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THIS IS AN UNCORRECTED TRANSCRIPT.

P R O C E E D I N G S

MR. GALE: [In progress] --Social Security reform. The symposium is hosted by the Brookings Institution and the Tax Policy Center. The TPC is a joint venture of the Urban Institute and the Brookings Institution.

We have a very large attendance for the event this morning. Besides the people in this room, which is full, there's at least one overflow room, maybe two, in operation right now. I think we can attribute this level of interest to three factors. First, the president has made Social Security reform a top priority for 2005. Second, as you'll see in a second, we have an outstanding panel set up to discuss these issues. And the third factor is the unique Brookings money-back guarantee, and that is we hereby promise that either we will completely resolve all Social Security's issues this morning and come up with a painless consensus solution, or we will fully refund the price of admission that you paid to come in here.

All right, as I mentioned, we do have an outstanding panel. Our first speaker will be Jeff Brown. He is an assistant professor of finance at the University of Illinois at Urbana-Champaign. He is a former staff member of the President's Commission on Social Security. Last week, well after it was already announced that Jeff would be appearing here, President Bush nominated Jeff to be a member of the Social Security Advisory Board. He's also a leading researcher on the economics of social insurance, annuities, and related issues.

Our second speaker will be John Rother. He is the director of strategy and policy at the AARP. He and his organization will play a key role in the upcoming

debates in informing the legislators and the general public about the views of his organization's members.

Our third speaker is Robert Pozen. He is the chairman of the MFS Investment Management and a former member of the President's Commission on Social Security. His views were featured just last week in an article in The Economist magazine, in a relatively rare invited op-ed.

And our last speaker will be Peter Orszag. Peter wears many hats. He's the director of the Retirement Security Project here. He is the Joseph A. Pechman senior fellow on tax and fiscal policy. He is the co-director of the Tax Policy Center. And he's the co-author, along with Peter Diamond, of "Saving Social Security."

Each speaker will be allotted 10 minutes. They'll speak from here with PowerPoint presentations. After that, we'll all come up and we'll give each speaker two minutes to rebut the comments of the others, and then we'll turn to you for questions.

So Jeff, the floor is yours.

MR. BROWN: Good morning, everyone. I'd like to begin just by thanking the Brookings Institution and the Tax Policy Center for sponsoring this. I'm looking forward to what I hope will be a substantive policy discussion about Social Security today and I'm optimistic about that, given the makeup of the panel.

As I look around the room, I realize there is sort of an incredible amount of Social Security expertise in this room. But nonetheless, I want to take just a minute at the beginning to review what the problem is and why we are here talking about this issue today. I then want to talk in very general terms about the types of solutions that are available and, rather than distinguishing among personal accounts or not personal accounts or what have you, I essentially want to distinguish among plans that actually

address the problem and those that do not. I will then at the end very briefly discuss personal accounts and then I hope we have some more discussion about that during the Q&A.

We all know that Social Security is basically a pay-as-you-go system. And what that means is that today's workers are paying taxes to support today's retirees and other beneficiaries. This type of a program works very well when you have lots of people paying in and not very many people withdrawing benefits from it. What we've seen over the years is a steady decline in the ratio of workers to retirees. It's fallen from 5 during the Kennedy administration down to 3.3 today; and looking forward a generation from now, that ratio is going to be down to 2. This means quite simply that in order to address the financing shortfall that this generates, we either need to have the workers pay in more or have the beneficiaries receive less. It's either that or, as Alan Greenspan said, repeal the laws of mathematics.

What this leads to is the following diagram, which you've all seen before, which simply shows the expenditures of the system and the tax revenue going into the Social Security System over the next 75 years. And of course people debate over when the problem actually begins. We know that the cash flow deficits will actually begin in the year 2018. The trust fund will run out of bonds in year 2042. There's some debate over which of those is the appropriate one. I happen to be in the 2018 camp, for the reason that, you know, let's take a few years prior to the trust fund exhaustion, say in the late 2030s: The annual cash flow deficits from Social Security, according to intermediate projections, are on the order of $325 billion--that's in 2004 dollars. Which, if you look at that--just to give you a ballpark--that's about three-quarters of what the U.S. spends today on non-defense discretionary spending. So this is a big number. So

when Social Security goes to redeem those bonds, Treasury has to come up with that money from somewhere, either through taxes or through expenditure reductions.

So what do we do about it? Well, the simple answer is that if we continue on a pay-as-you-go basis, we can either increase taxes or reduce benefits, or we can decide to increase taxes or reduce benefits today, or other spending, in order to pre-fund the system; in other words, set aside more resources today in order to reduce the burden on future generations. If we want to do that, then there's an important question of how we actually engage in that savings. And I'll come back to that at the end, because I think that trust fund is an inferior mechanism to personal accounts. I think personal accounts are a better way to pre-fund the system.

Now, there are four different approaches that you hear about in the news and the press. I want to distinguish not along Democratic and Republican lines, but rather along the lines of those that actually don't do anything to really restore fiscal balance and those that do. And there are both Democratic and Republican proposals in each of these camps.

Let me quickly dispense with what I consider to be the most irresponsible of the approaches, which is the group that essentially follows the strategy of sticking their head in the ground, denying that a problem exists, saying there's no real problem, no immediate danger, arguing that we can somehow just grow our way out or that it just requires minor tweaks. I think the evidence, bipartisan panels, analysts of all political stripes have clearly shown that this is not true and that simply doing nothing is not a viable solution to Social Security's problems.

At the other end of the spectrum are those that would like to follow the free-lunch approach, that share in common with the ostrich approach that they don't

want to do anything about--they want to leave benefits alone, that claim we don't have to touch benefits. But this group also says we don't have to raise taxes to do it, we can just take a free ride on the equity premium, invest in the stock market, and hope that this somehow solves the problem. I can assure you, as a finance professor, that if I thought this was true, I'd be the first to sign on. The fact that most financial economists understand that there are not any free lunches associated with financial markets suggests that this is not enough.

I'm a supporter of personal accounts. I'll talk why at the end. But my point is we need to do more than just introduce personal accounts in order to deal with the financing problem.

There are two approaches in general that will actually solve the problem. Some might call this the eat-your-spinach approach. There are two varieties of the spinach. One is to reduce expenditure growth and the other is to raise taxes. An example of each: The president's commission, if you set aside the personal accounts component for a moment and look at what they wanted to do, they recognized that a wage index system was not sustainable in the long run; wanted to switch to a price index system, which has the benefit of not affecting benefits of current retirees, making sure that all future retirees receive the same benefit in inflation-adjusted terms as they do today. This one provision is sufficient to place Social Security on permanently sustainable financial footing for the foreseeable future, without increasing payroll taxes.

Now, some people have argued that even though we are keeping benefits fixed in real terms so that purchasing power will be fixed, they don't like this plan because replacement rates relative to wages will decline. Well, if you want to keep replacement rates up, then you don't have much choice but to increase benefits. An

example of this approach was put forward by Peter Diamond and Peter Orszag, who we'll hear from. I'll let him explain the details of his plan in detail. Their plan relies more heavily on tax increases. Most of the actuarial improvement from their plan comes from various ways of raising taxes, although they do have some benefit reductions in there as well, slowing the growth through indexing to improvements in longevity.

I think it's interesting to note, however, that the Diamond-Orszag plan, while it is an intellectually honest plan that deals with the financing of the system. Unlike many of the people in this debate who just want to sort of stand on the sidelines and boo or throw grenades--they've actually gotten in there and gotten their hands dirty and came up with a plan that adds up. I should point out, though, that for the next 45 or 50 years, their plan actually costs a higher fraction of GDP than current law. And that's what is required. If you really want to, you know, fix the problem--and they have some benefit enhancements for low-income workers and so forth--it costs money to do that. There's no getting around that.

I happen to prefer the approach that would rein in the costs by slowing the growth of benefits rather than by relying on tax increases, especially given that we're probably going to need some of that tax revenue to deal with the Medicare problem. But I also am more in favor of reining in spending growth because of the economic impact.

These are estimates from the Congressional Budget Office over the last year. They say that the president's commission plan would increase GDP, increase national wealth, and, unfortunately, have sort of an ambiguous small effect on labor supply; whereas the Diamond-Orszag plan, according to their estimates, would actually reduce GDP, reduce the capital stock, and reduce labor supply. So just from a

perspective of what this is going to do for the broader macro economy, I certainly prefer the approach of lowering expenditure growth.

