

Center for American Progress



**One of the Largest New  
Government Spending Programs in History:  
National Interest Payments Due to President Bush's  
Social Security Proposal**

**Gene Sperling  
Christian E. Weller, Ph.D.**

**July 2005**

## *Executive Summary*

### **What if Interest Payments on President Bush's Social Security Plan were a Separate Government Program?**

- It is well known that the President's plan to partially-privatize Social Security would lead to a huge increase in publicly held debt.
- Yet, less recognized is the enormous spending increase that would be required to pay for the interest costs – or debt service – due solely to the President's proposal.
- If one considered the interest payments from the President's Social Security plan as if it were a separate government program, it would be one of the largest new spending programs on record. Indeed, it would:
  - Cost *\$163 billion a year* in inflation adjusted dollars between 2011 and 2050 or \$6.5 trillion in 2005 dollars.
  - By 2030, *cost more each year than our nation is expected to spend on the United States Army, Navy, or Air Force*.
  - Cost more than *three times projected spending on the Homeland Security budget* from 2011-2050.
  - Under current trends, eventually pay out at least \$5.6 trillion in inflation adjusted dollars to foreign lenders – including nearly \$1 trillion to China alone.

It is now well-known that the President's plan to partially privatize Social Security would dramatically increase the national debt over the next half century.

***What is even more startling is that between 2011 and 2050 the Bush Social Security plan would increase government spending on interest by \$6.5 trillion in 2005 dollars.***

While the White House has sought to downplay the significance of the additional borrowing due to private accounts – the increase in debt (even including savings from price-indexing) -- would increase government spending on interest by an average of \$163 billion a year between 2011 and 2050—\$2.8 trillion in the last decade alone.

***The cost of new interest payments from the Bush Social Security plan would be:***

- **Greater than total cost of the entire US Army, Navy, or Air Force by the 2030s.**
- **More than three times the projected Homeland Security budget from 2011-2050.** From 2011-2050, additional interest payments would exceed projected spending on Homeland Security by more than \$4.5 trillion in 2005 dollars.

- **Nearly 60 percent greater than total spending on veterans benefits.** From 2011 to 2050, the additional interest payments would exceed projected spending on veterans benefits by more than \$2.4 trillion in 2005 dollars.
- **More than 70 percent greater than combined federal support for non-defense research and development.** From 2011 to 2050, additional interest payments would exceed projected spending on research and development by \$2.8 trillion in 2005 dollars.
- **35 percent greater than the federal commitment to education.** From 2011-2050, additional interest payments would exceed projected spending on education by more than \$1.7 trillion in 2005 dollars.
- **Nearly five times the amount spent on the EITC and Child Tax Credit.** From 2011 to 2050 additional interest payments would exceed projected spending on these programs by \$5.2 trillion in 2005 dollars.

*The Bush Social Security plan would lead (under current federal borrowing trends) to the United States paying an additional \$5.6 trillion in today's dollars in interest payments to our largest ten foreign lenders between 2011 and 2050.* According to data from the Federal Reserve, foreign investors have financed an ever growing share of the government's deficits, averaging about 81 percent between 2001 and 2004. If these trends continue under the President's partial privatization plan:

- **Japan would own additional debt equal to 6 percent of GDP, while China and the UK would hold an additional 3 percent each on average in the 2040s.**
- **Additional interest payments to China alone would total almost \$1 trillion in 2005 dollars between 2011 and 2050.**
- **Combined payments to our top three lenders (Japan, China and the UK) would total about \$4 trillion in 2005 dollars between 2011 and 2050—more than five times the \$709 billion we will spend on foreign aid over that time.**

*Rather than lifting burdens on the next generation, implementing private accounts would force our children to pay off trillions in debt ---either through higher taxes or less investment in our future.* Traditionally, most have agreed that helping future generations better deal with the burden of supporting our future retirees is the main reason to act early to improve Social Security solvency. Yet, the President's Social Security plan would impose staggering interest costs on every American family and child. These additional costs would translate into:

- **\$48,925 in additional debt and \$2,765 in additional interest payments, in inflation adjusted dollars, for a family of four in 2050 alone.**
- **For each person under the age of 20 in 2005, annual interest payments on additional debt, in inflation adjusted dollars, would more than triple from \$201 in 2020 to \$691 in 2050.**

***This new debt is completely unnecessary for saving Social Security:*** All of these interest payments emanate from borrowing to finance individual accounts – which the White House has already admitted are not necessary for solvency.

