

## ***Strengthening Social Security for the New Millennium***

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I am pleased to be in Germany this week to discuss an issue of critical importance to both Germany and the United States—the future of our Social Security systems. The central question for both of our nations is the same: How do we strengthen our social insurance systems that have been so effective in the 20<sup>th</sup> century to meet the changing circumstances and needs of the 21<sup>st</sup> century? Finding consensus to this question is one of the most important issues facing us all.

Some nations in recent years have implemented significant changes to their social insurance systems. Most nations still face difficult choices as we seek to maintain economic security for our citizens as well as long-term economic viability of our programs.

In the United States, there is considerable debate about a broad range of options to assure the economic security of our retired, disabled and survivor population. Some of the options seek to maintain the current structure of our social insurance program and propose some combination of benefit cuts and revenue increases to assure financial viability. Other options introduce substantially more advance funding as well as different benefit and financing structures. All options must be debated as we move to consensus.

### **The Importance of Social Insurance**

A central question to me in this debate is the extent to which some of these alternative benefit and financing structures are consistent with the social insurance principles that have formed the basis for our extraordinarily successful programs for more than six decades. At the end of the day, we must have a social insurance system that is universal and fair, that is progressive, that provides a guaranteed benefit over a lifetime, and that also preserves long-term fiscal discipline.

The universal nature of the current Social Security system in the United States is able to spread risks associated with disability, premature death or old age over the entire working population. In terms of fair and equitable treatment, the current system ties benefits to a lifetime of earnings so that the higher a worker's earnings, the higher the benefit payments. But the progressive features of the benefit formula replace a higher percentage of income for the lower wage earner, recognizing that they have fewer resources to save or invest. Without this progressive benefit, millions of older Americans would be living in poverty.

Perhaps most importantly, our social insurance system provides a benefit people can count on over a lifetime, with annual cost of living adjustments, even during economic downturns. And, finally, the United States Social Security system has been sound for well over half a century; we need a system that is fiscally sustainable over the long term.

The United States Social Security system has proven to be a durable institution that has changed with the times—and in the process it has become part of the fabric of the country. But I believe Social Security must continue to change for it to be part of the fabric of the country in the future.

### **Demographic and Economic Landscape**

Let me briefly survey for you the demographic, economic, and retirement policy issues in the United States that must be confronted if we are to resolve this issue. I will then discuss recent United States developments and outline the key elements that I believe will be necessary to assure long-term sustainability of our social insurance system.

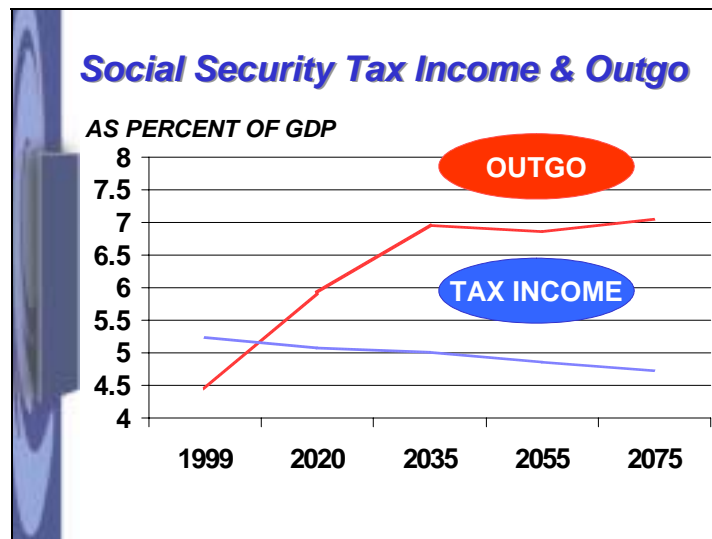
Like most countries, the United States is experiencing a sea change in the demographics of our population. Rapidly aging populations and lower fertility rates are creating long-range financial instability in our social insurance system. When the original Social Security Act was passed in the United States in 1935, life expectancy for a 65-year-old was 12 ½ years. Today, the life expectancy for a 65-year-old is 17 ½ years—and rising. The demographic challenge is not just the number of years that people are living; it is also the number of people living them. In the United States, the absolute number of people age 65 and older has tripled since 1940—and is expected to more than double again by the middle of the next century. Our fertility rate has declined by 43 percent over the past four decades—from 3.6 to about 2.0 births per woman—although this number appears to be stabilizing.