So up to this point I focus solely on the fact that there is some need for hard choices here. There's no way around the fact that we've either got to rein in spending growth or that we've got to increase taxes. I'm clearly in the camp that would prefer to do it through reining in spending growth.

What do personal accounts have to do with this? Well, I'm going to make three arguments, and we can talk more about this in the Q&A. The first is just a basic argument that if you look around at the wealth holdings of United States households, something like 50 percent of households currently have no exposure to capital markets. So most of the people in this room, I presume, are fortunate enough to work for employers that provide pension plans, 401(k)s. You probably have mutual funds, stocks, and so forth. In the lower half of the income distribution, most of these people do not have any access to financial markets. Some people may view that as a good thing; I don't. I think there are a lot of benefits to having a stake in the capital base of this country, the ability to bequeath assets to one's spouse, to one's kids, and so forth.

Secondly, if structured properly, personal accounts can improve work incentives by tightening the link between the contributions people are putting in and the benefits that they receive from those accounts. The current system, I pay in another dollar--it's a very complicated system. A lot of young people today don't think they're going to get anything from Social Security anyway. They're wrong about that, I understand, but that's the perception. So what that implies is that that linkage is broken, so they view it as a pure tax, which we know distorts labor supply decisions and is bad for the economy.

And then finally is this point about national savings. If we want to be serious about, you know--if we want to make a commitment to reduce the nation's consumption today in one way or another, either through reducing spending or increasing revenues, and we want to save that money for the future in order to reduce the burden on future generations, we need a mechanism for actually saving that money. I think that personal accounts serve as that mechanism, makes it harder for Congress to treat Social Security surpluses as though it's free money that they can spend elsewhere. I think it's a much superior mechanism to the existing trust fund setup, which has, I think, proven for at least two decades now that it is not very capable of increasing national savings.

I have a lot more to say on this, but in the interests of time, I'll turn it back over to the next speaker. Thank you.

MR. ROTHER: I suspect I'll have a lot more to say as well. Let me start, though, with saying some basic assumptions about this debate that we're entering into.

I think the overriding assumption is this is a program that touches every American family, and it's a very immediate concern to them. This is not going to be an issue decided within the Beltway or decided by who has the most clever advertising or even who's got the best economic model. This is going to be decided by a judgment of the American people. And I think that will be the most important driver of this debate. For AARP, it's certainly our signature issue. We're already out there at the grassroots level. I hope that my 10 minutes this morning can kind of clarify where we are, where we think we should go.

I do want to say, though, that any assumption that future retirees won't be just as reliant on Social Security as current retirees are is wrong, from our analysis of

what's happening. As Jeff kind of alluded to, the problem is that half of today's workers in the private sector don't have a pension plan and don't have any way to save for their retirement. And so even apart from Social Security, we have a problem in this country of helping people save for their own future. And we really have to solve that if we're going to have any kind of economic security in retirement going forward.

The other thing I'd like to say is, in terms of the projections, as I say, actuaries have been at this a long time. But there's also now the CBO, which has come up with slightly different figures. I don't think the story changes, but the magnitude does. I think the only point to make now is that both rely on very conservative economic projections about the rate of growth in the economy. I'm certainly not part of the head-in-the-sand school. Our view is we should do this sooner rather than later. But I am cautious about the certainty of going out 75 years, and I'm contemptuous of the idea that you can project this to infinity. I think that's ridiculous.

There are three goals to Social Security reform we have to keep in mind, not just solvency. Adequacy and equity are also important.

Also, there are some larger goals. As I mentioned earlier, the whole idea here is to strengthen retirement security, not just shrink a program, and should do this in a way that promotes savings and work options, certainly.

We should also be mindful of the impact of this program on the larger federal budget. As the baby boom retires and as we have to redeem some of the bonds in the trust fund, I think one certain objective that makes sense is to slow the spend-down rate.

And I think people need plenty of advance time to plan for their own future--another argument for doing things sooner rather than later.

And I think a political goal, certainly, is to restore the confidence of younger people in the future of the Social Security system.

So let's go through these quickly. On adequacy, I don't know how many people think the current system is that adequate, current initial benefits averaging at $955. I think that that's a minimal system. That's what it's designed to be. It must be supplemented in order to have a decent standard of living. This is not sufficient by itself. One of the things that I thought came out of the president's commission that was worthwhile was the idea of re-instituting a minimum benefit, which I think could help those at the very bottom. But certainly the idea of price indexing would, by itself, destroy any sense of adequacy over time.

In terms of equity, another idea that came out of the president's commission that I think is very worthwhile is doing something to improve the lot of the group that's very vulnerable today--widows. And increasing their benefit to 75 percent of the joint benefit is something that I think needs to be considered.

And, as I mentioned, we need a long lead time for people to plan.

So AARP has been taking very seriously the charge, the challenge, of taking this problem on and how do we solve it. And what we've been doing is holding events around the country and presenting people with a menu of changes and asking them, with their neighbors, face-to-face, to tell us how they would prefer to see this problem solved. And the number one preference, probably the only preference that's actually popular with the American public, is to raise the wage cap. And this alone, depending on how you do it, would close about 40 percent of the solvency gap. It's certainly not sufficient by itself, but it's the first thing that you can get an agreement on even among higher-income people. Everywhere we've gone this is a consistent theme.

A second area is to cover all new state and local employees. I think most Americans feel like this is a system for all of us and everyone should be part of it, just like federal employees and members of Congress who were brought into the system in 1983.

And finally, I think we do see support for investing in the market, although a lot of skepticism for individual investment. But people, I think, are increasingly comfortable with the idea that maybe the trust investments themselves should be diversified beyond just treasuries and that it might be possible and very efficient if you bought kind of an index fund of the entire market--you're not involved in governance issues, you're not involved in choosing winners and losers, you're just buying the whole thing--that this actually could improve the fiscal gap in Social Security maybe by 10 percent or so.

But if you combine these together, you've got more than half.

Then something else is going on which may or may not happen, and that is that the Bureau of Labor Statistics, in their effort to more accurately measure inflation, may adopt what's called a superlative CPI. If that were to happen, that would also narrow the gap by about another 15 percent.

So now we're up to about two-thirds of the total. I think you could easily deal with the rest through some benefit adjustments. This, of course, is the painful part for AARP. We're certainly not, at this point, ready to say which of these would be acceptable to our members and the American public, but I think that what we find is that people, even current retirees, understand that you're not going to solve all of this on the revenue side and you're not going to solve all of it on the benefits side.

So here are some options that we put in front of people:

Changing bend points so that the system becomes a little more progressive and you protect the benefits of lower-wage earners.

Counting more years in the benefit formula. Currently we only count 35. As the age of retirement moves up, you could increase that by three years.

Another suggestion that came out of the president's commission and Peter Orszag's plan is to index the initial benefit to any longevity gains in the future--kind of an automatic stabilizer idea.

You could raise the normal retirement age beyond 67, although most people react to this with dread because they can't imagine too many employers out there hiring 67-year-old people. And so it's a very personal judgment about is this real in terms of the labor market, in terms of their own future.

And, of course, there's the change that would really affect people, which is raising the eligibility for early retirement. Unfortunately, that doesn't give you too many savings into the system.

Our judgment is the diversion of payroll contributions into private accounts is not the answer. That's because to do that, as Jeff said, you'd have to cut guaranteed benefits, in terms of replacement rates, quite dramatically. In fact, if you actually adopted price indexing over time, the guaranteed part of the system would essentially wither away. It does put risk in Social Security in the same way that every other retirement plan is at risk. And it puts the individual, I think, in an untenable position of having no part of their future retirement protected.

There are transition costs, we believe, and those are quite substantial.

We think trying to put together a system, even a fairly efficient system, that runs millions of small individual accounts would inevitably be much more expensive to run than something that was collectively invested by the trustees.

One risk that doesn't get talked about a lot but we see already in 401(k)s is that when you tell people it's their money, they want it. And they don't want to wait for it. One of the problems in our private system today is that much of the money that's being contributed to retirement accounts gets taken out well prior to retirement.

And finally, I think we have to keep in mind the fact that disabled and survivors are part of the equation here. Some of these changes would affect them, some would not. That's going to be a major concern for us.