***If the President's proposal pushes up interest rates by driving down personal savings these interest costs could be even higher.*** If private accounts create a false impression about the size of Americans' savings, many could reduce savings in other areas—generating a net reduction in national savings. This could boost interest rates by an average of one to two percentage points depending on the extent to which Americans cut back. If personal savings declined by just 10 cents for each dollar put into private accounts, the long-term interest rate would rise by an average of 0.9 percentage points by the 2040s—adding \$597 billion in 2005 dollars to our total interest payments in that decade.

## Introduction

President Bush has not laid out a full plan for Social Security privatization. Instead, he has provided a few scant details on what his proposal for private accounts carved out of Social Security could look like and how he may cut benefits. Although these details are sketchy, they can provide the basis for an initial evaluation of the costs – something the administration has so far been unwilling to provide. Based on the details available so far, the impact on government finances – deficits, debt, and interest payments – has been calculated. Putting these figures into context shows the following:

- The interest payments on the new debt would dwarf spending on programs, such as homeland security, education, EITC and child care tax credit and international aid—eventually exceeding spending on the U.S. Army, Navy, or Air Force individually.
- The gap between interest payments and outlays for important programs would grow over time as the President’s proposals raise government deficits for decades.
- Because of our dependence on foreign lenders, the government would end up spending two to four times more on interest payments to China, Japan, and the UK than it will spend on international aid.
- By the 2040s, Japan would own additional U.S. government debt equal to 6 percent of GDP, and China and the UK would own an additional 3 percent each.
- If Social Security privatization reduces national savings, interest rates could rise by an average of one to two percentage points, increasing interest payments by hundreds of billions of dollars.

## Background

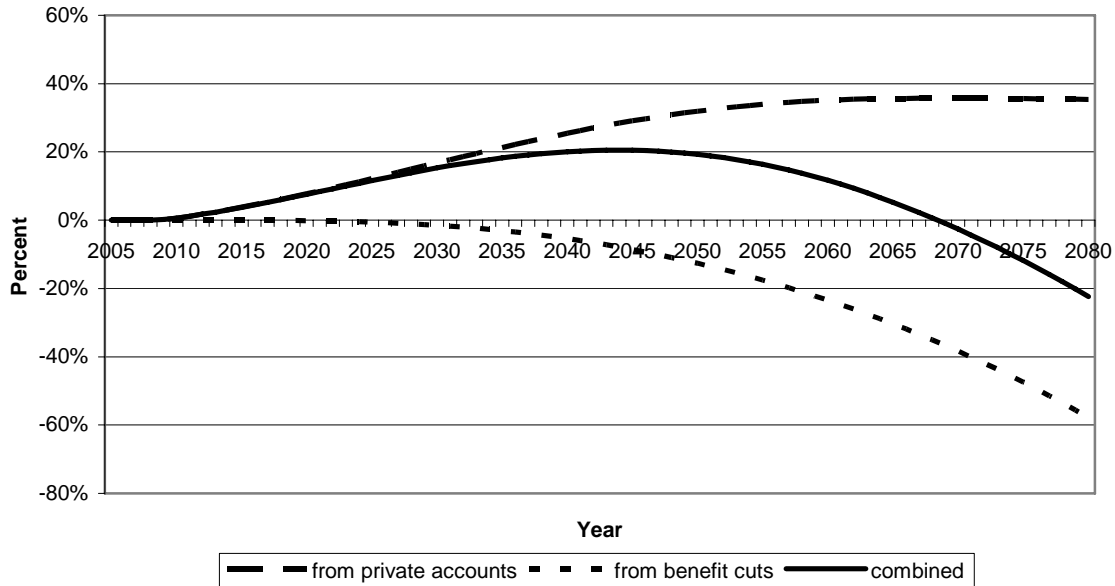
In this year's State of the Union address, President Bush provided a few specifics on how his proposal to privatize Social Security would work. Since then enough details have been made public through statements from the President and members of the administration that the basics of the plan can be isolated. Starting in 2009, some workers and by 2012, all workers could contribute 4 percent of their earnings, or about one third of their Social Security taxes to private accounts. Contributions would be capped at \$1,000 initially, but would increase annually by \$100 and average wage growth. By 2041, workers could contribute 4 percent of their earnings without any limitations.

