

ADDRESS: THE FUTURE OUTLOOK FOR SOCIAL SECURITY

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In last night's talk, Edward Berkowitz mentioned that the very first Social Security Advisory Council in the 1930s took 13 months and came out with one plan. Just so you are all aware of the rapid technological progress in this business, our 1994–1996 Advisory Council on Social Security was able to produce three plans in the space of only 30 months.

When I was asked to speak at tonight's dinner, I was asked to talk about the politics of Social Security. The request came three or four months ago, shortly after our report came out in January, and at first I tried to change the topic. In part I was sick and tired of politics, and in part not much politics was involved. I did not know what there would be to say, so I opted for the vaguer title that you see in your program, "The Future Outlook for Social Security." But now that the time has arrived, and now that I have heard the papers presented at this conference, I find that I do in fact have a few things to say about the politics of Social Security reform. But I will get to them later.

One very good thing about this conference is that it has brought out the recognition that America is not alone. We are one of many countries facing essentially the same issue—the aging of the population. The aging of the population comes about in part because we have had low fertility rates. If we consider the alternative to low fertility rates, it is worse. We should be thankful that fertility rates are declining around the world. If they were not, the world population problem would be even more serious than in fact it is. One of the major difficulties posed by declining

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fertility rates is that countries usually have an aging population and are likely to have trouble with defined benefit, pay-as-you-go pension plans. But it strikes me that we ought to be able to deal with that kind of problem.

I do not want to talk many numbers tonight, but let me say one thing about the numbers. The funding gap is said to be roughly 2.2 percent of payroll under the traditional 75-year forecast. That is a very long horizon, by world standards. So the fact that the Social Security system is in deficit by only 2.2 percent of payroll is relatively good news, again, by world standards. But a problem still remains. Because we have an aging population, the out years are typically years of high deficit. Truncating the forecasting horizon at 75 years is then not a random truncation—a truncation bias is present, because we know that the last years are going to be very high deficit years. As time marches on, these years come into the forecast horizon and they raise the actuarial deficit. Hence, I think this is one case where 75 years, even though it seems like an incredibly long time, is perhaps not the right way to look at the funding gap. The Council would like to have a standard that does not change simply because the calendar advances. We do not quite have that in this country, even though we do look ahead for many years. If we were to go to the permanent solvency standard, as suggested in our Council report, the gap would be on the order of 50 percent higher, probably more like 3.3 percent of payroll, based on the work of Alan Auerbach. I think this is the right standard to use.

In terms of dealing with Social Security proper, I have one lament about our Council. It strikes me that whatever we do, whether we adopt plan A, B, or C, we have two paramount goals. One is to preserve the social protections offered by Social Security. There are a lot of them: protection for low-wage workers, indexing of benefits, disability protection, protection of the families of those who die early in their careers. We have had a number of these protections for a long time, and we may take them for granted. One criterion of reform would seem to be that we should preserve these social protections. Another goal is to raise national saving. We have talked a lot about this goal here at the conference and I do not have anything particular to add, except to say that it is an important goal with me as well.

So we need a reform package that would achieve both goals—to preserve the social protections and to raise national saving. But I had trouble getting our Council to agree with that. We talked about it many, many times. One group of Council members were very strong on the social protections, but less strong on national saving. They were not necessarily against raising national saving, but they did not want to see it done through Social Security. Another group was just the reverse—strong on national saving, but sometimes you wondered, on all the social protections. A fairly small group of us in the middle—Marc Twinney and

I—worried about both goals. But while I lost the battle within the Council, I still have not given up on the war in the broader political debate. I do think that whatever reform package we adopt, we really ought to worry about both goals, and not just one to the exclusion of the other.

I have a few things to say about national saving tonight, so I will take some of my air time for that. First off, I would like to commend the discussion today, because we talked for an hour and a half about the national saving issue and we almost got through it without ever mentioning the stock market. That was a problem with the press coverage of the Council's work. I have spoken to reporters a lot this year and I have tried to keep them focused on what is important. And what is important is what these plans are doing for national saving. I think we lost the battle of the media on that one. Just about every news story on our Council focused on the stock market—this group or that group is going to put our Social Security money in the stock market—with any further distinctions left behind. Whether stock market investment would be done through a central fund or individual accounts or publicly managed individual accounts, the stock market was the magic button that got the press going. I regret the fact that the national saving issue got swept away in the current and that the stock market took all the attention. It seems to me that the important issue in Social Security reform is whether we have new saving, by moving to a more pre-funded system. This key point you are all aware of, and it was mentioned many times this morning. But I would like to repeat that pre-funding is the important issue, not whether it is done publicly or privately. There are advantages to doing it either way.

We talked a lot this morning about a technical issue concerning whether a particular set of measures will in fact raise national saving. But I agree with Larry Kotlikoff when he said that the discussion was a little too noncommittal in the case at hand, that "we know a little bit more than that." Suppose we adopt something like the individual accounts plan that I proposed. I do think it would raise national saving. The plan has essentially two components: One is what I have taken to calling kind and gentle benefit cuts—modest benefit cuts, working in slowly over time. The second is mandatory individual accounts. The benefit cuts would be cuts in budget expenditures. They would not be huge, but they should increase national saving. And if we mandate individual accounts on top of that, they too should raise national saving. Many people already have individual accounts. They might well reduce their own saving. But a lot of people do not have individual accounts, and they would have to increase their saving. And a lot of people are captives of inertia, a group that would include me. If somebody started a government individual account for me, that would probably raise my saving because I probably would never get around to lowering my other saving. So I do think that

a plan like the one I proposed would clearly raise national saving, and I do not understand our reluctance to recognize a positive effect on saving.

