Great Britain, I did the same thing and there was a marked difference in the demographics and the composition of the group.

So he said, "Well, you've observed a very important fact."

I said, "Fine. I don't understand the reason."

He said, "Well, in Great Britain, if there is a stroke patient that has a life debilitating stroke where the prognosis for any quality of life is very, very bad, the neurologist sends the patient to a general practitioner who sends them home and they die what used to be called the old man's death."

Now, imagine that kind of a dialogue in this country at this point. I've been responsible for a number of politicians losing their jobs given my agenda and you may recall Richard Lamm who ran for Senator or Governor in Colorado. He persuaded me, "Give me a modest proposal, will you?"

And I said, "Well, why don't you have something that requires people to have living wills?"

And he was foolish enough to accept that recommendation and he got severely pilloried as someone who was just totally insensitive.

Next chart, please.

Another phenomenon that makes our problem more difficult is that compared to the rest of the world we spend relatively much more money on the elderly than they do. As you can see, 7.8 times versus roughly half that. So to sum up my view on this matter, one of the reasons I think we ought to really fix Social Security is that it's much easier and clearer on how to fix it and the Medicare problem is much tougher.

Some administration officials have been visiting me, saying what do you think we ought to do?

And I said, "Well, if the President wants a legacy, at some point he'd better be talking about this big elephant."

And I didn't think I would say this some time ago, but I've been very impressed with what happened with the 9/11 Commission, which I think sets a new standard for what can happen with an outstanding independent commission and I have proposed to them for their consideration the possibility of setting up the most prestigious objective commission possible on health care in America, including people like Warren Rudman and Sam Nunn and so forth on a bipartisan basis to get this noticeably absent dialogue started.

Let's look at the second of the three deficits, the current account deficits. Again, I don't know

how many of these numbers you follow. The previous record current account deficit was about 3.4 or 3.5 percent in the '80s. You may recall the dollar fell by a third, we had stock market problems, et cetera. Today it's at 6.5 percent of the GDP, and by every estimate I've seen, heading north.

Now, this leaves us in the position of importing about $6 billion of foreign capital every workday, roughly half of that to finance these current account deficits, and the other half to finance investment. This gives rise to this whole hard landing/soft landing discussion.

When I did the Running on Empty book along with the help of Richard, Neil and some other people, I decided to interview 12 people on Wall Street who had been in public life who knew a hell of a lot more about global capital markets than I did. And they split right down the middle: half of them believe that we're running a significant risk of a hard landing and half of them disagree.

Those on the side of we're likely to have a hard landing would be Paul Voelker, who told me that he thinks there's a 75 percent chance of a hard landing in the next five years. Bob Ruben, my dear friend who is a genius at constructive ambiguity, speaks about a day of serious reckoning.

The other group believes we can have a softer landing, but make no mistake about it, it's still a landing in which the dollar falls more gradually and interest rates increase more gradually and so forth compared to the other.

I happen to be a Nebraskan by birth and I'm a great fan of Warren Buffet's, who is so much smarter than the rest of us, I always watch what he does. He and I discussed this subject a couple of years ago and concluded it was not sustainable. The difference between him and me is he put about $20 billion in foreign currencies a couple of years ago and has done remarkably well.

Now, we keep saying that it's not sustainable. We had a Nixon humorist in the White House in which I served, that probably strikes some of you as an oxymoron also, but Herb Stein said one day, "If something is unsustainable it tends to stop." And he said, "If you don't like that one, if your horse dies, I suggest you dismount."

We have an interesting dialogue going on in the country where almost everybody agrees you can't keep borrowing six or seven percent of the GDP.

Let me offer a couple of numbers, if you haven't thought of it in these terms. Imagine that the current account deficit remained at six percent of the GDP until the year 2020. What would America's external debt look like? And that would be about 120 percent of the GDP.

Imagine what the debt burden cost would be under that arrangement, at any reasonable number of interest rates.