However, we do not oppose personal accounts. We just oppose diverting the payroll tax to fund personal accounts. We think there are some ideas that ought to be part of this discussion that would promote more retirement savings, and one of them, as Jeff said, is to target lower-income people who are not saving today. An easy way to do that would be to make the savers credit, that's currently a law, refundable. We could match contributions for those people so they would have a tax advantage, just like all of us do, and that could be a very powerful way to build national savings as well as individual retirement savings.

Of course, to do this you'd have to require everyone, all employers, to actually institute a payroll reduction mechanism, because no one saves unless they have payroll deduction.

And finally, how could you pay for this? Well, one idea is through the state tax. But you could have others as well. I mean, there's no particular magic to any particular financing source.

So finally, I just want to say one word about public opinion. We're doing quite a bit of polling. We are going to release a poll next week. And what is says is that two-thirds of American age 30 and above want the current system preserved as close to its current form as possible, so long as it can be made financially stable.

They favor a balance, as I mentioned, of small revenue and benefit adjustments. They want to see it spread out--not all revenue, not all benefit.

When they are told of the downsides to personal accounts, support for that idea drops dramatically. And by "dramatically," I mean to less than 15 percent of the population, once they understand the costs involved and the risk involved.

And finally, there is wide public agreement that whatever we do in this whole area should not ask low-wage earners to sacrifice.

So thank you very much. I look forward to further discussion.

MR. POZEN: I'm going to speak without the benefit of PowerPoint. I do have a handout, if people want to see it.

I have been working on this problem with a number of the people in this room for quite a few years, and I've tried to come up with what I believe is a bipartisan approach. There are Republicans who just want a personal retirement account and do not want to have systematic reform of Social Security. I believe that they're just getting all the negatives without the positives and that's an irresponsible approach. But so far it appears, from the people I talk to in the Treasury and the White House, that they do want to combine personal accounts with some sort of serious Social Security reform. I think that's the way to go.

There are Democrats who, as Jeff said, see that there's no problem. I just think that the accounting we use now on a yearly basis for Social Security--remember, if

we accounted for the General Motors pension plan the way we account for Social Security; that is, we ignored all the long-term accrued liabilities and we just look at cash flow on a yearly basis, the person who did that would go to jail for accounting fraud. But in the United States government, it's okay. We do have a long-term liability with a present value, over 75 years, about $3.8 trillion. And that's a very accurate number, in my view.

So both Peter Orszag and Peter Diamond have put forward a very serious and very honest attempt to say here's how you could raise taxes and here are various benefit cuts that you could make that would get you to solvency. My problem is not economically--I think a lot of their ideas make sense economically--but politically, if you go to your constituents and say here we have tax increases and benefit cuts, how many are going to vote for it, I think the answer is almost none. I believe you need to view personal accounts as the political sweetener, the political quid pro quo to sell the serious and fundamental reform of Social Security.

So the question is what sort of reform should we talk about. As mentioned here, some people talk about moving retirement age back. I think you all know we're in the process of moving it back to 67 by 2027. I believe that it would be a mistake to move it back further--a mistake in part, as John Rother said, because it's very hard for people above 67 to get jobs, especially given the cost of health care and how that factors in. I think a more fundamental issue is the people in lower wages have much more physical labor than all of us, and therefore for them this would be a real challenge.

And that is my main point. My main point is that if we have not enough money to go around, we ought to look and protect the Social Security benefits of low-wage workers first. That's what we ought to do. Why? Because that's what Social

Security should be all about. That's the income floor that we tried to establish through Social Security. And another reason is they don't have 401(k)s and IRA plans. Look at all the statistics. Below $25,000 a year, IRAs and 401(k)s, trivial participation. Above $70,000 a year, almost everybody is participating.

So if we're not going to do retirement age, what about complete movement from wage to price indexing? This is very popular, it was Model 2 in the Commission's report, and there's a lot to be said for it. The problem I have is that it really hurts low-wage workers. It brings down their replacement ratio. It also brings down the replacement ratio of higher earners. But they have 401(k)s and IRAs to help get back some of those benefits. They can supplement their Social Security with ease. We know that most low-wage workers do not have other sources.

So, what is my solution? My solution is called progressive indexing. And it's very simple. You take the concept of moving from wage to price indexing of initial benefits and you divide the world into three parts. All workers who are at $25,000 in career wages and lower, as well as everyone in retirement and about to go into retirement, we keep them under the current system of wage indexing of their benefits. All high earners, which I define as $113,000 and above, we move to complete price indexing. Those people can handle it. Then, the mid-point, which is $69,000, we use half indexed to prices, half indexed to wages.

This progressive indexing, I think, makes a lot of sense. It obviously doesn't save as much as total complete wage to price indexing, but the good news is, according to Steve Goss, it saves about half. We reduce the long-term deficit from $3.8 trillion to $1.9 trillion.

So that brings us to the second question: How do you sell this to the middle and high earners? We are not actually cutting their benefits. Under my proposal, they would continue to grow, at least at the rate of prices--and for everyone under $113,000, above the rate of prices. So they'd be growing in both real and nominal terms. Nevertheless, I can assure you--and I hope the journalists in this room won't reinforce this--as soon as people hear "progressive indexing," they'll start yelling "benefit cut, benefit cut, benefit cut." It's actually slower growth of benefits. It may seem just nomenclature, but it's a big difference.

Still, we're going to have to sell slower growth to the middle and higher earners, and that's where I think personal accounts come in. That is where their function is, not as a matter of so-called ownership society--which I'm not sure I know what it means. It's a matter of the political quid pro quo, the sweetener that makes it possible for you to have benefit reform. So that's one function of personal accounts.

The second one is, a related function is let's give these people a chance to earn back through higher returns in a personal retirement account than they would have gotten under Social Security or they would have gotten under Treasury bonds. So we take 2 percent of their 12.4 percent FICA wages and we put it into a personal retirement account.

Now, I'm in the investment business and I've heard a lot of misconceptions thrown around. There's no one who's talking about allowing this money to go into commodities. When I saw the AARP ad which had a commodities floor, I must tell you, John, I was quite upset. The commission which I was on, which included some very conservative people, some very Republican people, voted basically no to index funds. And I would actually go one step further. I follow Professor Thaylor from

Chicago, who says presumptively put everybody into a balanced fund--60 percent in a stock index fund and 40 percent in a bond index fund--and make them opt out if they want to go to something different. Professor Thaylor has studied this and shows that 95 percent of the people stay there. That's where they are. And I would actually give a very limited array of choices.

If you look at that sort of investment portfolio, yes, there is year-to-year volatility, but I'll be glad to show anyone the numbers. The fact is that over long periods of time, it's very stable. It has a pre-inflation--over 35 years, if you look at all cohorts since 1950, the pre-inflation numbers are between about 7.46 annual return and 9.13 percent. That's what it is. So it's a pretty good number.

And yes, there were 13 down years in the stock market between 1950 and 2004. But guess what? In almost every single one of them, those years were matched by positive up years in the bond market. That's why you have a balanced portfolio for this sort of thing.

The third point is, are we going to achieve solvency? Again, there are many people who argue that you have to bring down the long-term deficit to zero. I've thought about that for a long time and I think they're just plain wrong. Some of them are just perverse. They're trying to have no reform, and they use that. I think there have to be two tests.

One is, do you complete borrowing before the end of the 75-year solvency period? Like John, I'm not for infinity. I got a hard enough time with 75 years. Infinity, I don't know. But, do you complete your borrowing within 75 years?

And second of all, more importantly, in the year 2079, have the lines crossed? Have the income and cost lines crossed? And under my proposal, as scored by Steve Goss, it meets both tests.

The borrowing--which, by the way, under my plan is substantially less than the current system. People don't want to admit that the current system has huge borrowings involved. My proposal has much lower borrowing, and the borrowing is completed about 2074 and '75. And in 2079, then, the lines have crossed and it's into positive territory.

So in short, the combination of progressive indexing and a modest personal account cuts the long-term deficit in half and gets you into self-sustaining territory in 2079. It's accomplished by slower growth, not benefit cuts, for middle and higher earners, who get in return, so that they will accept that, the chance to have a modest personal account.

That's my proposal, and I hope you would take it seriously. Thank you very much.

MR. ORSZAG: Thank you all for coming this morning.