If we go to some kind of individual accounts, a whole new set of issues are on the table, including questions about how the accounts should be managed. I am afraid of just unleashing people, telling them to go get IRAs. Among other things, something like 140 million individual accounts, many of them quite small, would seem to pose an impossible regulatory problem. I just cannot see how we would ever regulate them, and, as Peter Diamond has pointed out often, the administrative costs would be very large. So I would prefer to have the accounts centrally managed, even though that does raise some people's hackles. But that is one issue. If we have individual accounts, we will have to deal with their management and regulation, to keep the administrative costs low and the accounts safe.

A question also arises about annuitization, and the further question as to whether, if we do try to annuitize accounts, we can make that stick. Or whether in calling them individual accounts, people will feel the right of ownership and lobby hard to use their accounts for college education or other non-retirement purposes. There is clearly more to the argument than just asserting that the accounts would be annuitized. That again is an issue that should be studied.

Still another issue that should be studied was not discussed today: It is whether the individual accounts should be voluntary or mandatory. One of the great puzzles in Social Security reform, right up there with the equity premium puzzle, is why people do not take advantage of all the tax preferences and have more defined contribution accounts on top of Social Security. The accounts have tax advantages and many firms match contributions, making it very favorable to contribute, yet a lot of people do not contribute. If voluntary measures and cheerleading will get us close to the goal of universal pension coverage, that would be fine. I am certainly not wedded to government mandates. But for some reason, people just do not seem to want to make tax-deferred saving contributions. In that connection I read in a recent story in *The New York Times* that a number of firms seem to have precisely this worry. They offer subsidized 401K plans, which also receive favorable tax treatment. Yet a lot of their employees do not take them up, and the firms are beginning to worry on behalf of their employees. Many firms are actually beginning either to think about or to impose mandates. The firms that have done that seem to have been able to do so without too much objection. Perhaps this is a way to mandate: If people are upset about government mandates, maybe firms can mandate. There are various ways to skin a cat. What I personally am concerned about is that Social Security benefits already are not very large for many people. If we have to modify them to bring the system into balance, they will be that much lower. Then people will have

to save more for retirement, on top of the central system. Mandating may not be the best approach, but something should be done.

That is it for the economics of Social Security reform. Let me now say a couple of things about the politics, which is what I was initially asked to do. I could not fill up a whole speech, but I will make two points. The first was made today by Peter Diamond, who was sitting next to me. I jostled him and said, "You just took away my speech." And he said, "That's okay, say it and say it again." I have license to do that, so I will. The point is that when we look at the politics of Social Security, it is definitely wrong to take apart a package and say this part of this package will be politically unpopular. We have to consider the whole package *as a package*. We have to consider the parts and the whole and we have to consider the interaction. The reason this comes up is that we have proposed a mixed system, and there is a serious worry, I fully admit, about whether a defined benefit (DB) system and a defined contribution (DC) system can coexist. Will there be pressure to route money out of the DB system into the DC system? It strikes me that enough firms have mixed systems, and enough other countries have mixed systems, that it looks like coexistence can be possible. But nobody can be sure of this. It is a very important question and it ought to be studied carefully.

The other point I would make is that we have to worry about the politics of pure DB systems. Right now the "money's worth" ratios or rates of return, whatever we want to look at, are reasonably high. But they are going to drop steadily, as long as our fertility rate and real wage growth stay low. They are going to drop down to a 1 percent rate of return, on average. We have to worry about the politics of that, too. I do not know just how to worry about such politics, but I do have this nagging fear, and I think a lot of us in the Council had the same fear, that as we get to lower and lower rates of return, the underlying popularity of the Social Security system could be threatened. Hence, when we start worrying about the politics of Social Security reform, there is a sense in which it may be desirable to have a defined contribution element in this system, offering a little better rate of return. The combination might actually save Social Security as we know it. I do not have any answers here but it is a very important question and a very complicated question. It appears that we know even less about the politics of these plans than we do about their economics.

Having said that we really do not know much about politics, I am going to end up by saying something I think that I do know, or at least suspect. I think that the professional politicians are too afraid of Social Security reform. Social Security has a reputation of being the third rail of American politics: Touch it and you die. But if you try to think about this reputation logically, I do not agree. Take our Advisory Council, for example. We proposed three very different plans, each with the common feature that it barely touched the benefits of present retirees. We all were

very cognizant of changing the system over the long run, getting it on a different track, restoring financial solvency using the 75-year test, all those kinds of considerations. But nobody actually took a hatchet to current benefits. And so it strikes me that this third rail analogy may be inappropriate.

We have a Social Security system. We know that young people are worried already about the financial solvency of Social Security. That has been confirmed by a great deal of polling data. It is possible to devise a package that would deal with both social protections and national saving. Such a package would put the system on a sound footing. It could reorient the benefit schedule, but not by a huge amount. It could do so in a way that no new "notch babies" would be created. It could modify benefits very slowly, but to an important degree in the long run. And it could do all these things without taking a big bite out of any present benefits. It could make the system more popular with younger workers, and no less popular with retirees. So it strikes me that if we really look at the politics of Social Security reform, where does the Congress have a better deal? There is nothing like that for the health programs. Even the budget bill had to include some current pain. The upshot is that the politics of Social Security reform might be much more favorable than the politics of some of these other issues that the Congress already has to deal with.

I know some professional politicians. I have talked to a few of them about this issue and they still shy away from Social Security reform. But I think that there may be a sense in which something could now be done about Social Security. And believe me, the time to do it is now. We want to get the system in shape and get a new benefit schedule established before the baby boomers begin retiring. Having said that we do not know much about politics, I do think we know something. When we really look at the politics of reforming Social Security, they might be more favorable than we think.