Sunday, October 11, 1998

Copied
Speechwriting

10-11-98

THE PRESIDENT HAS SEEN

In only 447 more days, the 21st Century begins--a century in which the education of our nation's children will matter more than it ever has before. Yet far too many of our public schools are not ready for the 21st Century. We've all seen the news stories--about teacher coll~~ege graduates who can't pass grammar tests;~~ who didn't major in subjects they're teaching about schools so overcrowded they have trailers out back to handle the overflow; about classrooms with 35 or more students, all vying for a minute of attention from their stressed-out, overworked teachers.

This can be changed. We cannot afford to wait if we are to give all of our children the first-class education they will need for the 21st Century.

10-11-98

THE WHITE HOUSE

WASHINGTON

October 10, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: PHIL CAPLAN Phil
DAVID GOODFRIEND

SUBJECT: Recent Information Items

We are forwarding the following recent information items:

(A) **Yellen Memo on Budget Surplus --** Responding to your question about the relationship between the FY 1999 budget surplus and economic conditions, Janet reports that the projected surplus ($58B) would disappear if real GDP declined 0.5% in 1999, as opposed to the estimated growth of 2.1%. In general, each percentage point reduction in real 1999 GDP lowers the expected surplus by roughly $24B. *Janet provides a table of multiple scenarios.*

(B) **Letter to Erskine from Pete Peterson --** Erskine forwarded to you a letter and other material he received from Peterson (Blackstone Group, Concord Coalition). Highlights include: 1) between 2012 and 2032, he predicts Social Security deficits will reach about $6.9T, making "Save Social Security First" even more relevant; Medicare presents even more daunting problems: aging of the worldwide population will result in foreign nations' unfunded liabilities; 2) a piece by Fred Bergsten argues that your authority under the International Emergency Economic Powers Act (*e.g.*, regulating imports, exports, and private financial transactions during a "national emergency") might prove useful in the global economic crisis; Bergsten helped write the statute in 1977.

(C) **Secretary Riley's "Back to School" Speech --** Secretary Riley appreciated receiving from you the September 18 Weekly Economic Briefing clip on teacher quality; in return, he forwarded his "Back to School" speech which emphasized, among other things, improving teacher recruitment and training. Highlights include: 2.2M teachers must be recruited in the next ten years; over a million veteran teachers are on the verge of retiring; and veteran teachers deserve better pay incentives.

Tab B - copied Caplan/Goodfriend cover note and Tab B to Bowles/Sperling
Berger copied cover memo and Bergsten notes only

The Blackstone Group

October 2, 1998

Erskine Bowles
Chief of Staff to the President
The White House
1600 Pennsylvania Avenue, NW
Washington, DC 20500

10-11-98

Peter G. Peterson
Chairman

'98 OCT 6 AM 10:29

Re: Our discussion on Thursday, October 1, 1998

Dear Erskine,

I do sleep better because you are in the White House. However, given what you told me about your plans, I guess I'd better be prepared for some insomnia in the post-election period.

As discussed, I attach two items.

The first is a Social Security speech. I've underlined the portion on page three relating to the $6.9 trillion of deficits between 2012 and 2032 when the system is allegedly solvent. When I tell people the size of this number, some of their premature euphoria over the mere trillion dollar surplus quickly fades and makes the "Save Social Security First" theme even more relevant. Nor does any of this discussion, of course, refer to the even more daunting fiscal, ethical, philosophical and political choices in the reform of Medicare.

Finally, Erskine, there is the global aspect of all this. I'm just finishing a book on the implications -- fiscal and otherwise -- of global aging. I am simply astonished at how much sooner and harder the unfunded liabilities in Japan and Europe are going to hit.

Thus, as to Social Security, this is a long-winded way of saying we not only have to do everything we can to allocate and current surpluses to support Social Security's future, but makes the need for overall entitlement reform in the U.S. all the more urgent.

The second attachment, on a totally different subject, is the piece on International Economic Powers Act. I happen to chair the Institute for International Economics and I leaned on Fred Bergsten to prepare this. Whether, and how, to use this kind of leverage involves a very complex set of issues. But the point of this is that the President has the authority.

I am now working on one way—a "carrot and stick" approach—this might be used as part of a speech I'm giving next week. When and if I get it done, I will burden you with that too.

In the meantime, hang in there as long and as best as you can.

Sincerely,

Pete

Peter G. Peterson

P.S. Please tell the President again, I get nothing but very good comments on his Council on Foreign Relations speech.

The Blackstone Group L.P.
345 Park Avenue
New York NY 10154
212 935 2626

Blackstone Financial Services®

WILL AMERICA GROW UP BEFORE IT GROWS OLD?
By Peter G. Peterson*

Apparently, I drive my critics not simply to suicide, but to various forms of rhetorical assassination. Some of the more charitable characterizations of me include Chicken Little, Cadillac Cassandra, the Mr. Magoo of the Financial World, the Intellectual Dr. Kevorkian, and, finally, the Social Security Bridge to the 16th Century.