I think when we're evaluating Social Security reform plans, we have to remember what the role of Social Security is. It's intended to provide a foundation, or a core layer, of financial security during particular times of need--retirement, disability, the death of a family member. It was never designed, and it won't be under any of these reform plans, sufficient by itself to provide a comfortable retirement. Just to drive that point home, as John has already mentioned, the average retirement benefit is below a thousand dollars a month. If you talk to financial planners, they say you need about 70 percent of pre-retirement wages in order to live comfortably in retirement. For an

average-earning worker who claims benefits at age 62, which is the most common age, Social Security is providing about 33.

So everyone should agree that we need about 40 percent more on top of Social Security, and Social Security was never designed to be enough by itself.

Now, for that bottom tier of retirement income, I think you want several attributes. You want a benefit that lasts as long as you're alive, that's protected against inflation, that does not decline when the stock market does. And guess what? That is exactly what Social Security already provides. For that core tier, those attributes are very important.

Now, individual accounts are great. I want to say, I love individual accounts. We already have them. They're called 401(k)s and IRAs. And they are the key to topping up Social Security that extra 40 percent to live comfortably during retirement. I'm going to show you in a moment a bunch of common-sense reforms that can boost saving in those accounts. However, they simply don't belong in the core tier, in the base foundation of retirement income. That's not where accounts make sense.

There are a series of very easy common-sense reforms that we could do today and we could enact on a bipartisan basis that would dramatically raise saving in individual accounts on top of Social Security. And regardless of what you think about how Social Security should be reformed, we should do this.

For example, simply changing 401(k) plans so that you're automatically in the plan, unless you opt out, rather than having to affirmatively sign up for the plan, dramatically raises participation rates. And when this kind of plan is coupled with an automatically escalating contribution rate over time--which, again, workers could opt of at any point--there is the very substantial potential for significant increases in saving.

Just to drive that point home. Look at workers under $20,000 in earnings, where there's a significant savings problem. If they have to sign up for a 401(k) plan, less than 15 percent participate. If they're presumptively in the plan unless they opt out, 80 percent. There is not a single step that policymakers could take to boost retirement security this much than to simply get these plans in place, the automatic 401(k). And there are a variety of other steps that one could take outside of the 401(k) system that would be similar.

Accounts, however, just don't make sense within Social Security--especially, by the way, as the pension system on top of Social Security is moving from a defined benefit one to a defined contribution 401(k) type plan. And especially because, regardless of what the commission wrote down on paper or what people will design on paper, over time in a realistic set of individual accounts, there will be pressures that will undermine the accounts within that core tier, or in terms of providing a foundation. There will be a lot of pressure for early withdrawals. You've told someone that the account is theirs, they've got $30-40,000 in it, the kid's sick, they need a new refrigerator, they're 35 years old--they pull the money out. That's fine, but the money's not there for that foundation during retirement.

Similarly, a lot of plans assume that people will annuitize--that is, transform their account balances into something that lasts as long as they're alive--at retirement. It's unlikely, in my view, that that will be sustainable. We've seen in the United Kingdom that that kind of a requirement comes under a lot of pressure, increasing pressure over time.

And I haven't even mentioned the so-called transition issues associated with individual accounts that are part of Social Security. Under commission Model 2,

which was the leading plan from the president's commission, publicly held debt did not decline, relative to no reform at all, for 60 years. So just imagine that for a second. That would be like we enacted that plan at the end of World War II, we actually stuck with all of the benefit reductions that it entails in the out years, no backsliding--and I think that's unrealistic--only today would we be experiencing any net reduction in public debt from it whatsoever. So this transition is not a decade or two decades. It's many decades, and it's big and deep.

Well, I've been talking about how to boost the saving on top of Social Security and why accounts don't make sense within it. But obviously, there is an underlying deficit in Social Security in that core tier, and that core tier should be shored up. We've already talked a little bit about the size of that problem. You hear numbers of $10 trillion--which, again, as has already been mentioned, is over an infinite horizon. Over 75 years, the deficit is somewhere between .4 and .7 percent of GDP. That's roughly a half a percent of GDP, or roughly a third the size of the tax cuts that have been enacted over the past several years.

As has also already been mentioned, it is very important in this debate to remember that this is not the key problem facing the federal government. The key problem facing the federal government is health care. These lines demonstrate that. The red line is Social Security. Yes, costs go up and we should address the problems associated with that. But if you were to ask why is the federal government as a whole facing very large fiscal deficits as you roll out in time, the answer is primarily Medicare and Medicaid--those blue lines--which skyrocket in cost. I actually think one of the primary benefits of enacting Social Security reform would be that we would take the

issue off the table so that events like this would be focused on health care, which is the real problem, rather than Social Security, which is not.

So what would I do to shore up that base foundation of retirement security? Peter Diamond and I have put forward a plan. It does restore long-term sustainable solvency. It does not destroy the program in order to save it. By that I mean it retains the core features that you want in that foundation--benefits that last as long as you're alive, that are protected against inflation--that foundation upon which one can build with accounts. It also does not adopt any accounting gimmicks or magic asterisks, so it's an honestly scored, honestly financed plan which--I would note that basically there is no other honestly scored or honestly financed plan. All of them involve very substantial general revenue transfers from the rest of the budget without telling you where that money would come from. And it does combine benefit reductions and revenue increases, rather than relying exclusively on either one.

In addition, it is progressive. It protects the most vulnerable beneficiaries. I think there is some widespread agreement that we should do that. It protects disabled workers, it protects young surviving children--children whose parents have passed away while they were working, workers who have lifetime earnings, and widows. It does ask some modest sacrifices from average earners, which I'll describe in a moment. And it does ask higher earners to play a somewhat larger role in restoring solvency. I think it's worth pausing on that just for a moment. It asks them, for two reasons. One is that there have been various trends in the population, that are not widely appreciated, that makes it worthwhile to look to higher earners to play a larger role.

I'll just give you one example. Many people know that life expectancy is going up. Some people know that life expectancy is longer for higher earners, better

educated workers than everyone else. Very few people know that the gap between higher earners and lower earners in life expectancy is literally exploding. In my view, that justifies asking for some benefit reduction for higher earners in terms of their monthly benefit, because they're increasingly getting those monthly benefits for a larger and larger number of months compared to everyone else.

So bottom line for average earners. We do have some benefit reductions which apply only to those who are younger than 55. For a 35-year-old, for example, it's about a 4.5 percent benefit reduction. Just to put the numbers in context, for a 25-year-old, that's a smaller benefit reduction than at the time of the 1983 reform. So in our view, these are politically feasible precisely because they're phased in slowly over time.

We do couple that with some modest and gradual increase in the payroll tax. To put that in context, if the 2045 increase in the payroll tax were implemented this year--and again, it would not be for 40 years, but if it were--the average earner would pay an extra $37 a month in combined employer and employee payroll taxes. So some pain, but we don't think it's overwhelming.

So what are my conclusions? Basically, that individual accounts do not make sense as part of Social Security within that core tier, that base foundation of financial security. That Social Security does face a problem that should be fixed. It's better to address it sooner rather than later so that we can make the necessary adjustments gradually. And, perhaps most importantly, regardless of what one thinks about Social Security, there is a growing body of evidence suggesting what works to get people to save on top of Social Security. And both sides should agree on those steps. We need to make saving more automatic, make it the default, with people being allowed to opt out of that saving default. And the evidence suggests that that can produce a

dramatic increase in saving on top of Social Security, in particular for low- and moderate-income households. We have a new project here at Brookings called the Retirement Security Project, which is going to be devoted primarily to promoting those evidence-based policies for boosting saving on top of Social Security.

Thank you.

MR. GALE: We're going to have rejoinders from the authors now as the screen magically disappears. We'll do that in reverse order. So we'll start with Peter.

MR. ORSZAG: You get to hear from me again, I guess.

All right, I have just a few brief comments on what had been said before my presentation. I don't have any comments on my own presentation.

[Laughter.]

MR. ORSZAG: First, in terms of the interesting proposal from Bob Pozen, two thoughts are very important to remember. The first is that, I know from experience, it is a lot easier--and by "a lot," I mean a lot easier--to solve half the problem than to solve the whole problem. If Peter Diamond and I only had to solve half the problem, our proposal would look, from a political perspective, a lot better than trying to solve the whole problem. So it's, in my view, too easy to just say, well, it solves half the problem and that's good enough.

Secondly, in terms of the political quid pro quo, the political quid pro quo makes sense, I guess, if you're borrowing the money for the individual accounts. But then you're undermining the economic benefit of setting up the accounts. I'm not so sure that the American population will think that it's such a great deal to be either forced or allowed to set up individual accounts when you have to pay for that. So we have to remember that the political magic here is trying to give something to people without

paying for it, and that undermines the economic benefit. If you were setting up a system of individual accounts and said "and you have to pay for it," well frankly, workers can already do that. We need to get them doing it more. So I'm not sure what the quid pro quo is there from a political perspective.