The improvements in life expectancy and a decline in birth rates have put us on a path of rapid decline in the number of employed workers for every beneficiary. Today, in the United States the ratio is 3.3 to 1. In little more than 30 years time, it will be just 2 to 1. Without very rapid economic growth, this will create great strains on the pay-as-you-go nature of our system.

Although the long-term demographic and financial pressures that we face in the United States are very real, I should point out that they are not as severe as in many other industrialized countries. This is partly because United States immigration and fertility rates are higher. In addition, the United States Social Security retirement benefits replace only about 40 percent of earnings for the average wage earner—which is lower than many other industrialized countries—and because our law already provides for increases in the retirement age for full Social Security benefits that will be phased in over the next two and a half decades. The past decade of strong economic growth, low inflation and low unemployment also helped to ease some of the pressure on the system. There is no short-term Social Security crisis, and modest changes phased in over many decades will ensure that no crisis ever occurs.

While we face no crisis in economic terms, the aging of America will place real pressures on our economy. Pensions, health care and long-term care will all add to the pressures. Using mid-range economic assumptions, Social Security is projected to grow from 4.2 percent of GDP in 2000 to 6.5 percent in 2030. As Table 1 shows (from the 2000 Trustees' Report), we face a sizeable mismatch between income and outgo under mid-range economic and demographic assumptions. I would point out that this is not only an issue of increasing costs. Social Security tax income is projected to decline by about 10 percent as a percentage of GDP over the long term. With a doubling of the senior population, current financing sources are clearly insufficient. Over the next 75 years, our shortfall amounts to about 2 percent of payroll. Given demographic changes, the annual shortfalls amount to about 1 ½ percent of GDP by 2030.

**Table 1**



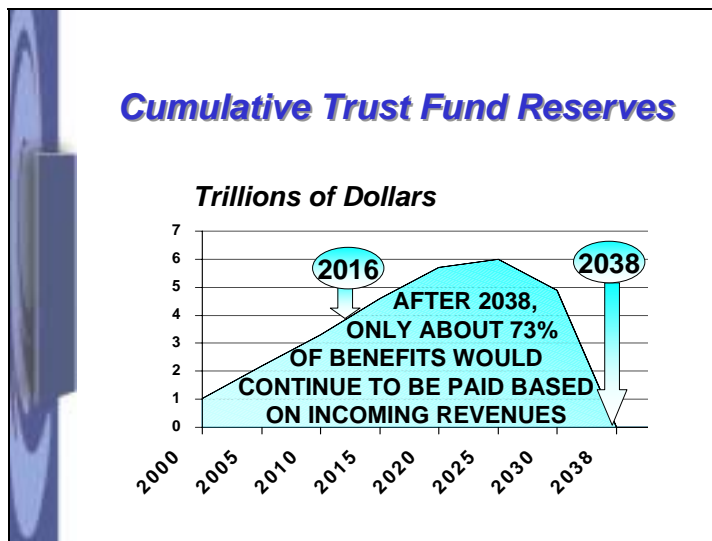
In 1983, as a result of legislation to improve both short-term and long-range program funding, the United States moved from a purely pay-as-you-go financing system to one that started building large reserves. Currently, Social Security income exceeds costs, but by 2016 outgo will exceed tax income

At the present time, about 90 percent of Social Security tax income is transferred in beneficiary payments; the balance, plus interest, builds in the trust funds. Our Social Security trust funds are thus paying down United States debt and building reserves to help finance the retirement of the baby boom generation, peaking at about 3 years of benefit obligations. But as Table 2 shows (from the 2001 Trustees' Report), given demographic changes, the trust funds will be exhausted in 2038, if no action is taken. At that time, tax revenues would be sufficient to pay only about three quarters of benefit obligations.