Now, a lot of people say, well, central banks are holding this money and it's true that they have about 75 percent of the treasuries. However, remember that there's about $8 trillion overseas that are liquid, and the vast majority of that is in individual investors who are not bothered by geopolitical, let's build jobs at home arguments, but are much more interested in their financial returns.

Incidentally, if you want to read a most interesting analysis of this issue, I read on the plane down, a speech that Roger Ferguson, Vice Chairman of the Fed, gave on the causes or the hypotheses about what's causing this current account deficit. And it's a most interesting analysis of about five schools of thought, but the one thing almost everybody agrees on is it's not sustainable.

We are depending very heavily on borrowing from Europe, and I've asked Richard and others to give us some projections on where senior benefits are going to be in 2040 and Europe's, as you can see, are a much higher percentage of GDP than ours are.

Now, one book from me is one too many, but one of the things we did in Gray Dawn was to look at not just the fiscal aspects but the demographic aspects. You may be aware of this in general, but you may not be aware of the magnitude of the effect on demographics with much lower birthrates. One way of looking at it, which is what this chart attempts to do, is to say by 2050 if the current birth rates continue, what will happen to the working age population, which is a highly relevant number because they're the ones paying the taxes in all of these pay-as-you-go systems.

You see, for example, in the case of Italy, and I've been meaning to ask the Pope about this phenomenon, they have a birthrate of 1.2. They expect to lose 42 percent of their workforce during that period and their enthusiasm for this much immigration is very restrained. So that's another factor for you to consider.

What's the tax situation abroad? I'm sure you know that payroll taxes are high there. You may not know how high they are. They are 41 percent in Germany, 43 percent in Italy, about 50 percent in France and 18 percent here. Overall taxes there are about almost 50 percent larger as a percent of the GDP than here.

Here, at least, we've got about half the people who have company pensions. In their case, only seven percent of them have pensions. And also they retire much earlier than we and you've all observed the riots in France when somebody makes the modest proposal of increasing retirement age from 55 to 58.

So I think a fundamental question, given the unsustainability of these current account deficits is: should we be depending on these countries who have plunging birth rates, earlier retirement, bigger benefits and higher taxes than we do?

The third deficit of the tri-deficit is the savings gap, and I think every economist wants to look at what they call national savings. You can see here a very pronounced trend for a dramatic reduction of what our net national savings rate is.

Now, there's a couple of ways of increasing savings, if you'll look at the next chart, please.

You can do it through corporate savings, but, frankly, most people believe corporate profits are about as high as they're going to be, so you get down to the other two ways of increasing national savings, which is reducing the budget deficits and increasing personal savings.

Now, there's been a lot of talk about this. You may not be aware of how much the personal savings rate has fallen; only a dozen years ago it was about eight percent of the GDP and it's now running at a touch under one percent of the GDP. We've gone from being the biggest savers in the world to the lousiest savers. And I'm fully aware of the arguments that all these measurements of savings are lousy because they don't include housing.

Well, because I'm not an economist, which has not been a terminal burden, I've asked a half a dozen people, including Greenspan, Volker, Ruben, the head of the New York Fed, et cetera, et cetera, which measure of savings do you think is important in this context? And they've said, look, we need savings that are usable, that are available for investment, that are available to fund deficits; we're not interested in savings that are locked up.

There are some other things going on in the debt service area that you may or may not be aware of. If you look at household debt service, it is now 13 percent. That's the highest as a percent of disposable income, the highest in the last two decades. If you look at household debt as a percent of net worth, it's at very high levels.

Now, the housing market is getting a lot of attention these days. You again might be interested in some of the numbers. The 30-year mortgage rate is now about five percent and I asked our research people if they would tell me what the 30-year average was. It was 9.7. I'm rather stunned that 48 percent of the dollar volume of new mortgages are for floating rate mortgages in which the rates obviously float; 23 percent of new applications for mortgages are interest only, at least for a period of five years or so. In California, it's always friskier, 39 percent of the mortgages are for interest only.