Because most of the money that Social Security currently receives is used to pay for current benefits, the diversion of up to one third of its resources means that Social Security would have less money available to pay promised benefits. To cover this shortfall, Social Security would have to borrow large amounts of money. According to estimates by Jason Furman, Social Security would need an additional \$4.9 trillion over the first twenty years of a privatized system, if two-thirds of workers chose to contribute to private accounts.

Over time, the additional debt for Social Security would be offset by reducing guaranteed benefits for those workers who participate in the new system. Workers who opt into private accounts would repay this money through offsetting reductions in their guaranteed benefits equal the amount of payroll taxes diverted into their accounts plus interest equal to 2.7 percent above the inflation rate.

These offsets, though, would not ease the government's financial woes for decades to come. As a result, total new debt would rise faster than economic growth through 2064 (figure 1). After that, the total amount of debt would continue to grow, but at a pace slower than economic growth. Consequently, the ratio of debt relative to the size of the economy would gradually decline. By 2080 though, the President's privatization proposal would still add debt equal to 29 percent of gross domestic product (GDP).

**Figure 1: Change in Debt from President Bush's Proposals**



Source: Calculations provided by Jason Furman, NYU and CBPP.

This new debt is not free money. The federal government has to pay interest on it. As debt mounts, so do interest payments. At its height, the federal government would have to dedicate almost two percent of GDP just for interest payments resulting from private accounts. However, this massive new debt would be somewhat offset by substantial benefit cuts for middle- and upper-income earners.

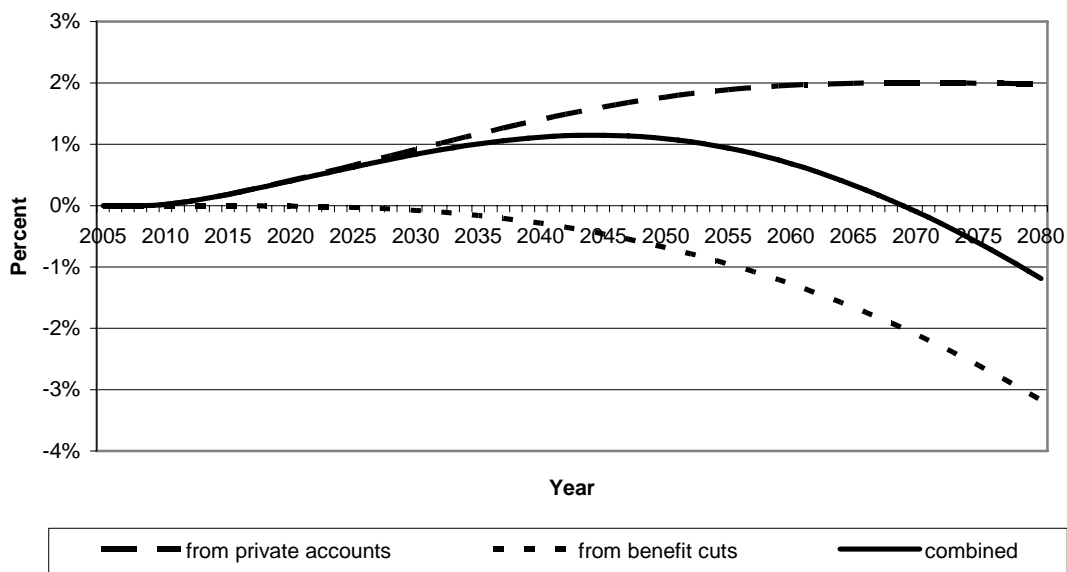
Under the current system, Social Security benefits for new retirees rise in line with living standards. This makes intuitive sense since workers' taxes are also tied to rising wages and living standards.