Given my zero -- or is it negative -- credibility in some circles, I desperately searched for a source whose credibility has the equivalent of the Good Housekeeping Seal. Recently, the Congressional Budget Office -- nearly everyone's ultimate source and known for its measured, understated style -- asked its Deputy Director, to testify before the Senate Budget Committee. He predicted that on the current path, deficits would hit an unthinkable 12 percent of the GDP, or $800 billion in today's dollars, in about 2020.

Now, and I quote, current budget policy will "severely damage the economy in the first quarter of the 21st Century." Thus, compared to the CBO prognosis, I have decided that I should replace Bob Dole as the most optimistic man in America.

What drives these unsustainable and melancholy projections? First, it is the impact of our aging societies – there are 76 million Baby Boomers and they start retiring just 11 years from now. We confront an era in which the retirees, the payees are growing five times faster than the workers, the payers.

How does this compare with the rest of the world? Been to Florida lately? You may not have realized it, but as you gazed upon vast concentration of seniors there—18.6% of the Sun State's population—you were looking into humanity's future. The U.S. will get there in about 2020. Italy will be there as early as 2003, followed quickly by Japan (2005) and Germany (2006).

We shall see a stunning drop in the number of workers, that is, the tax-paying workers. During a single decade, 2000 to 2010, the number of Japanese workers under age 30 is expected to fall by 25 percent. During the following decade, the entire working-age populations of Italy, Germany, the Netherlands and Spain may contract at the rate of one percent per year—losing some 20 percent of their workforce between 2010 and 2030. Even the U.S. workforce is unlikely to show any net increase.

A few words about fertility. With a fertility rate of just under 2.0—near its all-time low—the United States stands at the very high end of the developed world. At the other extreme are countries that experienced little or no postwar baby boom and whose fertility has now plunged to the lowest

---

*Peter G. Peterson is Chairman of The Blackstone Group, President of The Concord Coalition and author of *Will America Grow Up Before It Grows Old?* (Random House).

rates ever recorded, except during episodes of famine or war. Japan is now at 1.5, Germany is at 1.3. And as for Italy, forget the Mama Mia stereotype—you know, the overflowing (and faithfully Catholic) Italian family—has experienced a "bambini bust", the lowest fertility rate of any nation. Italy is now at 1.2. At rates this low—far below the population replacement rate of 2.1—each family generation is little more than half the size of its parents.

Further into the future, by the 2020s if not before, the total population of the developed world will likely climax and begin to fall into absolute numbers. While this decline will be mild (or may not happen at all) in North America, elsewhere the downward trend in unmistakable. Western Europe and Japan are on track to shrink to one-half or less of their current population by the end of the next century. My Japanese friends like to point out, only half-jokingly, that on their current course, there won't be any Japanese life a few centuries from now. In my view, we have not even begun to contemplate the economic, business, fiscal, political and social implications of lower populations.

Then, beyond the demographic, there is our unfunded, pay-as-you-go system of entitlements. Just how unfunded? Our public retirement and health-care programs have unfunded liabilities of $17 trillion. You know, a trillion here . . . a trillion there . . . amounts to real money after a while.

Forget Chicken Little. This is enough to wake up the whole barnyard. On the safe assumption that one speech from me may be one too many, I've decided to focus today on Social Security and not the other entitlements such as Medicare, which, indeed, presents an even more daunting problem, not only fiscally, but politically and ethically.

Left, right, and center, policy experts are debating the future of Social Security. And they should. Social Security has been one of America's most successful social programs. It has been a principal reason that elderly poverty has declined dramatically; indeed, it has been estimated that these Social Security checks reduce poverty among the elderly by nearly 75 percent. And the government dispenses these checks with atypical efficiency. The total costs of running the Social Security system is only about 1 percent of the value of the benefits paid out, far less than with private pension plans.

Social Security deserves to be saved. But to save it, we must reform it: indeed, it must be re-invented, philosophically as well as economically.

As for the public, over 90 percent believe that Social Security will eventually require "major change." Sixty-five percent say that the program "is in need of major reform now" and that includes an amazing 80 percent of Baby Boomers. Now, to be sure, the public is remarkably ambivalent -- as we used to say in Nebraska -- about the specifics of reform, but they at least recognize the existence of a real problem.

So what should we do about Social Security? Are there any obvious fixes?

Of course, we could simply cut future benefits. If Americans were saving enough privately, this might be a sensible fix. But they're not. Only half of today's workers are covered by any employer pension plan, and most of those are too meager to retire on comfortably. Even among adults in their late fifties, the age workers are staring directly at retirement, the financial net worth of the median household is about $12,000.

When you think about Boomers, those who will be retiring when benefits have to be cut, don't be fooled by the yuppie stereotype. Only a minority of this generation is riding the Dow Jones stock averages. The same goes for inheritances, another touted elixir for the Boomers' balance-sheet blues -- which, unfortunately, won't pan out to more than $30,000 for the median Boomer household. Let's face it: Muffy and Duffy will do just fine, but between half and two-thirds of this generation is going to need a floor of protection to keep them out of financial hardship -- the traditional role of Social Security. Remember: About half of all retirees now make less than $20,000 a year and about half of that comes from Social Security. If Social Security is slashed across-the-board in the future because we fail to reform the system when we should have, many ex-yuppies could become what one expert has called "dumpies" -- destitute, unprepared mature people.