Balancing the budget and reserving the annual Social Security surplus, which amounted to \$125 billion in 1999, about 1.4 percent of GDP, means that the bonds accumulating in the trust fund are matched very nearly dollar-for-dollar by

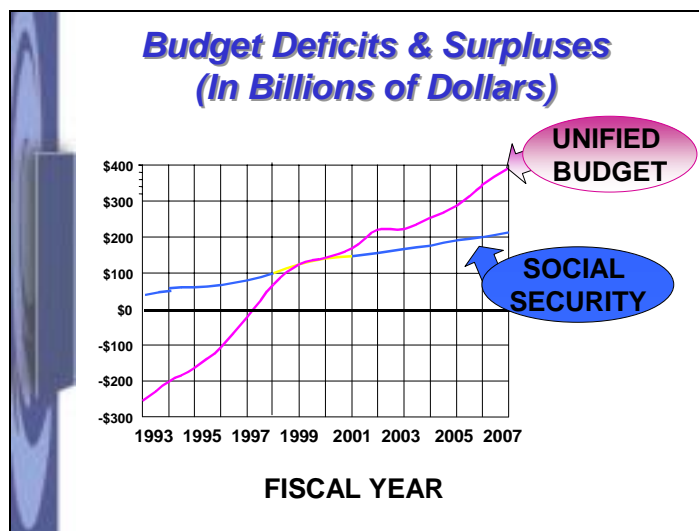
a reduction in debt held by the public. Put differently, accumulations in the Trust Fund truly represent accumulations of a national asset—an increased capacity to meet our obligations to tomorrow’s retirees.

**Table 2**



The United States is now running substantial Social Security and unified budget surpluses (see Table 3 from the Congressional Budget Office). One of the most important achievements of the past decade is that the United States, rather than running enormous annual budget deficits, which amounted to 3.8 percent of GDP in 1993, is now running very large budget surpluses. Two key questions for the United States is what to do with the large Social Security surpluses and what to do with the large unified budget surpluses not associated with Social Security.

**Table 3**



I believe that these surpluses represent an important first step to prepare for the retirement of the baby boom generation: moving toward more advance funding,

enhancing national saving, expanding the productive capacity of the economy and making us better able to meet the benefit obligations that are promised under current law.

### Are these Projections Overly Pessimistic?

The Social Security Board of Trustees is obligated by law to annually make an objective assessment to the public of both short-range and long-range solvency. The long-range estimate serves as an early warning to potential problems. Because of its objectivity, the Trustee's Report is viewed as highly credible. Its findings are widely used in government, academia, and the press, providing the basis for a common discourse on the future of Social Security. Table 4 highlights the three sets of demographic and economic assumptions that are used by the Social Security Trustees to project long-term trends.

**Table 4**

2000 Trustees' Assumptions				
<u>Parameter</u>	<u>Average for 1970 - 1999</u>	<u>Low Cost</u>	<u>Intermediate</u>	<u>High Cost</u>
Total Fertility Rate	1.94	2.2	1.95	1.7
Life Expectancy at Birth	74.2	79.4	82.7	86.8
Net Annual Immigration (thousands)	661	1,210	900	655
Real Wage Differential	0.76%	1.5%	1.0%	0.5%
Real GDP Growth Rate	3.09%	2.42%	1.73%	1.02%
Estimated Balance- Taxable Payroll	NA	+0.38	-1.89	-5.00

Some have argued that the intermediate assumptions, which are the projections that are traditionally discussed with the public, are overly pessimistic in terms of long-term growth, and that more robust growth assumptions would reduce the size of the long-term problem.

It is clear that the growth projections used by the Trustees are significantly lower than the recent experience, but the Trustees project lower long-term growth due to a significant reduction in the growth of the labor market in the decades ahead. Further, even if growth rates continue at higher rates, there would likely still be a long-term mismatch between revenues and outlays. Indeed, if productivity growth for the next several decades continues at the 2.3 percent rate experienced by the United States over the past five years, a sizeable actuarial deficit would still exist, albeit the size of the long-term problem would be reduced by about a third. Clearly, faster productivity growth would be beneficial, but absent extremely high growth rates, long-term challenges remain for our social insurance system. Absent extremely high growth, it would take a whole series of favorable trends—