Jeff had noted the CBO analysis of the Diamond-Orszag plan compared to Model 2. I think what's very important to realize there is, yes, there is some small change in economic growth that is driven solely by the fact that our benefits are much more robust than Model 2's. Our replacement rate for young workers today, average young workers, is 37 percent at age 65; under Model 2, even including the individual accounts, it's 22 percent. Very big difference. That's what driving the modest difference in economic growth.

I'd also note, by the way, over the next 25 years economic growth under our plan, under the baseline, and under Model 2 all average 4.1 percent per year. Ours is 4.09 percent; Model 2 is 4.11 percent. There's a little difference, but it all rounds to 4.1 percent per year, in case you wanted to calibrate things from that perspective.

And then the final point I just want to drive home is I think everyone here has--I don't want to say the word "admitted," but clarified that individual accounts have nothing to do with reestablishing solvency. So I'll put it quite bluntly. When President Bush says--when someone asks President Bush what are you going to do about Social Security's deficit, and he says "individual accounts," that's a non sequitur. Everyone up here has said that individual accounts have nothing to do with reestablishing solvency, with the exception of the political argument that Bob Pozen made. But in terms of a direct answer to what will establish solvency in Social Security, individual accounts are just irrelevant.

MR. GALE: All right, thank you. Bob Pozen?

MR. POZEN: I have seven points here.

First is I agree with Peter Orszag's point, the longevity assumption. People who say we don't have a serious long-term problem with Social Security try to say, well, the productivity assumption isn't so good, et cetera. I think the biggest question mark is the longevity assumption. I live in Boston, where there's a lot of biotech. If half those things come out to be true, people are going to live a lot longer, and that's going to be a huge difference in all these models.

The other thing is people say is it urgent. And my view is very simple. It's a political view. Once people get at or near retirement, you can't change anything about Social Security. I was born in 1946. I'm the first wave of the baby boomers. We're all starting to retire in 2011. You don't do something by 2008, we are politically not going to be able to do anything because we're not going to be able to touch anybody's benefits who retires in the baby boomers. And once you do that, all these models go out the window.

Second point is there are various discussions about increasing payroll taxes. Remember the Orszag-Diamond proposal involves raising the tax from 12.4 percent to 13.4 percent. At some point I think it actually, between the payroll and the transition tax, it gets above 14 percent. I think that for a lot of people in the United States, that's just not going to fly. You need a political sweetener for that one because there are a lot of people against it.

Similarly, third point--COLAs, bend points, these are all very fancy ways to bring about slower growth in benefits. Again, I think a lot of them make sense economically.

How do you get somebody to go for it? My fourth point is I think that the political count is not just a quid pro quo. Yes, it is a political quid pro quo, and that's one important function. But the other important function is it actually gives people a reasonable chance to earn back the slower growth of benefit, that the total of the lower traditional benefit, which we need to do in these various ways, plus the higher return on the PRA will get you in the ballpark of where to schedule benefits. So it has two roles, not one.

The fifth point is John Rother mentioned administrative expenses for personal accounts. I think the president's commission did a great job of showing how you can get those down by having a very streamlined system. And I note that my former employer--I was vice chairman of Fidelity Investments for quite a few years--is now offering stock index funds and bond index funds with a total all-in cost of 10 basis points, and they're giving pretty good service as well as good investing. So that's what it costs, 10 basis points. Yes, it's a little more than Social Security, but it's a pretty good deal.

Sixth point is John suggested government investing in the stock market directly. I was in New Zealand, I was involved with the government there. That's what they're doing. They have a statute that says the trustees of the fund are supposed to do two things. One is they're supposed to maximize long-term returns, and second of all they're supposed to do nothing to undermine New Zealand's reputation in the global world. And I swear, it's that bad. And I said to the minister of finance, well, what does that second phrase mean? And he says, I have no idea at all, because that's what we needed to get it passed. And I said, well, what's going to happen, how are people going to do this? And he says he has no idea.

Now, more systematically, the World Bank did a study in 2001 of all these government investing in stock markets. And guess what? They all had lower returns because of political interference--no tobacco stocks, no alcohol stocks, no gambling. It just goes on and on.

Last point is I strongly believe that in terms of solvency, Peter's last point, is the best is the enemy of the good. If you try to go to zero, if you try to reduce this long-term deficit, which I think we all accurately said under the 75-year period has a present value of $3.8 trillion, you will not be able to do it politically. It is too tough. I have not seen any congressman--where is the groundswell for the Orszag-Diamond plan? The answer is it isn't. It's too tough. There are too many benefit cuts, there are too many taxes. Let's be realistic. If we could get this deficit down in half, we would have helped things a lot. And the United States can handle, relative to its GDP, half the deficit, half the $3.8 trillion. So let's not get hung up with getting to zero. If we can get that $3.8 trillion to $1.9 trillion, we ought to all stand up and applaud ourselves. And it won't be easy to get there.

Thank you.

MR. GALE: All right, thanks.

John Rother?

MR. ROTHER: I just want to make two points, really, one from a public opinion perspective and one from an economic one.

In terms of public opinion, we find almost no support for the idea that somehow private accounts are viewed as a tradeoff for Social Security cuts. Quite the contrary. Instead of--I mean people like the idea of private accounts, but not as a tradeoff. They want Social Security as close to its current form as they can get it. And,

I think, to the public credit, in most of the work that we're doing people roll up their sleeves and get there. And they don't get halfway there, they get all the way there. But they do it by some of the changes that I was sharing with you earlier. So I think we ought to have a little more faith that the public, for the right purpose, namely, the continuation of a program that's so important to them, would be willing to be realistic about what it takes.

On the economic point, one of the things that just seems to me to be a puzzle is the comparison of past returns in a market with future very low rates of projected growth by the trustees and the Congressional Budget Office. So which one is it? Is it that we still have the robust economic growth that we've had in the past--and if that's true, then the projections are way too conservative; or is the market also going to flatten out with slower growth in the economy, in which case investing in private accounts is not going to be any kind of magic solution? So I think there's a disconnect here when we look back on economic growth in the market and then we look forward to much slower economic growth as a basis for the trustees' projections.

MR. GALE: Thank you.

Jeff?

MR. BROWN: Well, after all that, I have a very long list. So I'll keep going until Bill tells me to stop.

The first thing is I actually need to respond directly to something that John said in his remarks because he attributed something to me that I did not say and which is factually incorrect. John said that redirecting existing payroll tax revenue to personal accounts would reduce replacement rates--which is absolutely wrong. The only way that statement is true is if you ignore the income from the personal accounts. To the

extent that there are any reductions in replacement rates going on under any plan, it is due to the looming financial imbalance of the system, not because of the personal accounts.

MR. ROTHER: Just to clarify, I was citing the CBO.

MR. BROWN: Well, I think the CBO, there are people from the CBO that are here and I think they would agree with me on this point. We can ask them.

These are the kind of statements that, taken out of context, can be very misleading. So if those are the kind of statements that are being made to people in these focus groups across the country, well, it's no wonder that support for personal accounts drops to 15 percent, if you're feeding them misleading information.

The second point I would make, some comments were made about redistribution and the effects of the commission plan. The GAO put out a report in June of this year that examined redistribution within the president's commission Plan 2. And while they admit that the pie is shrinking, the system is actually more progressive in terms of dividing a larger share of that pie up to low-income earners. So there's nothing inconsistent about personal accounts, commission Plan 2, and being redistributed.

Third, a technical point. I actually want to defend infinite horizon calculations. I think they have a very useful role to play. Let me give an example. John said that one of the things the AARP supports is putting state and local workers into the system, and he claimed that that has a large effect on actuarial balance. Why is this the case? Well, it can only be the case for one of two reasons. One, which is the big piece of it, is that if you only start putting new state and local workers into the system, then over the next 75 years you get to take credit for the taxes that they pay. But you don't have to take the costs of the benefits that are going to be paid out outside of the 75-year

window. In a present value sense, if you're giving state and local workers a fair deal, that would have absolutely no effect on the actuarial balance. The only other way it could help is if you're giving the state and local workers a bad deal, giving them a less than actuarially fair deal from the system. Seventy-five-year horizon calculations allow you to play those types of games. Infinite-horizon calculations, while they are wildly uncertain--the numbers are sensitive to assumptions--they at least recognize--they provide a way of sort of discovering where those games are being played.