Well, maybe we can just raise taxes. But that certainly wouldn't be painless either. The requisite tax hikes would be very large -- between 4 and 7 percent of payroll by 2030. And they would come on top of even larger tax hikes needed to cover the rising cost of other senior programs, especially Medicare. Indeed, if we wish to balance both Social Security and Medicare, these costs amount to payroll taxes for my grandchildren that aggregate to between one-third and one-half of their pay. Obviously, these kinds of tax increases are unthinkable -- politically, economically, and, indeed, morally.

Then there's the little matter called payback equity. Today, for the first time in the history of Social Security, large categories of newly retiring workers are due to get back less than the market value of their contributions, in other words, "market losers." They understand that Social Security already offers them a lousy deal. Any reform that merely raises taxes or cuts future benefits will worsen the system's cascading pattern of generational inequity.

Well, I suppose there's always a third option -- just do nothing. But doing nothing means leaving benefits and taxes alone and borrowing the difference.

It's an option that might work if the amount to be borrowed were small and could be easily financed out of national savings. Unfortunately, the amount is anything but small. Beginning in 2013, when Social Security annual revenues fall behind annual payments, it ramps up, very rapidly. By 2030, Social Security's annual operating deficit will exceed $700 billion. That's what Treasury would have to borrow from the public to pay full benefits. Between 2012 and 2032 – the year we are endlessly told the system is solvent – the additional cumulative debt arising from such borrowing will reach about $6.9 trillion. As for the second condition -- that the deficits could be easily financed out of national savings -- there's not a prayer. Just Social Security's 2030 operating deficit would consume about 80 percent of net national savings at today's anemic savings rate.

You see, the last time the system was reformed in 1983, the theory was – and oh, what a beautiful theory it was – that a trillion dollars or so in excess revenues over benefit payments would be "saved" and used to reduce the national debt. Every year, as the theory went, these surpluses would be available for economic investment which, in turn, would generate higher growth. By the time that the retiring Boomer generation began to claim benefits that would exceed the payroll taxes paid by their children, the U.S. Treasury could pay back the loans from Social Security from the added revenues coming from the added growth produced by tens of years of added capital investment, underwritten by decades of Social Security surpluses. Alas, once again, a beautiful theory got mugged by a gang of ugly facts. This time, we didn't save the money for investment, we spent it for consumption.

Now, if we can't finance these deficits domestically and if we can't draw down past savings, well, maybe we can borrow from abroad. Borrowing foreign capital has become a way of life for us. It has been relatively easy in the 80s and 90s. But come the 2020s, such inflows would be manifestly impossible at affordable interest rates. The entire industrial world is aging even more rapidly than we are, and many of today's principal capital exporters -- Japan, Germany, and the rest of Europe -- will be facing deficits even wider and sooner than our own to fund generous pension and health benefits for their aging workers.

I've looked carefully at the public pension projections for other G-7 nations. Their unfunded liabilities are 50 percent to 100 percent larger than ours as a percentage of GDP. Between 1995 and 2035, the combined deficit swing of these benefit programs will be over 50 percent of today's G-7 savings rate. The whole industrial world, in short, is en route to cannibalizing its savings in order to fund its pensions.

Japan's public pension balance is scheduled to deteriorate the most. Their increasing longevity, low birth rates, and minimal immigration is a toxic fiscal cocktail. Indeed, the Japanese labor force is already beginning to shrink. In 2010, when the ratio of workers to retirees in the United States will still be about 3 to 1, these factors will push the Japanese ratio down to about 2 to 1. That year, just the Japanese public pension deficit swing is projected to hit about 3 percent of GDP; by 2040, it will hit 8 percent of GDP.

How do these deficit swings compare to foreign purchases of U.S. government debt. Japan's deficit swing alone due to public pensions, between now and 2020, will be roughly five times larger than Japan's current (and massive) capital exports to the U.S. Go out to between now and 2040, and the swing will be roughly eight times larger. The developed world's deficit swing due to public pensions, between now and 2020, will be roughly three times larger than the developed world's current (and massive) purchases of U.S. government debt. Between now and 2040, the swing will be roughly six times larger.

Many believe that a crisis will be necessary to galvanize public action. If they are right, I think that an aneurysm in the global capital markets – a high spike in interest rates, for example, as one nation or another tried to finance unprecedented Social Security deficits – would be a likely candidate.

The majority of those who debate entitlement issues suggest that the future of Social Security is all about ideology or political philosophy. It may be those things too. But first and foremost it is all about the brute arithmetic of growth of spending – and about how to keep that growth from metastasizing.

Perhaps America's major trading partners will avoid this future by changing policy course -- that is, by raising taxes or cutting benefits. But we shouldn't count on it. At a recent conference in Europe, I was distressed to learn that the politically active unions in Italy and France make our own AARP lobby look like a pussycat. And as far as raising taxes in Europe enough to make any real difference, have you looked at gargantuan European tax bills and lack of competitiveness lately?