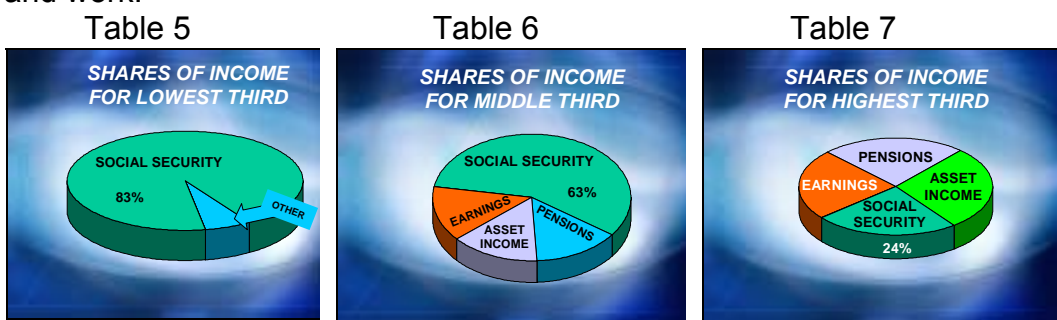
favorable in actuarial terms—for the long term funding situation to disappear; it would take faster growth, higher fertility and immigration rates and a slowing in the growth in life expectancy for there to be no long term funding problem. I believe such a confluence of occurrences is unlikely.

### Three-Legged Stool

Social Security only represents one leg of the “three legged stool” of retirement income. Pensions and personal savings make up the other legs of the stool. Social Security is almost fully funded on an intergenerational basis. Savings and pensions are advance funded.

The following three charts from the Social Security Office show the shares of income for Americans over age 65 by income source, with the population divided by thirds.

As Table 5 shows, Social Security makes up the vast majority of income for lower income Americans over age 65. For this group, there really is only a one legged stool—Social Security. For the middle third (Table 6), Social Security still represents the majority of income, but there are also other sources of support. And for the top third (Table 7), Social Security represents about a quarter of income. But for this group, we see the emergence of a four-legged stool, with roughly equal shares of income coming from Social Security, savings, pensions and work.



Key questions for policymakers and the public is how these charts will change – and should change—for future generations. Will work make up a larger or smaller share of post-age 65 income? Will pensions and savings make up more? And will Social Security make up less?

It is possible that work may make-up a somewhat higher proportion of income for some workers over age 65. As Table 8 shows, it is clear that declines in labor force participation rates in the United States stabilized in the mid-1980s and are projected to rise very modestly in future years. While it is not the purpose of this paper, it is clear that public and private solutions will be needed to encourage more older workers to remain in the workforce.

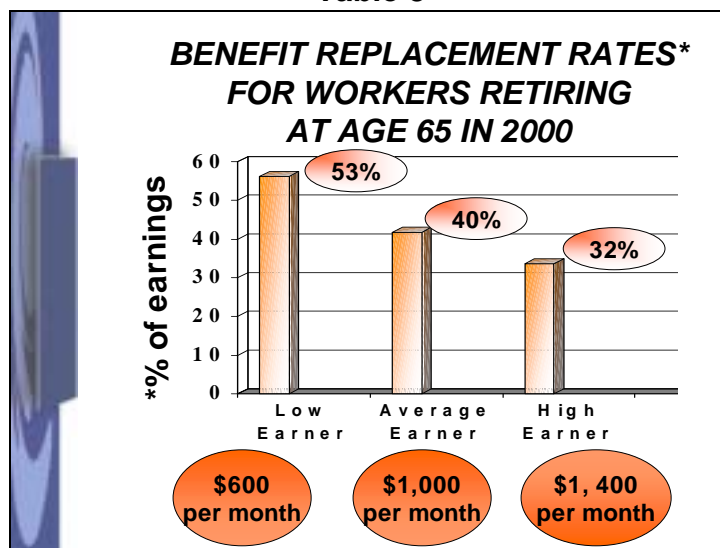
The pensions and savings areas are certainly not projected to be areas of sizeable growth under current policies. The number of older Americans who

receive pensions has only increased modestly in recent years and large shares of workers still receive no pension coverage. The proportion of year round, full time employees participating in retirement plans has remained relatively stable over the past 30 years and only grew modestly since the 1990s, from 55 percent to 58 percent. And the number of active participants in defined benefit retirement plans fell from 30 million in 1983 to 23 million in 1995.