If you look at the mortgages taken out by people who are buying houses just for speculative or investment purposes, the number last year was nine percent. It used to be six not long ago and I read The Wall Street Journal this morning which said they're pushing ten.

If you want to look at how many of the homes being bought are for investors by individuals, it's a stunning number to me but nearly one in four of second homes are being bought for speculation or investment.

Now, the reason I raise this point is there are some very basic assumptions that these people must be making. One is that housing prices are going to continue going up, in other words, and the other is that interest rates are going to remain very low.

Now, you don't need to be a mathematical wizard to imagine the implications of somebody making $75,000 or $100,000 and borrowing $400,000 on a floating interest rate basis only and having interest rates rise to their typical level.

For those of you in business, this is something that kind of stunned me. The CEO of UTC is a friend, George David, and he did a big bond offering recently and he was simply astonished that in

view of all these long-term issues that are out there the difference in rate between a 30-year bond and a 10-year bond was only half of one percent. So it is as though we are kind of downplaying these long-term factors.

Now, what is the typical interest rate?

If we could have the next one.

The current rate is about 4.1. Over the last 40 years, it's 7.2, so leave aside all these other macro issues, if cyclically these interest rates were to come up, we've got a society right now that is highly leveraged.

I'm looking at my watch and see it's about 2:00 o'clock, so I think I'll shut up here. You get the general idea of what I feel.

Thank you very much. [Applause].

Richard Jackson: Would you be willing to take a few questions?

Peter G. Peterson: Sure. Is everybody exhausted or not?

Rudy Penner: Rudy Penner, Urban Institute. Historically, financial markets have been a disciplining force over fiscal policy. They went into some turmoil in 1980 when Jimmy Carter offered a deficit of approximately 16 billion, and I got the general impression through the '80s that Wall Street was looking over the shoulder of Congress much more intensely than it is today, and that they played some role in the deficit reducing actions that were undertaken in the '80s and '90s.

I may be wrong, but I don't see the same intense concern today, even though we're much closer to the calamity that you describe. The current account is in much worse shape.

I wonder if you can explain what I think is a relative disinterest in Wall Street in all this.

Peter G. Peterson: As I said, Alan Greenspan says it's a conundrum. I don't know why I should be presumptuous and say otherwise.

There are some differences that exist in financial markets and one of them that's being hotly debated on Wall Street is the enormous amount of savings that are coming out of third world countries that don't feel that they have the investment opportunities at home and they look at the United States and say, you know, compared to other alternatives, it's all right. Those flows are very large. I heard an economist this morning at the Council on Foreign Relations saying that they thought that it had increased as a percent of the GDP about two percent. So that, Rudy, could be one thing that's going on.

I'm not an economist or a sociologist or a philosopher or anything. I don't know really if there's something going on in our society as a whole. I think people of your intellect and experience might want to address a question which is "why is it that this country went from this very high savings society to this borrowing consumption obsessed society" where I just gave you some numbers? And "how much of it has been caused by the boomer mentality?" "I'm entitled", you know. It's not one of my favorite words. "I want it all, I want it now," kind of an exaggerated case of short-term-itis.

The financial markets have never been preoccupied with the long-term future, but I must say, Rudy, they're certainly less involved now than I have ever seen them and I don't know whether the appropriate analysis here is deep therapy or whether there are some factors going on here that we don't yet understand, but clearly a lot of people are surprised and in view of everything that's happened to interest rates, long-term rates are this low and persist this low.

So I don't know how much of it is the financial reality, Rudy, and how much is a change in the culture of this country; I really don't know.

Yes?

Question: Ed Lorenzen with Centrists.Org. *In Running on Empty*, you talked about how both political parties are bankrupting our nation with their policies and I'm wondering if you could talk about that a little bit more. Also, what can be done in terms of changing incentives and political

reforms that might reverse that cycle.