It's time to face the facts underlying Social Security's fiscal challenge. The United States, like so many other nations, is about to embark on an unprecedented demographic transformation. In the end, there's only one way to enable tomorrow's relatively small workforce to support this much larger number of retired dependents. That is to boost productivity growth. And that, in turn, means raising our national rate of saving and investment, which is precisely what we would not be doing if we were to leave these programs unreformed.

Permit me now to use a well-known technique among the senior White House staff. I call it the "Option B" approach -- Option B being your own approach, Options A and C being the ones you wished to have the President reject in favor of yours.

We always used a little hyperbole -- negative, of course, in discussing the other guys' options. So, if I do that, just blame my White House training.

Today, I'd like you to reject Options A and C on Social Security in favor of mine -- Option B.

Option A in its purest form is essentially the status quo: We are told the system is "solvent" until the year 2032. Since it ain't broke, why fix it? Their message is as soothing as it is wrong.

Option C in its purest form is full privatization -- just put the Social Security revenues and its "surpluses" into the stock market. The returns will be so much higher that the benefits could be even while you lowered payroll taxes. This is what you might call the supply-side approach to Social Security. The brute truth is we are going to have to eat some fiscal spinach, but before taking even a bite of spinach, we are told we are "entitled" -- my least favorite word in the language -- to a fudge sundae.

Now, both Options A and C have the uniquely attractive feature of being very politically correct; that is, they give everybody at least as much as they have now while insisting that any other solution would be a rip-off. Thus, what all too many conservatives have in common with all too many liberals when they approach the question of senior benefits is the urge to fan the flames of victimization while holding out seductive free lunches – or (if you allow me to tidy up my metaphors) seductive fudge sundaes.

My Option B is politically incorrect in that it suggests that there must be real reform -- which is a euphemism for some cuts in benefits. And, at the same time, there must be more savings, which I get first by eliminating the government's dissaving (that is, its budget deficits, including its Social Security deficits) and then by setting up mandatory, personally-owned, portable and vested retirement accounts. These accounts would increase personal savings and be invested in the real economy.

Permit me now to return to Option A, which is predicated on the soothing notion that the trust fund will keep Social Security "solvent" all the way to 2032.

I've come up with a one-line response to those who believe the system is solvent until the year 2032: If you believe that, you'll believe that Dennis Rodman has signed up for a course in assertiveness training.

In fact, the claim that Social Security is financially sound until 2032 rests on an outrageous fallacy -- namely, that trust-fund surpluses accumulated in prior years constitute genuine savings that can be drawn down to cover trust-fund deficits in later years. They don't. As we have discussed, today's surpluses are spent by Congress the moment they accrue to cover non-Social Security deficits.

You know, I have collected oxymorons since I was Secretary of Commerce. One day someone called me a powerful Secretary of Commerce. I knew that was the ultimate oxymoron. The House Ethics Committee was another of my favorites. Continuing my relentless record of irreverence, I consider this Trust Fund a fiscal oxymoron, or more appropriately, a dis-trust fund. In our pay-as-you-go system, these so-called trust fund assets are, in fact, Treasury liabilities -- paper IOUs – a polite and politically convenient fiction; an awesome example of double-account bookkeeping. In fact, nothing is put "in trust." It is very much like what in business we call a "memo account," a way to tally one stream of revenue that has been used against another stream of spending.

To which, the status quo say, "But these are regular government bonds in the trust fund. They carry the full faith and credit of the U.S. government!"

To which I say, as in the Hertz commercial, "Not exactly."

These Trust Fund bonds are a very special kind of bond. The interest cost on them is not counted in the annual unified budget deficit. And to add another chapter to this bit of accounting fiction, the interest costs attributed to these government bonds is added to the trust fund "assets." Furthermore, the bonds themselves are not counted in the publicly held debt. And they are not authorized to be sold to the public.

Let's look at the Trust Funds in another, more direct way. Suppose for the moment that there were no Trust Funds? What difference would this really make? For example, when the Social Security annual operating deficits hits about the year 2012 and mushroom thereafter, would we need to borrow any less from the public? Or, if we then decided to increase taxes to balance the national books, would we need to tax any less? On both counts, the answer is clearly "no."

Most important, when it comes time for the trust funds to redeem these IOUs, Congress must raise taxes, cut other spending, or borrow more from the public -- that is, turn these paper or accounting IOUs into real IOUs.

So when someone says the trust funds will keep the system solvent until 2032, presumably that means we would try to redeem these special IOUs in order to pay the benefits. Thus, already by 2020, when the annual short fall is expected to be about $200 billion, the Treasury would have to raise this additional large amount of capital from an economy that has not benefited one iota from years of very large annual Social Security surpluses.

I agree with Alan Greenspan's view that it is the government's net annual borrowing balance with the public that is the relevant measure; in other words, the actual Social Security operating deficit, not some "actuarial deficit" that treats the trust funds as though they are funded assets. What the government borrows from the public is what crowds out private savings that might otherwise have gone to private investment. And that investment is what, in turn, generates real wage growth.

Think about it. We are headed toward a system which, while still technically solvent in 2032, will require Treasury to cough up about $700 billion to pay benefits in that year alone, just for Social Security.