Fourth, I agree with Peter that health care, Medicare costs and so forth, are a larger problem in this country. But to me, the conclusion of that is it's hard to imagine a solution to Medicare that doesn't involve increased revenues. And unless you think you can impose payroll tax rates of 25 or 30 percent 50 years from now to pay for both Social Security and Medicare, I would rather save whatever taxes are necessary to cover Medicare, not Social Security. I think there are better things we can do on Social Security.

Peter also pointed out that--he made a statement that Commission Plan 2 takes a long time to get to the point where publicly held debt falls. Publicly held debt is not the relevant measure of national savings. If you think about national wealth, by which we mean not only publicly held debt, but also the value of money in the accounts and so forth--this is something we call national wealth--the CBO estimates that under Commission Plan 2 the national wealth would actually increase during that period. So yeah, we have publicly held debt rising, but you also have a lot of money floating up into the accounts.

The last thing I will say is I understand Peter's point about personal accounts and their effect on the system's finances. And it's true that [tape flip] can't

solve the problem. But I do think personal accounts have an important role to play here. And that is, if we want to be serious about saving money for the future, if we want to pre-fund Social Security by putting more money aside today, whether that's increased taxes or lower benefits, in order to reduce the burden on future generations, we need a way to protect those savings from being spent on other government programs and so forth through the budgeting process. The trust funds have not proved useful in this way. There's a good political economy argument that suggests that personal accounts would be useful in that way. So I don't think it's fair to say that personal accounts are totally irrelevant in this debate.

MR. ORSZAG: Bill, can I ask a quick question of Jeff on that point?

MR. GALE: Very quick.

MR. ORSZAG: Yeah. Which is, deficit financed individual accounts. So we put a dollar into the individual account and borrow the money to pay for it.

MR. BROWN: Yes.

MR. ORSZAG: The first order effect--

MR. BROWN: It has no effect on national saving.

MR. ORSZAG: No effect on national saving, therefore is not accomplishing the goal that you're putting forward for the accounts.

MR. BROWN: That's true, but I would also say that neither do debt financing the accounts make anything worse. So if we want to have a discussion about transition costs, let's be clear that transition costs aren't really a cost in present value. We're simply retiming things. So if you really think about the balance sheet of the U.S., by which we take into account unfunded obligations as well as debt, if we reduce the

unfunded obligations and increase publicly held debt by the same amount, the balance sheet of the country hasn't really changed.

So I will agree with that point if you will agree that the transition costs are just a way of doing saving for the future.

MR. ORSZAG: But I just--we can have the discussion, but I just wanted--the advantage that you put forward for individual accounts is erased by--you know, you might say it does no harm, but there is no advantage to doing individual accounts if they're deficit financed.

MR. BROWN: Well, except if we did them today--we're expected to run surpluses in the Social Security system for the next 13 more years, if we put those surpluses into accounts rather than into the trust fund, I think you would get a boost in national saving.

MR. GALE: Okay, good. Thank you.

[Laughter.]

MR. GALE: So I was right, we have reached a consensus.

Just a couple of quick rules on the questions. I'll call on people. There are people walking around with microphones. Please speak into the mike, please state your name and affiliation. Most importantly, be sure you have a question, not a statement. And please keep it short. There are a lot of people that want to ask questions.

QUESTION: Jack Farrell from The Denver Post. I've been going to a lot of these forums and listening to--watching the two lines over and over again get closer and further away.

But with everything else in the budget, it seems that there's a goal at the end--that the Defense Department knows it's going to need so much money to keep so

many soldiers in the field. I don't hear any of you guys saying that in 2042 a retiree is going to need X amount of money for medicine, housing, food, and that right now under wage indexing they're going to have far much more money than they need, or under price indexing they're not going to have enough money. And I'd just like at some point--I mean, is there a hidden table somewhere on the Brookings Web site that says this is what people need and this is what we should be heading towards and right now we're over-funding it or right now we're severely under-funding it?

MR. ORSZAG: I'll take a first crack at that. In terms of--that's precisely why I think we need to keep that core foundation relatively --. There is some reduction that is necessary, but the price indexing proposal goes way too far. So again, coming back to the replacement rates--and again, even if you include the individual accounts, the CBO says for young workers today, or young people today, you're going to wind up with a replacement rate from Social Security of 22 percent of your previous wages, for an average earner. That is too low. For that core tier, that is too low, especially--I haven't even come to it--but especially when you take into account that Medicare Part B and the drug benefit, Part D, premiums are subtracted from your Social Security check before you even receive it. So when you take that into account, the decline is even steeper, and I think you wind up with a system that is simply inadequate.

And I want to emphasize, the United Kingdom has actually done this. They have price index benefits and they have voluntary individual accounts. And they are now realizing that that is a hugely problematic system both because the price index benefits are inadequate and because the individual accounts have lots of problems associated with them--which I could discuss if someone else asked me about it--

[Laughter.]

MR. ORSZAG: And I think we should actually look to the United Kingdom. They have done what President Bush says we should do here, and frankly, I think if you talked to most people in the United Kingdom, they would think that--I won't be impolite about it, but that we are misguided in thinking that that's a particularly good model.

MR. POZEN: Can I give an answer? I think it's a hard question to answer. But my view is your retirement benefits should be roughly, if you can, 40 to 50 percent of your earnings when you're working. There's no magic about that, but that's saying you're going to have to have some scale-down, but that's in a basic area. You get that retirement income from three sources--Social Security; second of all, from your 401(k)s, IRAs; and third of all, from your private savings.

Now, the reason I'm against wage indexing [sic] for low-wage workers is because they don't have much of the second and the third. So if we take their number from Social Security and reduce it from 46 percent to 25 percent--which are my calculations, but in the ballpark with Peter's--then they don't have anything else to get back from 25 to 40 or 50. If we take it for a person who makes $100,000 a year and reduce it from 46 to 25, I'm not worried, because I know that that person has 401(k)s, IRAs, and personal savings, and they'll be up to the 40 or 50 percent.

So that's, I think, probably the most useful thing we can say about it. We can't get a lot more precise because we don't know the exact cost of health care in 2050.

MR. GALE: One thing we all agree on is that Bob meant that he was against price indexing for low-wage workers, not against wage indexing.

MR. POZEN: Yes, I'm sorry. Excuse me. I'm sorry. You're correct.

MR. ROTHER: I think I made this point, but I'll make it again. The current system is a floor, but it's a very low floor indeed. Approximately a third of retirees count on Social Security for 90 percent of their income or more; two-thirds, it's the majority of their income. So we haven't even achieved yet the kind of tiering that everybody up here is talking about. And there's no evidence that that will happen on its own for the boomers, because so many of them are not saving and don't have a pension. So to take away that bottom tier when we haven't done anything about the rest would be a catastrophe for the future, particularly in light of rising health care costs.

MR. BROWN: Just two quick points. Number one is we're not taking away the bottom tier. Future retirees would get the same thing, even under price indexing, as current retirees do, even after adjusting for price growth.

Second, regarding the U.K., the upside is they're one of the only developed countries in the world that are not facing a huge unfunded pension liability. So now they're in a position where they actually have the financial flexibility to deal with the problems that are arising.

QUESTION: Mike Wyand, BNA.

Should President Bush include Social Security in his FY '06 budget?

MR. ORSZAG: Yes.

MR. POZEN: No.

MR. ROTHER: Well, I think honest and transparent account to the public is key. I can understand why the president will not do that. But I do think that ultimately we've got to be very above-board in how all these things are handled. So whether it's part of the budget or separately, I think it would be helpful to put it in a

budget. But the budget's really only five years out. We're now looking 75 years out for this.

MR. POZEN: I think all administrations have played this game of using the cash flow surplus. What will be interesting is, when we get to 2018 and the cash flow surplus turns negative, then how many president's are going to include it in their budget? And Howell Jackson has written a brilliant piece in the Harvard Journal of Legislation explaining how bad the accounting is and proposing various ways to do it. And he has an op-ed piece. The accounting, the misstatements in the accounting contribute to the misunderstanding of the problem and create the illusion that not only isn't there a problem, things are great--we've got a $200 billion surplus. It's a most unfortunate thing. I can't understand it politically. Getting the accounting right would be a good first step.