Peter G. Peterson: Well, those of you who haven't had a chance to read the book, and there are more than a few of you, I'm kind of an equal opportunity basher in this book because I think both parties deserve a hell of a lot of criticism. And one of the things I do is attack what I call the theologies of both parties, and as a lifelong Republican this isn't easy for me to say, but I use the word theological because I think we're seeing political figures who are, almost more than any I can recall in the past, very faith-directed in their decisions and it's not just in the economic area, it's also in the foreign policy area, relatively untouched by history or evidence.

Richard Nixon at least, I was a senior economic Kissinger, or whatever the hell they called me. He used to want to know what are the options, what are the costs and what are the benefits and what are the risks, what are the critics saying and so forth.

I have a feeling that these decisions being made are delivered with a kind of moral certitude that defies ordinary analysis.

Now, to take my party, we've adopted a kind of a tax cut theology in one branch of the party that's kind of morphed into any tax cut, any time. And if you consider the theological metaphor, they've got an unholy alliance with a real oxymoron in my day, which is big government Republicans. As you know, the non-defense costs have risen very substantially in the last four or five years and it isn't just me, an aging curmudgeon. I mean, the Cato Institute refers to the spending explosion and Dick Armey, hardly a liberal or moderate or whatever you want to call him, so we can't pin this one on the Democrats, they're in charge of everything. My friend John McCain says it's the biggest spending binge he's seen in his 20 years in the Congress.

Then we have a third group in my party that I'm sure you're aware of called starve the beasters. And paradoxically, their argument on the supply side tax cut argument is diametrically opposite. They take the position that of course if you cut taxes you're going to reduce revenues, and that's what we want because then we can cut these programs.

I've had one or two debates with them, on television and elsewhere, and my dialogue with them goes as follows: I want to be sure you people be careful what you wish for. Do you know that a third of the people that reach retirement age in the United States have no net financial savings at all? Do you know that somewhere around 20 percent or thereabouts, some would say it's higher than that, of the people getting Social Security depend on Social Security for over 90 percent of their cash income?

So I said I want to be sure I follow, you can't talk about social or moral issues because of your political scenario. We're going to have 77 or 78 million boomers, twice the number we've had before, and you're telling me that some large number of those, whether it's a third or whatever it is, 25 or 30 million of the most organized political lobby in the world, when you suddenly announce that we're going to have to have a quick and Draconian cut, they're going to say, what, “thank you, I needed that, I deserve it for my fiscal profligacy?” And when in the middle of a crisis did government get smaller?

So I'm having trouble really understanding what the underlying rationale is of many in my party and I guess a true bipartisan basher has to ask where's the President been on this?

As I'm sure many of you know, he's the only President since, the first President since John Quincy Adams who hasn't vetoed a single bill. He's had plenty of opportunities to do so if he truly wanted to.

My former Democratic friends have got their own theology. Many of them have never met a universal entitlement program they didn't want to create or expand and if you look at the last 40 years, federal benefits to individuals have gone up about six times per capita in real terms. George Bush, to his credit at least, has put something on the table. Bob Kerrey is one of the co-chairs of the Concord Coalition, as we all know, and I said, "Hey, Bob Kerrey, where is your Democratic plan?"

And he said, "You haven't heard of our Democratic plan?"

I said, "God, no. I try to read this stuff pretty carefully."

He said, "Yeah, we call it the Do Nothing Plan."

So now we're confronted with a party that has no alternative that they've presented and

rather disingenuously say to us, well, we ought to focus on Medicare. Well, when was the last time you heard a Democrat lay out a proposal for what they meant by confronting Medicare?

And then, finally, I think our whole political system, there's a lot of talk about the stridency and venality and so forth, there's also something else going on here, which is that we've become a society that's kind of all gain and no pain and all carrots and no sticks or whatever metaphor you want. And it seems like it's politically incorrect to ever suggest that anybody has to give up anything, even if it's for the public good.

So I think we somehow need some leadership at some level to explain to the American people that these programs are unsustainable, your children are at stake, the future is at stake, and let's work out a reasonable plan instead of sticking to these theological beliefs that you only have tax cuts and you can't cut the entitlements and so forth because both of those roads lead to disaster.