According to a recent Congressional Research Service study using data collected by the Bureau of the Census in 1997 through its *Survey of Income and Program Participation*, only 37 percent of current United States workers owned one or more retirement accounts, including IRAs, Keogh accounts, 401(k) accounts and other employer-sponsored savings or thrift plans. Almost 68 million workers between the ages of 25 and 64 did not own a retirement savings account of any kind. According to the United States Department of the Treasury, only 7 percent of Americans eligible to participate in an IRA did so in 1995. And among the 40.3 millions workers who owned a retirement savings account of any kind in 1997, the mean value of all such accounts was \$29,261 and the median value was \$11,000. When all of the retirement accounts owned by the workers and other members of their households were combined, the mean value was \$45,443 and the median value was \$20,000.

Currently, the Social Security system replaces about 40 percent of pre-retirement income, with higher rates for lower wage earners (see Table 9). But given the changes already enacted into law to raise the normal retirement age from 65 to 67 for receipt of full benefits, these replacement rates will decline modestly over the next 25 years. And given future demographic challenges, increases beyond current law in this area seem highly unlikely.

**Table 8**



Given demographic and economic trends, it is clear that more is needed to better prepare for the future. Steps will need to be taken to strengthen all the “legs” of the stool.

### **More Advance Funding?**

I believe that more advance funding of our retirement system would better prepare individuals and the nation for the challenges ahead. Within this context, one of the key issues of long-term Social Security financing reform in the United States focuses on questions of whether to advance fund more of the social insurance system to better prepare for the coming demographic changes. Historically, Social Security's funding was purposely established as an intergenerational transfer of resources so that there could be immediate help for older citizens in the Depression era economy. Practically, politically and I believe morally the United States could not wait to establish an advance-funded system—and it was not then needed since tax flow adequately supported an intergenerational transfer system. The issues of advance funding were debated a half-century ago, and today, we see that the center of the debate is again the advance-funding issue, and the related questions of whether the government can and should set aside resources to meet future liabilities.

Pre-funding more of the system might prove beneficial so that future generations are not held as responsible for the financing solution. However, pre-funding the system also forces current workers to contribute “twice” to the program, once to pay for current benefits, and again for their own future retirement benefits. The choices are difficult. The benefits of advance funding are distant and compete with the current and legitimate demands of citizens, such as education and health care.

Policymakers are asking if we should return to a purely pay-as-you-go system, or advance fund more of the system. And if a partial advance funding option is pursued, should the government invest a portion of growing trust fund reserves in equities for higher rates of return, or should advance funding instead be done through mandatory individual savings accounts?

The center of any debate on advance funding is whether government has the capacity to set resources aside to meet future liabilities. Do we, as a democratic society, have the will to set aside resources and to resist the temptation to use the funds for tax cuts or new spending programs? And if individual retirement savings are enhanced, will this add to savings or will the added savings be consumed before retirement?

We as individuals have a difficult enough time making the tradeoffs required to, say, advance fund our children's college education. We have mortgage and car payments to make, vacations we want to take and hundreds of other demands on our pocketbooks. And lower income persons worry first and foremost about adequate food, clothing and shelter for their families.

At a societal level, these choices are just as difficult. The benefits of advance funding are remote in time, diffuse and difficult to connect to one's needs today. Yet the costs involved in moving to an advance funding would have to be made painfully apparent to all concerned, as specific losers would have to be identified. And there are many legitimate, competing demands that citizens want

government to provide for today—education, health care, child welfare, childcare, and hundreds of others.

Proponents of more advance funding coupled with equity investment of the trust funds say that the fundamental nature of our current Social Security system would be preserved, while reducing the need for decreases in future benefits or increases in tax revenues. Proponents believe the trust funds could benefit from the expected increase over the long term in the stock market. They also say the government could bear this additional risk better than individuals, many of whom will depend on their Social Security benefits for most of their retirement income.

Critics of equity investment by the government say the higher average returns on equity investments only come through acceptance of higher economic risks. Critics believe that there would be significant political pressure to use Social Security investments to achieve additional social, political or economic goals.

Proponents of advance funding through individual savings accounts say that it would have a positive effect on national savings, and help insulate the Social Security system from the effects of demographic changes. Proponents also mention that establishing individual accounts would increase each worker's choice in how his or her Social Security taxes are invested.

Critics of this approach say not only does this proposal expose individuals to higher risks, particularly during economic downturns, but could entail significant transition costs. They say that it also may not increase national savings because individuals could decrease their investments in other savings instruments to offset their Social Security savings account. And they say that individual accounts often replace part of the Social Security guaranteed benefit structure. Some experts also question the administrative and economic efficacy of universal individual accounts.