QUESTION: John Sabelhaus.

A long question and a quick answer. Two of the proposals that I think I heard talked about that you might agree on. One was an increase in the tax max, and the other is longevity indexing. So I wonder if we could go down the row and everybody give us opinion on this?

MR. POZEN: I'll be glad to say I'm against longevity indexing. It's a more sophisticated way to do moving the retirement age back because it essentially says you can retire at 65 instead of 69, but you're just going to get less money. So it has a financial penalty which cuts equally across all income groups. And it doesn't take into account that it is the low-wage worker who has the problem getting physical labor jobs later. So it looks like it's income-neutral, but it really isn't.

As to raising the wage base, the maximum taxable wage base, there are many proposals that say it's at $90,000 now with 12.4 percent, why don't we just raise it to $200,000, 12.4 percent. I'm strongly against that because what you're doing is you're increasing the taxes of those people by a huge amount, and everybody who's making a million dollars is okay. So if you're going to do an increase in the wage base--and this is probably a point we do agree with--I think probably what you would do is say above $90,000 we're going to do it like Medicaid, with a 2.9 percent above that. And that will go all the way up in income and not stop at $200,000.

But that's something you can agree with in principle. I don't know, I've noticed that Congress isn't too into increasing taxes lately. So I think we ought to be all realistic about that.

MR. ROTHER: Two points quickly. First of all, as I mentioned, I think the public opinion work shows the public has reached a very strong consensus around the first point, raising the wage base. And, you know, to be fair, it's because it doesn't affect most of them. And secondly, I think that the jury's very much out on any of the benefit changes, because that really does depend on what a whole package looks like and the perception --. You're not going to get people to say on a one-by-one basis whether this is okay or this isn't. It really depends on the total impact, as Bob said, especially on the lower-wage worker.

MR. ORSZAG: On the maximum taxable earnings, two points. One is it is important to realize that because of growing wage inequality, with wages growing much more rapidly at the top than in the middle or at the bottom, the share of earnings that are above that cap, and therefore go untaxed, has risen from 10 percent in 1983 to

15 percent now. And I think it does justify some walking back of that share that goes untaxed.

And it's interesting, the president's principles, which were the same when the commission was appointed in 2001 as they are now, rules out an increase in the payroll tax. As many of you may know, there's some ambiguity, and the White House press spokesman has danced around the question of whether that does or does not include raising the base against which the payroll tax is incorporated. For those of you who are interested in that question, you may be particularly interested in a footnote in the commission's report which says that one of the plans, Model 3, had considered an increase in that payroll cap, but it was judged to be inconsistent with the president's principles. So at least as of 2001, there was a definitive interpretation that ruled out that option as being inconsistent with the president's principles.

MR. BROWN: I was just going to comment on the longevity indexing piece. I'm not wed to price indexing. My view is that the current system, a wage index system, is clearly unsustainable without rapidly rising tax rates. And I want to find a way, some way, to reduce the growth rate in expenditures. And if that--you know, there are many ways to do this, through changing retirement age through longevity indexing, price indexing, and there are other ideas out there as well. And I don't necessarily want to rank-order them. I think in general any of these approaches which slow the growth rate in expenditure to a level that we can afford with something close to current tax levels is something I'd be willing to consider.

QUESTION: Simon Kennedy of Bloomberg News.

Both Peter and Robert Pozen touched on this, but the kind of international lessons. The president has praised the Chileans for what they have done, and you

mentioned the U.K. The international lessons of private accounts, I guess they have appeals to both camps. But, you know, what do we learn from those, particularly the Chileans?

MR. ORSZAG: I'm going to answer that by focusing particularly on the United Kingdom.

[Laughter.]

MR. ORSZAG: And there's a very good piece that was just recently published in The American Prospect on the experience in the United Kingdom with individual accounts. I want to point out a couple of aspects of that.

The first is the administrative fees. Some people in the United States say that we're going to wind up with low administrative costs just through competition. That is not what happened in the United Kingdom even though there are low-cost funds that are available there, just like there are low-cost funds that are available here. The average charge was very, very high and would have eaten up more than 40 percent of an account balance at retirement had the U.K. government not stepped in and regulated fees. There are now fees on the so-called stakeholder accounts no more than 100 basis points, or 1 percent per year--which, by the way, still adds up to about 20 percent of your account balance at retirement. So administrative costs have been a huge problem.

A second issue has been the fact that this is a voluntary system and there's a lot of financial education that's required in order to guide people into whether the accounts make sense, how they should be invested, things like that. The financial firms, insurance firms in particular, have been accused and--I don't want to say "convicted," but have been found to have misled individuals into the accounts when that was not

appropriate--the so-called mis-selling scandal. And the firms have been required to pay more than £10 billion in compensation to individuals because they were mis-sold.

Now, you look at that high administrative cost, a voluntary system that has a lot of complexity associated with it and misleading advice that's being provided, and it does bring me back to wondering, whatever rules we write down--again, Bob mentioned that there are low-cost index funds out there--whatever rules we write down initially, the question is will those be sustainable. You can say you're only going to be allowed to invest in index funds, but if you sold the accounts as being ownership, and by the way part of that index fund includes tobacco firms, it includes firms that do abortions and all sorts of other things, that the American public might say I don't want my money, even .001 percent of that money, invested in index funds. You see things start to unravel. And you wind up with the type of system that the United Kingdom has, with very high administrative costs, with large problems about financial education. And I don't think any of us would want to replicate the experience there.

MR. BROWN: I was going to say, you can draw any lesson you want from international experience because there are over two dozen countries that have reforms along these lines. Some of them have done things well and some of them haven't. I think the appropriate role for the international comparisons is to try to draw lessons from those in designing new systems. I'm not going to sit here and advocate that I want a high-administrative-cost system. I don't know very many people that would. The point is, what we can learn by careful analysis, rather than using these international comparisons for sort of partisan talk points, what we ought to be doing, and what a lot of academics are doing, is trying to go in, understand these systems, figure out what features lead to high costs and which to low costs, so hopefully, if we actually do this,

we're going to design the policy in such a way that we have low administrative costs, we avoid these types of mis-selling scandals and things of that nature.

I'd be happy to talk in more detail afterward, if you want. But there are a lot of countries that have done these sorts of things well, and I think it's important not to overlook that.

MR. POZEN: Let me speak about the Chile example. I think a lot of people, especially from the right-wing side, say that shows you you can have this big account, it will solve the whole system. I think that's just a plain misreading of Chile. Chile had no social security system before. They had not $3.8 trillion embedded deficit. We're talking about tabula rasa. So in that respect, Chile tells you nothing.

But on administrative costs, Chile has essentially a series of five or six--they call the ATPs or ATFs, that basically you choose between one of these four or five, and they all give you a balanced account. And they have relatively low administrative cost. And, you know, one of them can provide you with an index without alcohol or--you know, a socially responsible one, and then the other four don't.

So that's actually what you learn from Chile, that they actually did a pretty good job on the administrative side. But everything else about Chile is, really, almost irrelevant to the U.S.

MR. ORSZAG: Bob, but just to clarify, the average administrative fee on those AFPs in Chile are about 10 times the figure you quoted.

MR. POZEN: Yeah. Well, Peter, it's a very small market. It's a very small market. The average fees on almost everything there. But what I'm saying is if you have a balanced account through the federal thrift plan, like the commission proposed, you're talking about administrative fees in the 10-30 basis point range.

QUESTION: Bruce [inaudible]. A quick comment or question for Peter, and then one for the panel.

Peter, you mentioned at the beginning of your comments that the opt-out would make a lot more sense than the opt-in for 401(k)s. But how many employees percentage-wise in the United States have the option at the moment of 401(k)s to opt out of? That's one question.

The question for the panel. I haven't heard the gimmick that's going to prevent people from cashing their private accounts for dire personal needs at some point in time, as people do when they leave savings plans at current employers.

MR. ORSZAG: Let me answer the direct question first. Basically, it's roughly 50 percent or so of workers are offered a 401(k). About 35 percent or so, 35-40, take it up. So the opt-out would directly address that 10-15 percent gap.

There are also similar types of ideas outside of the 401(k) plans to pick up additional people. For example, the best opportunity for most households to save outside of a 401(k) plan is when they get their tax refund, about $2000 a year. We should have a system in place where you check a box on your tax return and an increasing share of your tax refund is deposited automatically into an IRA each year. You can, again, opt out at any point. That's the same kind of automatic escalating system replicated outside of the 401(k) system. And the more we can do of this, the better.