To keep the system solvent beyond then, referring to this hollow notion they call actuarial balance, which is another accounting sham incidentally, the status quo-ists sometimes acknowledge a little fix may be needed -- a "2.2 percent solution." This payroll tax hike would only push the first year of operating deficits back only nine years, from 2012 to 2021, after which Social Security would supposedly finance 50 straight years of growing operating deficits by cashing in an even larger mountain of phony trust fund assets.

Sound plausible? As John Wayne used to say, not hardly. And that's not the only problem with the 2.2 percent solution.

First, the payroll tax would have to be hiked by the full amount beginning in 1997 -- something that obviously cannot now happen. Second, even if it could be implemented today, this tax hike is hardly "small." Between now and the year 2002, it would raise total federal taxes by over $500 billion -- about as much as Bob Dole proposed cutting them. A tax increase of this size would be inconceivable in today's political climate – indeed, the President has come out four-square against any payroll tax increase-- and no one would dream of calling it "modest" or "bearable," if it were actually (rather than just rhetorically) proposed. Remember, too, this tax increase would fall most heavily on the middle class -- the very middle class to whom most politicians are constantly promising tax cuts. While on the subject of tax increases, permit me to remind you of this melancholy fact: On an honest accounting basis – not the phony "trust fund," "actuarial" kind of accounting -- the payroll tax increases required to balance the books just for Social Security (not including Medicare) would by 2030 be in the range of 4 to 7 percent of payroll.

Let's face it: Accounting gimmicks will not do our savings for us. To say that the Social Security trust funds are a bit richer and that Treasury is a bit poorer makes no difference for the economy -- either now or in the future.

So much for the status quo-ists. What about the pure privatizers? Obviously, their political agenda could not be more different. While the status quo-ists want to perpetuate today's pay-as-you-go system, the pure privatizers want to totally replace it with some new system of privately owned accounts. But the closer one looks at many of the privatization schemes, the more they look like just another shell game.

Many privatizers would simply allow younger workers to take their current FICA tax and invest it privately. Future retirees are promised higher returns, while current retirees are assured they will lose nothing. What the privatizers neglect to say is that, unless Congress makes up for the FICA revenue it loses, Treasury will have to borrow a dollar from the public for every dollar invested in the new private accounts. Such a "reform" merely shifts IOUs around the economy. Like the Wendy's customer, we need to ask: "Where's the beef?" That is, where are the <u>additional</u> savings, the additional <u>funding</u>, without which reform is just a zero-sum game.

Privatizers sometimes concede that their plans may not raise national savings and that Treasury will have to borrow to make up for the missing FICA revenue. But apparently they believe that the workers' private accounts could forever earn greater returns (with no greater risks) on the new equity assets than would be lost on the new debt liabilities.

Let me focus for a moment on the issue of risk. The privatizers rely on the historical long-term real rate of return on U.S. equity (over 6 percent), which is much higher than the real rate on government debt (roughly 2 percent). But solving this so-called "equity premium" puzzle poses a real dilemma for free-market theorists. On the one hand, they can surmise that the 4 percent spread is a rational estimate of the <u>perceived extra risk of owning equities</u>. Or else they have to conclude that markets are fundamentally irrational. Why else would markets not bid down the price of bonds and bid up the price of stocks?

The truth is that any plan that banks on the permanence of this sort of spread between stocks and bonds is a dicey proposition. If workers start buying stocks on a large scale and Treasury starts selling debt on a large scale, the yield on bonds will rise and the return on stocks will fall -- narrowing the favorable spread on which the plan depends. But, let's even assume the privatizers are right about how everyone will earn 6 percent real annual returns by the year 2050. Let's now suppose that the Dow Jones from 2000 to 2015 does no better than it did between 1967 to 1983 -- in other words, that it goes nowhere. In fact, the real value of the Standard and Poors Index <u>fell</u> about 40 percent in that period. Forget economic theory. Imagine how Americans would react <u>politically</u> to finding their retirement holdings have not appreciated as "promised."

Thus, using a high discount rate, many of the privatizers make the job of transitioning to a "privatized" system seem miraculously painless. It means that we can leave the benefits alone, rack up trillions of new federal debt (and the related increase in interest rates and interest costs), stuff the borrowed money in every worker's equity account, and make every American much better off.

Yes, the spread is tempting -- so tempting that even many status quo-ists are climbing aboard. Just have government invest the trust fund surplus in the stock market, they say, and the higher returns will shore up the system. The twist here is that, if the stock market tanks, the risk will fall not on individual account holders but on government -- that is, on taxpayers collectively. No major government engages in this sort of high-risk arbitrage. And if it did make sense, one wonders why government should stop with Social Security? Why shouldn't Treasury borrow trillions from the public under any pretext, invest it in the stock market, and then refund the profits to taxpayers? To ask the question is to answer it.

It's time -- while we still have time -- to move beyond delay, denial, and diversion. Up to now, as I think about Options A and C, the tinkering of the status quo-ists will not suffice. Nor will the free lunches of some privatizers.

