Social Security Reform: National Saving and Macroeconomic Performance in the Global Economy

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Thank you. I am delighted to be here.

I would like to talk with you today about some of the economic challenges we face as a nation. There are, of course, many angles from which to view these challenges. As a macroeconomist, I would like to consider one particular perspective—one that emphasizes the importance of national saving. As you may know, national saving in the United States is low, as judged by either historical or international standards. Several of President Bush's top initiatives for his second term are aimed to increase national saving over time. Foremost among these is reform of the Social Security system—and that will be the main focus of my remarks today.

The Challenges of the First Term

When President Bush came into office four years ago, the economy was sliding into recession after the bursting of the high tech bubble of the 1990s. The immediate problem facing the economy was not low saving; it was a large decline in aggregate demand. Spending by households and businesses was insufficient to maintain full employment.

Thanks to expansionary monetary policy and the tax relief passed during the past four years, we've just completed a year in which the recovery blossomed into a full-fledged expansion. About 2.3 million new payroll jobs were created during 2004, the largest gain since 1999, and the economy expanded by roughly 4 percent. The unemployment rate is now below the average of each of the past three decades. Most forecasters expect solid growth to continue in 2005 and beyond.

With the short-run path of the economy under control, policymakers can put renewed focus on the longer-term economic challenges. The low national saving rate is one of them.

The Importance of National Saving

Any good student of basic economics can explain why national saving is so important. Saving is the main source of funds available for domestic investment in new capital goods. Capital accumulation, in turn, is a key driver of productivity gains and rising living standards.

The only way to finance domestic investment other than through national saving is by borrowing from abroad—that is, by running trade deficits. Although most laymen focus on the trade deficit as the difference between exports and imports, economic theory reminds us that it is also the difference between national saving and domestic investment. If the trade deficit is to move toward balance over time, it will require either a rise in national saving or a decline in domestic investment. From the standpoint of economic growth, higher saving is the better alternative.

Recently, net national saving in the United States has represented about 1 percent of GDP. That compares to the historical average of about 8 percent since 1950. Many economists from across the political spectrum have suggested that higher national saving should be a key priority for public policy.

Let me talk about three of the President's policies that should, over time, lead to higher national saving.

Tax Reform

The first is tax reform. The current tax code is a drag on the economy, discouraging saving and investment, and requiring individuals and businesses to spend billions of dollars and millions of hours each year to comply with the system. The President has stated that his goals are to make the tax code simpler, to make it more fair, and to further promote saving, growth, and job creation.

A large scholarly literature has pointed out that one way to improve the tax code would be to reduce the bias against saving and investment inherent in the current system. Over the past several decades, there has been some progress in this direction. Policies such as individual retirement accounts and 401K plans exempt saving from taxation and, in doing so, move the tax base from income toward consumption. Similarly, last year's Jobs and Growth bill lowered taxes on dividends and capital gains; by reducing the double taxation of income from corporate capital, that bill can also be seen as taking a step toward a tax system that is more favorable to saving. Despite these improvements, the tax code is still far from what most economists would recommend as an optimal system.

The President has promised to pursue tax reform in his second term. As a first step, he recently named a bipartisan panel of experts to develop reform proposals by the end of July. The excellent reputations of the panel members should be seen as a signal of how serious the President is on this issue.

The Near-Term Fiscal Challenge

Another fiscal policy challenge the United States faces is the budget deficit. The deficits we have seen in recent years are an understandable response to the recession and to the spending required for the War on Terror. While they are manageable today, we need to keep in mind that the costs of budget deficits are paid by future generations. Deficits also can reduce national saving, putting upward pressure on interest rates and crowding out investment. This offsets some of the expansionary effects of tax cuts, both in the short run and in the long run. This is why, as the President has said, deficit reduction and spending restraint are so vital.

As the economy continues its recent expansion, it is crucial to have a plan to reduce the deficit over time relative to the size of the economy. This is the case under the President's policies. The deficit as a share of GDP is projected to diminish by more than half over the next five years.

To meet this goal, government spending growth must continue to be restrained. In the President's most recent budget, growth in discretionary spending was kept to 4 percent. Discretionary spending other than defense and homeland security was kept to less than 1 percent—below the rate of inflation. You should expect to see continued spending discipline in the President's future budgets.

Social Security Reform

The greatest fiscal challenge facing the nation, however, is beyond the standard five-year budget window. As the population ages and the baby-boom generation retires, the entitlement programs for the elderly will put gradual but substantial pressure on federal spending. The President has correctly called this "the real fiscal danger." Unless action is taken, budget deficits will rise significantly over the next several decades, reducing national saving and depressing economic growth.

The President has not yet decided precisely what reforms to Social Security he will advocate. But it is important, as the Nation considers the options we face, to understand the nature of the problem.

The fiscal challenge in the Social Security system reflects two factors. The first is simple demographic reality. Compared to past generations, Americans are having fewer children and living longer. As a result, the elderly are representing an ever larger share of our society. In 1950, there were 16 workers paying into Social Security for every person receiving benefits. Now there are 3.3, and that number will fall to 2 by the time today's young workers retire.

The second driving force is that, under current law, each generation of retirees receives higher real benefits than the generation before it. This stems from the indexation of the initial level of benefits to wages, which over time grow faster than prices. A person with average wages retiring at age 65 this year gets an annual benefit of about $14,000, but a similar person retiring in 2050 is scheduled to get over $20,000 in today's dollars. In other words, even after adjusting for inflation, today's 20-year old worker is promised benefits that are 40 percent higher than what his or her grandparent receives today.