The President's proposal would cut benefits from their scheduled levels for 70 percent of wage earners using a "blended indexation method," based on the model developed by Robert Pozen, a former member of President Bush's Commission to Strengthen Social Security. Under this plan, benefits would be decoupled from living standards for all but the bottom 30 percent of wage earners. Anybody with wages currently above \$20,000 would see lower benefits than currently promised. The highest income earners – those with wages and salaries constantly at the cap above which earnings are no longer subject to Social Security taxation, currently \$90,000 per year – would see the largest cuts. Their benefits would rise only in line with prices which have historically grown slower than wages. Thus, over time their benefits would fall further and further behind currently scheduled level. Workers earning more than \$20,000, but less than \$90,000 would see benefit cuts to varying degrees, growing larger with income.

These benefit cuts would reduce the government obligations. Over time, this would mean less government borrowing (figure 1). For instance, by 2050, the government’s debt would be reduced by 13 percent relative to GDP. Commensurately, interest payments would go down. By 2050, this would mean a reduction in the federal government’s interest expenditures by about half a percent relative to GDP.

In combination, though, the President’s two proposals would damage the government’s financial health. Only after 2069 would benefit cuts and the offsets in benefits to private account holders reduce the government’s additional debt to where it was in 2009, zero dollars. In the meantime, the government would have spent trillions of dollars servicing additional debt, squeezing other government programs or requiring higher taxes.

**Figure 2: Additional Interest Payments from President's Plan**



Notes: Calculations provided by Jason Furman, NYU and CBPP.

### It Looks Bad in Comparison

To understand the implications of the additional interest payments, it helps to compare them to the size of important government programs, such as homeland security or education. It turns out that total interest payments would quickly dwarf the outlays for many programs and that the difference between interest payments and spending would grow over time (table 1). Even in the first few years under the President’s plan, interest payments would be larger than spending on international aid or the Earned Income Tax Credit (EITC). By the 2020s, interest payments would grow larger than the federal government’s outlays for education, veterans affairs, non-defense R&D, international aid, EITC and Child Tax Credit and homeland security individually. *By the 2030s, interest payments would likely exceed federal spending on the Army, Navy, or Air Force individually.* In the 2040s, the total spending on additional interest payments, including all offsets, would total \$2.8 trillion in constant 2005 dollars— nearly equal to *combined* federal spending on homeland security, veterans affairs, and non-defense R&D.

It should be noted that our calculations assume that the additional interest payments will not be offset by cuts to other spending. Without massive tax increases or spending cuts elsewhere, it is likely that the spending on the programs listed here could be much smaller than we project as a result of higher federal government outlays for interest payments on the widening debt.

**Table 1**  
**Comparison of Interest Payments Resulting from President Bush's Social Security Privatization Proposal and Select Government Programs**

	2010s	2020s	2030s	2040s
<b>Sum of Spending During Decade (Constant 2005 Dollars)</b>				
<u>Interest payments</u>				
• From accounts	\$343	\$1,261	\$2,546	\$4,047
• From benefit cuts	-\$3	-\$70	-\$387	-\$1,232
• <b>Combined</b>	<b>\$340</b>	<b>\$1,191</b>	<b>\$2,159</b>	<b>\$2,815</b>
U.S. Navy	\$1,466	\$1,715	\$1,993	\$2,320
U.S. Army	\$1,261	\$1,475	\$1,714	\$1,996
U.S. Air Force	\$1,477	\$1,729	\$2,009	\$2,339
Homeland Security	\$395	\$451	\$524	\$611
Veterans Affairs	\$800	\$936	\$1,088	\$1,267
Non-defense R&D	\$729	\$853	\$992	\$1,155
Education	\$940	\$1,099	\$1,277	\$1,488
EITC and Child Tax Credit	\$283	\$303	\$352	\$410
International Aid	\$139	\$162	\$189	\$220