What's the answer? Well, unlike the status quo-ists, I believe in major change. In particular, I favor <u>transitioning</u> to a system of personally owned accounts. Unlike many privatizers, I believe these accounts must be mandatory, regulated, and backed up by a strong floor of protection. And unlike either side, I believe any new retirement benefits must be <u>fully funded</u>.

Properly designed, such a system would have the enormous advantage of generating higher national savings, and hence higher productivity and higher wages in the years before retirement. Because a system of personally owned accounts would be fiscally transparent, it could never be "underfunded" nor could it mask deficits elsewhere in the budget. Such a system would offer yet another plus: <u>security</u>. Social Security was originally set up because people trusted government more than markets. Today, most Americans under fifty feel the opposite. They know that Congress must ultimately renege on its pay-as-you-go promises. They know that the government has proven incapable of saving payroll retirement taxes and that workers should be able to save for themselves. They know that no politician can take away personal assets invested in the real economy. Speaking of the real economy, a comprehensive plan of mandatory, personally owned retirement accounts would also have the beneficial effect of aligning the interests of millions more American workers more closely with the progress of the real economy. Finally, such a plan would provide workers with far more freedom and flexibility in planning their retirement schedule and, indeed, their mode of retirement.

Yes, getting from here to there would require sacrifice. Today's workers would have to start funding their own retirements at the same time that they continue to pay for their parents'. And to be fair, many of today's retired parents (those who can afford it) would have to forego a bit of what they're now receiving. To put it another way, if society is to save at a higher rate, it must also consume at a lower rate -- at least until the productivity advantages of higher savings kick in.

The first task is to keep the cost of the current system from soaring in the next century. In my plan, I propose three reforms which, together, would erase Social Security's projected operating deficits and keep it from becoming a drain on national savings when Boomers retire.

First, I would raise the eligibility age for full Social Security benefits, starting next year, by 3 months per year, until it moves to age 70 by the year 2014. And I would index the retirement age thereafter. Let's not wait until we have to change the rules with 2 minutes left to go in the game. Give the Boomers plenty of time to plan now. And consider this: By 2014, because of rising life expectancy, the average retiring 70-year old will still receive Social Security for 2 years longer than the average 65-year old retiring in 1940 -- the year Social Security paid its first benefit.

Next, we should (at a minimum) legislate a half percentage point reduction in COLAs—a Diet COLA, if you will. There's no justification for overindexing benefit payments -- and most experts now agree that the CPI overstates inflation by at least this much. Nor is there any justification -- certainly no moral justification -- for giving us un-needy seniors what is, in effect, an after-tax pay increase at the same time many of our own children are experiencing a stagnation, or even a decline, in their real after-tax incomes.

Finally, I would apply an affluence test to Social Security -- and indeed to all federal entitlement benefits. Right now, nearly 40 percent of all Social Security benefits go to seniors with incomes about the U.S. household median. I would reduce by 10 percent the benefits going to households with total incomes above $40,000, a bit more than the U.S. median. I would add an additional 10 percent cut for every additional $10,000 in income – up to a maximum cut of 85 percent. To be sure, Social Security benefits for fat cats like me would be reduced by the full 85 percent -- but the remaining 15 percent would still constitute a 3.5 percent tax-free return on all of my personal FICA contributions and about 1% nominal return on my personal and employer's FICA taxes.

Up to now, these proposals are all about sacrifice – necessary sacrifice to be sure – but nonetheless sacrifice, a negative concept in contemporary America. Thus, what is needed is a positive framework – in this case, the positive of an assured retirement security for the individual. Thus, as we limit the cost of pay-as-you-go benefit promises, we need to replace the lost benefits by putting in place a second tier based on genuine savings. I would require workers and their companies to contribute up to as much as 5 percent of their pay, on top of the then current FICA, to a system of government regulated but personally owned and directed and portable retirement accounts. In an era in which the typical worker is expected to hold six or seven jobs during their career and in an era in which more and more workers prefer flexible working hours and styles, portability is crucial. I would, at the same time, strengthen Social Security's floor of protection and direct government to match some of what low-income workers put into their personal accounts. Unlike either the pure privatizers or the status quo-ists, I want those who really need the benefits to have those benefits in a secure framework. I don't want the neediest Americans to be subjected to the whims of the market or the failures of the political system.

The transition to this new system could be full or partial. And it could move at any speed.

We could stop at a two-tiered system in which all retirees will continue to receive some traditional Social Security. Or, we could take my approach a step further. Over time, the personal accounts could be expanded and the pay-as-you-go benefits phased down, except of course for a solid floor of protection. Depending upon how much benefits are reduced, one could imagine a cut in the FICA tax and/or putting any Social Security surpluses into the personal retirement accounts on a pro-rata basis.

By increasing national savings, my plan would do more than help the economy. It would help increase individual retirement incomes and guarantee retirement security for all. It would greatly reduce inter-generational conflict since the working population would, over time, be paying for their own retirements, not someone elses. Finally, it would also greatly reduce free riding, or should I say free loading, on the public safety net.