This current system of indexing initial benefits to wages has not been part of Social Security since its inception. In fact, it was introduced by the Carter Administration in 1977. At the time, some leading experts on Social Security objected to this change, arguing that it would put Social Security on an unsustainable path. In a prescient letter in the New York Times (published on May 29, 1977), Peter Diamond, James Hickman, William Hsiao, and Ernest Moorhead wrote, "the wage indexing method calls for a much larger growth in benefits for future retirees at a time when the country may not be able to afford it.…Only a Social Security system without a large deficit on the horizon can have the flexibility to deal with this and other needs. It would be sad if the legacy of a particularly forward-looking President [Carter] were a political nightmare." Despite their advice, President Carter signed into law the indexation regime with which we are still living.

Just as this group of economists and actuaries predicted in 1977, the current benefit structure is colliding with demography to make the system unsustainable for the long term. Benefits rising with wages could be sustained if we had a stable number of workers for each retiree, because economic growth raises real payroll tax revenues and thus makes available more resources to pay benefits. Conversely, the demographic shift of a declining number of workers for each retiree could be accommodated by economic growth if each worker was not required to support a benefit that grew as rapidly as currently scheduled. But the combination of large benefit increases and a growing elderly population puts the Nation on an unsustainable path.

Annual spending on Social Security will exceed the system's tax revenue in 2018, with deficits increasing from there. The Social Security trust fund will be empty in 2042, at which point the system will be insolvent. Under current law, the benefits the system will be able to pay from that year on will be only as great as the revenues coming in. Retirees would receive only about 75 percent of scheduled benefits. In total, Social Security has made promises that exceed its resources by more than $10 trillion in present value.

The United States is, of course, not unique in facing the fiscal challenges of an aging population. Most developed countries face similar or even larger increases in the ratio of elderly to the labor force. But the United States is unusual in not responding to this development with significant reform in recent years. Since 1990, several nations, including Germany, Italy, and New Zealand, have raised the eligibility age for their public pension systems. Australia, Sweden, and the United Kingdom have all undertaken reforms that included personal retirement accounts.

Without reform, the United States will face little choice but vastly higher taxes and the resulting drag on economic growth. Putting Social Security permanently on a sustainable basis through higher taxes alone would involve raising the tax rate from 12.4 percent of taxable payroll to 15.9 percent—a 28 percent increase, equal to $1,400 for a family making $40,000 a year. Delay only makes the tax increase that would be needed to bring the system into balance even larger.

Such large tax increases would have serious adverse effects on the overall economy. Nobel Prize winning economist Ed Prescott has written in a recent paper that a large part of the difference between our economy and those in Europe is that Europeans work less because they are taxed more. Raising taxes to solve the Social Security shortfall would, in essence, make the U.S. economy more like those of Europe. With nations in Western Europe lagging the United States in growth and job creation, that is not the direction we should be heading.

In one of his last acts in public life, the late Patrick Moynihan, the former Democratic Senator from New York and a former Harvard professor, co-chaired the President's Commission to Strengthen Social Security. The commission proposed a number of possible reforms to fix the system. The commission's proposals are consistent with the President's principles for reform. They do not alter benefits for current retirees and those near retirement. They do not raise taxes. And they offer voluntary personal accounts to younger workers so they would have the opportunity to receive the benefits of long-term investing.

Beware of the Sophists

As the nation debates alternative proposals, you should be careful to avoid the sophistry of those opposed to reform. In particular, be wary of those who argue that there is no Social Security problem or that only small changes are needed to address it. The truth is that Social Security faces fundamental financing challenges. Just ask the Social Security Trustees, the Congressional Budget Office, or any other group of nonpartisan analysts. Reasonable people can debate what kinds of reforms are best, but don't let the Ostrich Caucus convince you to put your head in the sand.

Some will argue that these problems are far in the future and that there is no need to address them today. Imagine if a financial planner offered the same counsel to his 30-year-old client: "Don't worry Joe, retirement is 35 years away, you don't need to save anything." That planner would be guilty of the grossest malpractice.

The economics here would be understood by any parent who has contemplated saving for his or her child's college education. The sooner you start preparing for that future expenditure, the easier it is, and the better prepared you will be.

This President recognizes that his job is to take the long view and to plan for our nation's "retirement." He is rightly committed to acting now.

You should also be wary of comparisons between a new, reformed Social Security system and current law. The benefits now scheduled for future generations under current law are not sustainable given the projected path of payroll tax revenue. They are empty promises. Unless a listener is discerning, empty promises will always have a superficial appeal.

By contrast, the proposals of the Social Security Commission recognize the need for reform. Under these plans, future retirees receive benefits at least as high as those retired today, and they have the option of investing in a personal account and taking advantage of the higher return that accompanies equity investment. But the plans do not promise more than the System has the ability to pay.

Let me conclude by quoting the words of a President. “This fiscal crisis in Social Security affects every generation. We now know that the Social Security trust fund is fine for another few decades. But if it gets in trouble and we don't deal with it, then it not only affects the generation of the baby boomers and whether they'll have enough to live on when they retire, it raises the question of whether they will have enough to live on by unfairly burdening their children and, therefore, unfairly burdening their children's ability to raise their grandchildren.” That was President Clinton speaking on February 9, 1998. President Clinton was most definitely not a member of the Ostrich Caucus.

It is time to confront head-on the challenges facing Social Security. President Bush is now developing the specifics of the Social Security reform he will advocate. One thing is certain: His proposal will be a credible plan that puts the Social Security System on a firm foundation for generations to come.

Thank you.