In terms of your question, I'll just go first, since I'm talking. I think this is a key impediment to why individual accounts don't belong in that core tier. Precisely because they are sold as providing ownership and control, there is a very substantial danger that the money will be pulled out over time, before retirement. And frankly, you

can, again, write down any set of rules you want in terms of how the system would work, and I know we're going to hear that the commission would have prevented this from happening by writing that rule, but realistically, especially given the way that the accounts are being sold, I think that this is a very substantial problem. And it makes sense to be able to have some flexibility with the money you have above that core tier, but that core tier should be very solid and should not be touched before retirement.

MR. BROWN: I want to speak to the question about 401(k) plan participation levels. Peter's right. About half-- First of all, I want to say that all the work that Peter and others are doing on the 401(k) side I'm in complete support of. I think there are a lot of very deep common-sense approaches there on that side. But it avoids the fact that 50 percent of the people in the country don't have access to 401(k) plans. And therefore, one of the--I actually view that as a reason to be supportive of personal accounts within Social Security, because I can't imagine any other system by which we're actually going to be able to get opportunities for asset ownership and so forth to all Americans. I think it's naive to believe that we can sort of just mandate that all employers start offering 401(k) plans and so forth. But I actually view that as a positive.

MR. POZEN: I would just say, I think the question of cash-out is important, and I think Peter's point about how they're sold is relevant. That's why I don't want to sell them as personal accounts for ownership. I want to sell them as a supplemental retirement vehicle. And if it's sold that way, people should understand they're not allowed to take it out. Or if they take it out, they're going to pay a 50 percent penalty, something that's really Draconian. Unless we do that, then we don't have a workable system.

And if we sell it as ownership, I view this whole thing of ownership, on the one side ideologically and on the other side, you know, this "there is no problem in Social Security." Those are two of the least productive ways of viewing the problem.

MR. ROTHER: I just want to say, I appreciate Bob's comments there. But I think the evidence is overwhelming. If you look at the work that Alicia Munnell has done recently studying actual behavior of Americans who put money into IRAs, 401(k)s, it's a pretty depressing picture. We're not, as individuals, all that prudent about planning for the future.

QUESTION: Jim [Inaudible.]

This is for Bob Pozen. Twice you've said now that there are those who say there is no problem in Social Security. In fact, the first time you said it, you said that some Democrats say there is no problem in Social Security. I've heard a lot of Democrats say that there is a problem, but there is no crisis, and that it is more important to do it right than to do it fast. Could you give me the name of the Democrat who says that there is absolutely no problem?

MR. POZEN: Well, I can--I'll be glad to--there are people who say the assumptions of the Social Security actuaries are so questionable and so far off that we don't believe that there is a problem, and we question those assumptions; and if you change those assumptions, there isn't a problem. I suggest that the biggest questionable assumption is the one of how long people are going to live.

On the second point, even you admit there are all these people who say, yes, there's a problem but there's no urgency, my view is once you get to 2008, that means that the whole baby boom generation is close to retirement. You will never be able to change any benefit formula or any aspect of those people's Social Security, and

that is your U generation. And all of us who do these models, if you said to us, well, there's this little group, the baby boomers, and you're not allowed to change their formulas and that's where we'll be in 2011, none of us will be able to make any reform models work.

So my view is the urgency is the fact that the baby boomers are going to retire and we won't have any flexibility to change anything. That is what I believe is the urgency. And people can say I'm wrong, but I don't think that that is accurate. I do believe, once the baby boomers start to retire, it will become very difficult to change anything.

QUESTION: You're going to see that quote, "no problem."

MR. POZEN: Please give me your card and I'll give you--

QUESTION: I would like to see some of them put there money where their mouth is, and if they recognize there's a problem, put a plan forward.

MR. GALE: We have lots of hands, very little time, so let's keep questions and answers short.

QUESTION: I'm Cindy Moore with the National Council on Teacher Retirement. I have a question for Mr. Rother, and any of the panelists who would like to join in, feel free.

Thirty percent of public school teachers in America are not covered by Social Security. Instead, they are covered by pension programs that include both a pension benefit and the equivalent of Social Security. These programs are pre-funded, there are actual assets in there, not just government securities. And AARP has proposed covering all newly hired state and local government employees as a way to offset the

problem with Social Security. The states have set up responsibly funded programs, so why should the states have to then contribute to a problem that is a federal issue?

MR. ROTHER: Essentially for the same reason that we brought federal employees in in 1983. And there is certain transition assistance that would have to be there in order to assure that everybody who's affected by that would continue to have a two-tier system instead of a one-tier system. But it's a simple matter of equity that everyone be part of our national Social Security system.

QUESTION: I was interested, I saw Mr. Rother's comment about using the superlative index for the CPI as one possible fix. I would like him to comment a little bit further on that, and the other panelists, of whether using the new superlative index for CPI for COLAs is a possible part of the solution.

MR. ORSZAG: I'll take a crack at that. I think it is worth pointing out that the Bureau of Labor Statistics has suggested that this superlative index is a more accurate measure of the cost of living than the existing so-called CPIU or the CPIW, which is used to index Social Security benefits. I think it's very important that if we move as part of a Social Security reform to indexing Social Security benefits to this index, we also change the indexing throughout the federal government--on the tax code, in various other programs simultaneously. I think it is something that should be seriously considered.

MR. ROTHER: My point was not that we would support this as a legislative change, but that we have supported it in the past and will continue administratively changes that are designed to improve the accuracy of the CPI. And as long as there's plenty of empirical evidence that this is more accurate, that would be an acceptable change, from our point of view. It does not need legislation.

MR. BROWN: I'm just happy you've given something else that Peter and I can agree on.

MR. GALE: All right, thanks. One last question.

QUESTION: Lee Price, Economic Policy Institute.

All the talk here has been about retirement, although there have been some references to disability and survivors. But all the three are integrated in a similar kind of formula. If you start to index one, then you're going to affect the rest. And while Mr. Pozen talked about the problem of equity for low-income people, it's got to be at least as severe for people who are survivors or disabled. Do you have a similar program, or do other people have ways that you're going to deal with-- If you're going to--or maybe I'll just address it to you. I mean, if you want to cut benefits because they have to be cut, then what do you do about the equity to widows and orphans and disabled, because they are part of the same formula?

MR. POZEN: Well, I guess I'd say it's just a point that is a very well-taken point. I think any change would then have to be thought through. In my approach, surely people who were in that situation, many of them would be considered low-wage workers and therefore continue to get wage indexing rather than price indexing. But my experience in the commission suggests that this is one of the most complicated problems. And how you treat, if there's money in a personal account when somebody dies, when they have a spouse, these are all the sorts of details that would have to worked out.

Actually, one of my major objections to moving back the retirement age is, if we move back the retirement age, we will predictably increase the number of disability claims. And my experience is the most difficult thing we do here, and we do a

lot of difficult things in Social Security, is decide who are truly disabled and who aren't. You know, you could say I'm disabled now, but I use my mind and, you know, sort of--or try to use my mind.

[Laughter.]

So I just think it's a really important question, and all I can say is it's the sort of thing that when you get everything else at least preliminary, then you can work through it. It's hard to work through it unless you know where you're going on a lot of these other issues.

MR. ORSZAG: If I could just add two comments briefly. First, the National Academy of Social Insurance has put together a panel that will be issuing a report later this month that tackles questions--and both Jeff Brown and I are on that panel--that tackles questions like what should the payout rules be from individual accounts for people who are disabled, if we had a system of individual accounts--obviously, we disagree about whether individual accounts should be part of Social Security, but if they were.

The second point I would just note is Peter Diamond and I do have a proposal where we focus on shoring up benefits for people who are disabled at younger ages rather than those who become disabled around age 60 or 62, precisely for the reason that Bob Pozen mentioned, which is it becomes really hard to worry about incentives out at about age 62. And furthermore, the people who become disabled at younger ages, frankly, are the needier people. If you're on disability benefits and can't work for 30 or 40 years, that is a much different situation than if you become disabled at age 60.

MR. GALE: All right, thank you. I want to apologize to everyone that wanted to ask questions but could not. Just like Social Security, we do not have the time resources--

[Laughter.]

MR. GALE: But I do want to thank our panelists for an outstanding discussion.

[Applause.]

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