Notes: Dollar figures are in billions. Sources are calculations provided by Jason Furman, NYU and CBPP, Congressional Budget Office, Budget and Economic Outlook, January 2005, Washington, D.C.; Office of Management and Budget, Budget of the United States Government, Fiscal Year 2006, Washington, D.C.; Department of Defense, Financial Summary Tables, Part 1, Defense Budget Materials, Fiscal Year 2006; Homeland security expenditures and EITC and Child Tax Credit expenditures after 2015 are assumed to increase with GDP growth. Expenditures for education, international expenditures and veterans benefits are assumed to rise with GDP after 2010. Spending for non-defense research and development, the Army, Navy and Air Force are assumed to grow with GDP growth after 2006.

### **Foreign Governments Hold U.S. Financial Future in Their Hands**

With national savings at low and often negative levels, the U.S. has been forced to borrow money from overseas to make ends meet. Much of the money from overseas has gone to pay for the federal government's deficits. Since 2001, the share of the federal deficits financed by foreign lenders has reached new heights. Data from the Federal Reserve show that foreigners have financed an ever growing share of the government's deficits, averaging more than 80 percent between 2001 and 2004.

If we assume that foreigner lenders will by and large not change their behavior in the coming decades as the federal government runs up additional deficits under Social Security privatization, the amount of foreign held debt would grow substantially (table 3).

Between 2011 and 2050, interest payments on new debt to our ten largest foreign creditors would total \$5.6 trillion in today's dollars. In the 2040s alone, additional

payments to foreigners would rise to more than \$2 trillion—an amount equal to 1 percent of our GDP. That is, each year, the U.S. would have to send an additional 1 percent of its national resources abroad to pay off the debt incurred by privatization. These interest payments would be in addition to the debt service that the federal government will already pay to finance its current deficits. Future generations would thus work to send an ever growing share of the fruits of their labor abroad.

**Table 2**  
**Changes in Interest Payments to and Debt Holdings by Top Foreigner Lenders Resulting from President Bush's Privatization Proposals**

	2010s	2020s	2030s	2040s
Average additional debt held, relative to U.S. GDP				
• China	0.7%	1.8%	2.8%	3.0%
• Japan	1.2%	3.5%	5.3%	5.8%
• UK	0.7%	1.8%	2.8%	3.0%
Total additional interest payments (constant 2005 \$s)				
• Japan	\$99	\$344	\$621	\$800
• China	\$52	\$179	\$322	\$416
• UK	\$52	\$179	\$322	\$412
• Memo: International Aid	\$139	\$162	\$189	\$220

Notes: Dollar figures are in billions. Figures are based on combined debt. Authors' calculations based on Board of Governors of the Federal Reserve System, Release Z.1 Flow of Funds Accounts of the United States, Washington, D.C., and data provided by Jason Furman, NYU and CBPP.

It is important to keep in mind that the federal debt held by foreigners is not equally distributed, but concentrated in the hands of investors in a small number of countries. Specifically, Japan, China, and the UK are comparatively large investors in U.S. treasuries and they have been increasing their investments in U.S. government debt over time. If this trend continues, Japan would remain the largest holder. On average in the 2040s, they would own \$1.4 trillion of the new debt created by President Bush's proposed changes to Social Security (table 3). China would own a sizeable additional \$741 billion in today's dollars on average in the 2040s.

With more and more money owned by foreigner lenders – both private and public – growing interest payments could impede future U.S. economic growth. For instance, interest payments owed on new debt to China would total an estimated \$416 billion in today's dollars in the 2040s. The payments to Japan would exceed three quarters of a trillion dollars in today's dollars and the interest payments to the UK would total \$412 billion in the 2040s. To put this in context, the interest payments to Japan alone are projected to be more than three times as large as all U.S. international aid in the 2040s (table 2). Importantly, though, money spent on interest payments on foreign held debt is money lost to the U.S.--not spent on investment or consumption domestically. Consequently, these interest payments would drain national income and could lower future standards of living.