Think of this plan as privatization plus two. Plus one is gradually curtailing the benefit promises of the current system which will, once the Baby Boom starts retiring, otherwise become unaffordable. Plus two is providing for additional private savings so that privatization is honestly funded.

Will my plan actually achieve all these objectives? I was about to say I'd stake my reputation on it. Then, I remembered saying to a client one day that I would stake my reputation on some business deal. The client stated, a bit dryly I thought, "Pete, it will have to be something more substantial than that."

So, for the time being, let me leave my plan aside. Go ahead and look at the other plans out there. As you do, let me urge you to ask five simple yet fundamental questions about them.

1. Does this plan cut benefits? No plan will add up without restraining the growth of pay-as-you-go Social Security benefits. It's not enough just to cut benefits to future retirees. It's both fiscally necessary and simply fair that current un-needy beneficiaries share some of the burden.

2. Does this plan raise taxes? Let's remember that the coming age wave will push enormous dependency costs on to tomorrow's workers that have nothing to do with Social Security. Any tax hike -- whether in payroll taxes (to pay for the status quo-ists' tinkering) or in income taxes (to pay for the privatizers' debt bomb) --ought to be kept to a minimum. Or, better, avoided entirely. Indeed, part of the rationale for reducing Social Security benefits is to be able to save some resources to deal with the bigger and far more daunting problem of Medicare. Medicare also touches on a variety of deeply ethical issues, but I'll pass on those today since I know how persuasive many feel investment bankers are on the subject of ethics.

3. Does this plan pay for the transition? Moving from a mature pay-as-you-go system to a funded system necessarily requires society to pay for two retirements at once. This transition cost is huge. Paying for it means cutting someone's consumption, at least temporarily. Plans that pretend to accomplish this transition without sacrifice are accounting shell games.

4. Does this plan increase publicly held Treasury debt? Both the status quo-ists and the privatizers depend upon Treasury issuing massive new debt to the public, whether they acknowledge this melancholy fact or not. Steve Forbes' privatization plan, for instance, would allow workers to take 3 percent of payroll away from their current FICA and put it into private accounts. In the year 2000, that would come to about $100 billion (assuming all workers under 50 elect the private accounts option). By 2015, the addition to the publicly held debt under the Forbes plan would be about $3 trillion: that's more than all the federal debt accumulated from President George Washington through President George Bush.

In recent testimony before the Senate Budget Committee, I recommended that the Committee's Chairman, Senator Pete Domenici, invite some of America's top bond and equity traders to review the real-life market implications of some of the reform plans under consideration, with special attention to the global pension crisis. What will happen to interest rates, to international capital flows, to exchange rates, or to the spread between debt and equity? I don't want to prejudge the answer, but I suspect market professionals would find the thought of trying to issue hundreds of billions of dollars or more in new Treasury debt at a time of global capital shortage to be a scary prospect indeed.

And my final question:

5. Does this plan raise national savings? Or to put it differently, is this plan truly funded? It can't be repeated too often: Without new savings, without real funding, a plan cannot increase the productivity of tomorrow's workers, and thus becomes a zero-sum game of pushing liabilities from one pocket to the other -- or from one generation to the other. The coming Age Wave demands a new and material commitment to our young and to our future. Social Security reform must play a key role in securing this commitment.

In the midst of all these melancholy numbers I have shared with you today – or should I say imposed on you – there is some good news, indeed very good news.

Beyond the President's initiatives, the political landscape is far more benign than anyone could have imagined: Democrats—Senators Moynihan and Kerrey, and Republicans—Senators Santorum and Gramm, to name a few—are actually touching the up-to-now untouchable third rail of politics, with specific reform proposals.

I would go further and say something that would have been wholly improbable even a few month ago: I think there is now a reasonable chance—if all of us keep working at it—that we will see some social security reform in 1999.

Permit me to sum up in the following way: It's easy to make light of dire threats to our economy's future – particularly long-term threats. And when the projections seem impossible, it's easy to say: Why worry, they'll never happen. Back when I was in the Nixon White House, I recall Herb Stein -- economist and sometimes Nixon humorist (perhaps some of you would call the idea of a Nixon humorist an oxymoron, too) -- saying that if something is unsustainable, it tends to stop.

Or, as another pundit put it, if your horse is dead, we suggest you dismount. Dismount we will, sooner or later. The real issue is how and when -- and whether we end up killing us riders too.

Schumer Dinner 10/12

Acknowledge: [redacted]; Iris Schumer (Schumer's wife); Jessica and Alison (Schumer's daughters); Hosts: Steve Rattner and his wife Maureen White.

Also in NYC to suppt. Vallone (*not present*)

I'm happy to be here to support Rep. Chuck Schumer for Senate.

- No race is more important in country
- Schumer is one of the most accomplished legislators in Congress
- He'll do more in 1 yr. as a Senator than opponent has done in 18 yrs.

Just look at Schumer's record:

Copied Gottheimer

1. Schumer wrote Brady Law: 242K guns away from felons, etc. His *opponent voted no.*
2. Schumer wrote Crime Bill and put 100K police on street. His *opponent voted no.*
3. Schumer wrote Assault Weapons Ban. His *opponent voted no.*
4. Schumer wrote Violence Against Women Act. His *opponent voted no.*
5. Schumer fought to protect Medicare and Medicade. His *opponent voted w/ Gingrich* to double premiums.