I haven't been invited to the White House lately and perhaps there's some logical reasons for that, but those are my honest views of the situation.

Question: Pete, I wonder if you might reflect on the flip side of the [inaudible]. Obviously part of it is that we're not investing a lot in terms of fiscal capital, but you mentioned just very briefly the smaller number of engineers we're having trained in our society. I wonder if there's not a play in terms of forming some new consensus over worry about what I think is going to happen as we squeeze this budget between the entitlements and the lower taxes and that there's nothing going to be left over for programs for children, for investment in schooling. In fact, I could argue, and I'm sure you'd probably agree, that we're operating a schooling system that's almost got a 19th century design. So if we have systems that are broken that need fixing, there are a lot that we could work on.

Peter G. Peterson: First, on the science thing, again, I'm not an economist, as you know, I was presumably educated at the University of Chicago, you know. And Adam Smith was our patron saint there. I'm getting older, though I didn't know him personally. But he taught us about comparative advantage, how we favor free trade and an open world and so forth, and what's important is for each country to move up the scale of their comparative advantage.

And I hear other people saying, well, we can also just become a service economy. But if you ask the rather awkward question of if we're in an infotech society, which I think we are, and we're in this flat world that Tom Freedman talks about, don't we have to pay some serious attention to what our comparative advantages presumably would be? Which I would assume require a higher order of education, of bigger investment in research and development. But you're absolutely right, you would know the numbers better than I, but I think we used to spend about six percent of the GDP or some such number on what you call investment, including education and research, and it's down to three or something like that.

So part of the crowding out phenomenon is what you're getting at. I think we're going to be crowding out the very investment in human know-how and competence that is a requirement in this modern world we're living in. So I think you ask a very profound question.

Question: [Inaudible] …here, that the rest of the G8 may be even worse and I was trying to find some common thread or somebody who is going in the right direction and while there seems to be maybe a little bit here and a little bit there, there doesn't seem to be anyone of those countries who are grappling with the issue and the only common thread that I seem to see is the aging of the population and the development.

Do you see any country that's going in a direction?

Peter G. Peterson: You raise another very basic point. If I were an idealist, a theoretician, and you said the current global imbalances are unsustainable, you can't keep it up, well, then I'd have a little discussion of what we mean by sustainable. And sustainable, it seems to me, implies a very important change, not only in America, but in the rest of the world.

In America, it seems to me obvious, if you're going to save more relatively, you're going to have to consume less; savings have to go up as well as our investment in our society. Our exports

have to go up and so forth. And yet as you look at the rest of the world, they aren't cooperating in that little tango and as Kid Gavelan says, it takes two to tango, you know?

What should they be doing? They should be doing the opposite. They should be stimulating domestic demand on their own, instead of depending on huge exports to this country.

I just came back from China and I don't think there's any question that they see our current account deficit as one of the very important answers to a domestic problem. Well, you can't have everybody saying to hell with my stimulating my domestic demand, I'm going to rely on the United States because that's what leads to this.

So we really ought to be having a discussion with our allies around the world -- if we are willing to move in the direction we should move into, what are they doing to move in the opposite direction? And we haven't had that dialogue, in my opinion.

I think everybody's probably exhausted, aren't they?

All right. Thank you all very much. [Applause]

Richard Jackson: Thank you very much.

Thank you all for coming. I'm not sure if we've moved the ball down the playing field for this game or this season, but hopefully we've helped lay the groundwork constructively for tackling this issue.

Again, thank you very much on behalf of CSIS and The Concord Coalition.

Bob, do you have anything you would like to say?

Robert Bixby: Thank you for coming.

Richard Jackson: By the way, in case anybody hadn't noticed, we have videotaped this event. We will be posting this on our web site within five, six days. We will also have a transcript of it available, if anybody missed any of it or just simply is dying to hear it a second time. Thank you.