**Table 3**  
**Average New U.S. Government Debt Held by Top 10 Major Foreign Owners of U.S. Treasury Debt (in 2005 Dollars)**

	Japan	China	Caribbean Banking Centers	UK	Taiwan	OPEC	Korea	Germany	Hong Kong	Switzerland
2010s	\$197	\$104	\$31	\$104	\$47	\$11	\$32	\$15	\$34	\$24
2020s	\$635	\$331	\$102	\$331	\$149	\$36	\$101	\$48	\$109	\$75
2030s	\$1,123	\$583	\$181	\$582	\$262	\$63	\$177	\$85	\$192	\$132
2040s	\$1,427	\$741	\$226	\$734	\$333	\$81	\$225	\$108	\$244	\$167

Notes: New debt is based on calculations provided by Jason Furman, NYU and CBPP. All figures are in billions of constant 2005 dollars. It is assumed that all countries start from the purchasing levels of new treasury issues of the years from 2000 to 2004. It is further assumed that all countries increase/decrease their relative purchases of new treasury issues at the rate of increase of the past twenty years. A limit of 90 percent is imposed on new treasury issues and total debt held by all of the top 10 foreign owners of U.S. treasury debt. Shares are calculated by authors based on data from U.S. Department of Treasury, Treasury International Capital System, Major Foreign Holdings of Treasury Securities, Washington, D.C.

### **President Bush's Privatization Will Heavily Tax Future Generations**

The new debt taken on to finance private accounts would also burden future generations.

By 2020, the additional debt from President Bush's Social Security proposals would amount to an additional \$15,176 in today's dollars for a family of four. By 2050, this amount would grow to \$48,925. Just in one year, a family of four would have to pay \$805 in additional taxes to cover the extra interest payments in 2020. In 2050, this amount would be \$2,765 (table 4).

Today's children, those under the age of 20 in 2005, would face a growing bill to cover. The debt they would owe under the President's Social Security proposal would grow from \$3,794 in today's dollars in 2020 to \$12,231 in 2050. Over the same period, interest payments for those under the age of 20 today would rise more than threefold from \$201 to \$691 in 2050 (table 4).

**Table 4**  
**Debt and Interest Payments Relative to Population (2005 Dollars)**

	2020	2030	2040	2050
Average additional debt for family of four	\$15,176	\$32,895	\$46,720	\$48,925
Average annual interest payments for family of four	\$805	\$1,800	\$2,597	\$2,765
Average additional debt for children below 20 in 2005	\$3,794	\$8,224	\$11,680	\$12,231
Average annual interest payments for children below 20 in 2005	\$201	\$450	\$649	\$691

Notes: Authors' calculations based on U.S. Census Bureau, International Data Base, Washington, D.C.: Census.

### **Costs Rise If It Is Not a Zero Sum Game**

So far we have assumed that the President's proposals to establish private accounts would have no effect on long-term interest rates. Some observers assert that Social Security privatization should have no effect on long-term interest rates because the total amount of national wealth does not change. In essence, government debt is offset by increased balances in people's private accounts. This assumes that the change from a guaranteed Social Security benefit to private accounts will have no offsetting effect on people's savings outside of Social Security.

However, it is possible that the President's proposal could result in higher interest rates exactly because of such offsetting effects. Due to its basic design, the President's proposal makes private accounts look artificially good. Specifically, the loan amount, with interest, that people accumulate by diverting money into private accounts would not be charged to private accounts, rather it would be deducted from the guaranteed Social Security benefit. In terms of the sum of both benefits, this is a semantic distinction, but for workers it would make the private account balances look bigger than they actually are since it hides the money due to Social Security in an obscure calculation tied to the guaranteed Social Security benefit. Consequently, people may think that they have more wealth than they actually do and reduce their saving elsewhere.

If people do reduce their personal saving, there would be fewer savings in the economy. With less money available for investment interest rates would likely rise. According to estimates by the Federal Reserve, an increase in the national deficit by one percentage point relative to GDP raises long-term interest rates by 0.25 percentage points (Laubach, 2003). By that estimate, if families reduce their personal savings outside of private accounts by 10 cents for each dollar that goes into private accounts, the long-term interest rate would rise by 0.7 percentage points on average in the 2040s. This would add \$597 billion in 2005 dollars to the federal government's total interest payments in that decade (table 5).