Don't listen to the opponents' 30-second ads. Look at the record. Think of what Schumer's done already and think about what he'll be able to do for the people of NY as a Senator.

• **5 ½ yrs ago**: **New Dir, old values**: opp/resp/comm. Ec, Env, Edu, Welf, Cr, For.

• **Results**: BB-Oct.1; 25-Cr; 28-unempl; 29-Welf; 29-BB; 32-Infl; record homeownership. Income gains: typical family income up over $3,500 since '93. Poverty: Af-Am poverty rate lowest level on record. College opp: Hope $1,500, Pell, work-study. Child health: 5M, highest immunization Env: fewer toxic dumps; Service: 100K, Amcorp; AmReads. FMLA: helped millions past 5 yrs

• **Times are good, but prosperity faces risks --** International economic turbulence. Must keep economic strategy going:

1. Soc Sec 1st
2. Educ
3. Economy/ IMF
4. HMO B of R
5. Enviro rider

EB | Gene | Sandy
any poss uses.
in the present situation?
BC

10-11-98

Copied
Sperling
Berger
Bowles

THE PRESIDENT
10-11-98

IEEPA: TOOL FOR TOUGH ACTION

C. Fred Bergsten
Director, Institute for International Economics

The International Emergency Economic Powers Act (IEEPA) is an obscure but enormously powerful tool under which the President can take virtually any economic measures against a foreign country that he desires. IEEPA is the economic successor to the Trading With the Enemy Act (TWEA), which was the legal basis for most of the tough actions against Japan in 1971, and essentially replicates its powers and procedures.

To invoke IEEPA, the President needs simply to declare a "national emergency." When I negotiated the IEEPA statute with the Congress in 1977, its goal was to sharply limit the President's discretion and thereby avoid further "abuses" – mainly in the security area – *a la* Vietnam. But the final legislative criteria were vague, Presidents have invoked emergencies under the law on the thinnest of rationales, the Supreme Court subsequently gutted any meaningful Congressional oversight, and Presidents have thus been able to use IEEPA against such dire threats to our economic well being as Nicaragua, Libya, Panama, and Angola.

IEEPA gives the President sweeping powers to regulate (or ban) exports, imports and private financial transactions. Hence it escapes the limitations of the Export Administration Act and other legislation that authorizes economic warfare only in highly specific circumstances and only with restricted tools. The only significant limitation is on the President's ability to seize (as oppose to freeze) foreign assets.

To invoke IEEPA, the President must declare a "national emergency" under the National Emergencies Act. He can then deploy a very wide range of economic sanctions. Before doing so, he is directed to consult Congress – but only "in every possible instance," a phrase I insisted on to permit decisive actions that would invariably be compromised by consultation. Moreover, the Congress recognized in the legislative history that the President's powers "should be sufficiently broad and flexible to enable him to respond as appropriate and necessary to unforeseen contingencies."

The President must report and explain his IEEPA actions to Congress. He must annually renew the "national emergency" declaration on which his IEEPA actions are based. But he can keep the sanctions in place as long as he wants unless Congress forces their elimination by passing a joint resolution (which the President can veto, thus requiring a two thirds vote of both houses to end the action). In practice, the President's powers under IEEPA are almost totally unfettered – just as they were under its predecessor TWEA.

The initial, and still most dramatic, use of IEEPA was when our (Carter) Treasury used it to freeze about $12 billion of Iranian assets (including those in foreign branches of US banks) in retaliation for the hostage crisis in 1979. The US courts subsequently upheld the use of IEEPA in that case despite a number of lawsuits being filed against it. Hence it is clear that IEEPA can be used to control financial as well as trade transactions.[1]

[1] An interesting use of the TWEA was by President Johnson in 1968 to limit outflows of US foreign direct investment to protect our balance of payments, a situation with some parallels today. (Johnson relied on President Truman's declaration of a national emergency because of the Korean War in 1950, which had never been terminated.)

President Reagan was a frequent user of IEEPA. He invoked it against Nicaragua and South Africa in 1985, Libya in 1986 and Panama in 1988 (and to preserve the Export Administration Act on three occasions when Congress let it lapse). President Bush used IEEPA against Iraq and Angola/UNITA. President Clinton has done so against Haiti, Yugoslavia, Middle East terrorists, narcotics traffickers, Burma and Sudan. IEEPA is currently in force in nine cases: Iran, Libya, Iraq, Yugoslavia, Angola/UNITA, Middle East terrorists, narcotics traffickers, Burma and Sudan.

<u>Conclusion</u>

<u>IEEPA</u> has been used more times in its twenty years of existence than TWEA has been used throughout the eighty years since its inception. It <u>can clearly be invoked whenever, for whatever purpose, and for as long as a President may desire</u>. It is fully as potent as TWEA ever was.

Hence <u>the President has full legal authority to act unilaterally against any country that may be creating significant economic problems for the United States</u>. Ample precedent would justify almost any conceivable action that might be contemplated in today's circumstances.