**Table 5**  
**Additional Interest Rate Payments from Lack of Offsetting Personal Savings**

	2010s	2020s	2030s	2040s
Offset of 10 percent in Personal Savings from Private Accounts				
Avg. change in interest rate	0.1%	0.3%	0.6%	0.9%
Total constant 2005\$s	\$9	\$72	\$247	\$597
Offset of 20 percent in Personal Savings from Private Accounts				
Avg. change in interest rate	0.2%	0.6%	1.1%	1.7%
Total constant 2005\$s	\$18	\$144	\$489	\$1,146
Offset of 30 percent in Personal Savings from Private Accounts				
Avg. change in interest rate	0.3%	0.9%	1.6%	2.4%
Total constant 2005\$s	\$27	\$216	\$730	\$1,696

Note: Authors' calculations based on data provided by Jason Furman, NYU and CBPP. It is assumed that each percentage point increase in budget deficits relative to GDP that is offset by decreases in personal savings results in an increase of the long-term interest rate by 0.25 percentage points.

**References:**

Laubach, T., 2003, New Evidence on the Interest Rate Effects of Budget Deficits, FEDS Working Paper No. 2003-12, Washington, D.C.: Board of Governors of the Federal Reserve System.

## About the Authors

**Gene B. Sperling** is a Senior Fellow at the Center for American Progress. He served in the Clinton administration as the President's National Economic Adviser and Director of the National Economic Council. Mr. Sperling was the third person to hold the role of chief economic adviser in the White House, following Robert Rubin and Laura Tyson.

Mr. Sperling, who served as either National Economic Adviser or as Deputy NEC Director for all eight years, was called by Mr. Clinton "the MVP" of the economic team. As Director of the NEC, Mr. Sperling was responsible for coordinating domestic and international economic cabinet members. Mr. Sperling coordinated the President's Social Security and debt reduction efforts, and played a key role in such initiatives as the 1993 Deficit Reduction Act, the expansion of the Earned Income Tax Credit and technology literacy initiative.

Mr. Sperling also works on a variety of economic and international issues in several capacities: he is Senior Fellow for Economic Policy and Director of the Center on Universal Education at the Council of Foreign Relations; a weekly Economic Columnist for Bloomberg News; a frequent commentator on CNBC, Bloomberg Television, CNN, and Evening News on federal reserve policy, consumer confidence, and tax and budget issues; and is a contributing writer and consultant on NBC television drama, *The West Wing*.

**Christian E. Weller, Ph.D.** is a Senior Economist at the Center for American Progress, where he specializes in Social Security and retirement income, macroeconomics, the Federal Reserve, and international finance. Prior to joining American Progress, he was on the research staff at the Economic Policy Institute, where he remains a research associate. Dr. Weller has also worked at the Center for European Integration Studies at the University of Bonn, Germany, in the Department of Public Policy of the AFL-CIO in Washington, D.C., and in universal banking in Germany, Belgium and Poland. His publications appear in publications ranging from the *Cambridge Journal of Economics*, *the Journal of Policy Analysis and Management*, *the International Review of Applied Economics*, *the Journal of Development Studies*, and the *Journal of International Business Studies* to the *Atlanta Journal Constitution*, *USA Today*, *Detroit News*, *Challenge*, and the *American Prospect*. Dr. Weller is often cited in the press and he has been a frequent guest on news programs on ABC, NBC, CNN, MSNBC, CNBC, Fox News and Bloomberg Television. Dr. Weller holds a Ph.D. in economics from the University of Massachusetts at Amherst.

# Center for American Progress



## **ABOUT THE CENTER FOR AMERICAN PROGRESS**

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is “of the people, by the people, and for the people.”

**Center for American Progress**  
**1333 H Street, NW, 10<sup>th</sup> Floor**  
**Washington, DC 20005**  
**Tel: 202.682.1611 • Fax: 202.682.1867**  
**[www.americanprogress.org](http://www.americanprogress.org)**