President Clinton had proposed taking further steps toward advance funding by using a portion of the non-Social Security budget surpluses—specifically, the amount equal to savings from paying down the debt—to strengthen the financing of Social Security. This change would extend the solvency of Social Security by about two additional decades. President Clinton also suggested investing a relatively small portion of Social Security trust fund assets in equities, so as to achieve higher returns for Social Security Trust Funds. Such a change, similar to the Canadian reforms, would further improve the long-range solvency of the program. President Bush has proposed allowing some form of individual savings accounts for younger workers funded from the current payroll tax, which would likely replace part of the guaranteed benefit structure.

### **Public Education and Debate**

In a democratic society, the establishment and continuance of any major institution depends on its ability to win and to maintain public support. It is not hyperbole to say that in the United States the Social Security system is the most successful and widely supported domestic program in the nation's history. But the legitimate concerns about the future of Social Security, particularly among

young people, must be addressed. For an institution as central as Social Security, we need broad-based legitimacy—across generations, across income groups, and over time.

There have been significant public discussions in the United States over the past three years on this issue. Members of Congress, the former President and the Social Security Administration were all deeply involved on these public education endeavors. And last year's Presidential candidates both focused some attention on the issue. My goal as the former Commissioner of the Social Security Administration was to build better understanding and public confidence in Social Security as well as to build public support for changes to strengthen Social Security for future generations.

### **Still No Consensus**

The public education activities have somewhat increased public understanding of the issues, but much confusion and misinformation remains. I wish that today I could stand before you and tell you that these efforts have enabled the United States to resolve these issues; unfortunately, we haven't resolved these issues—yet. There is no public consensus and no consensus among policymakers.

While there is general agreement on saving the Social Security surpluses, there is not yet a consensus on other steps, including the use of the Social Security budget surpluses or the use of the projected non-Social Security surpluses. Some want to use these non-Social Security surpluses to strengthen Social Security; others want to use the non-Social Security surpluses for other purposes. President Bush has proposed using a substantial portion of these non-Social Security surpluses to fund a tax cut. Others would use the surpluses to enhance priority government programs. And some would use the Social Security surpluses as the base to create individual accounts; and others would save them to pay future Social Security guaranteed benefits.

Further, there is no broad agreement on the specific programmatic reforms to achieve Social Security solvency for 75 years—the standard that is used by the Social Security Trustees and the Congress when evaluating the long-term health of the program.

At the same time, it would be wrong to suppose that no progress has been made. The truth is that the United States has made some progress toward building consensus. There is general agreement on several important issues. There is agreement on the need to reserve the Social Security surpluses in some form of advance funding to better prepare for the future. And there is growing consensus on the need to strengthen retirement savings, although there is still no consensus on how to accomplish this. Lastly, there is a growing consensus on the importance of Social Security as a solid guaranteed benefit—even though there is disagreement on the level of that benefit.

These are very big and very important issues. Important in terms of the United States economy and important to the security of future retirees. And, at its heart, these are also basic values questions: how do we define collective responsibility

versus individual responsibility for economic security. And what is the level of obligation we have for each other's well being?

The solutions that we reach—both in America and the rest of the world—will have a major impact on the world we leave to future generations. We need the public involved in such a debate, and in the United States we need a broad-based consensus that includes both political parties.

### **Bush Commission**

On May 3, President Bush announced establishment of a Commission *“to study and report...specific recommendations to preserve Social Security for seniors while building wealth for younger Americans.”* The Commission has been asked to make recommendations to restructure Social Security, using six guiding principles:

- No change in Social Security benefits for retirees or near-retirees.
- The entire Social Security surplus must be dedicated only to Social Security (including the funding for the new individual savings accounts).
- Social Security payroll taxes must not be increased.
- The government must not invest Social Security funds in the stock market (no collective investment).
- Social Security's disability and survivors insurance programs should be continued.
- Changes must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security guaranteed benefit.

While the Commission has bipartisan membership, all the Commission members support changes generally along the lines of the principles outlined by President Bush, and therefore does not represent a cross section of American opinion on this matter.

Prior to announcing the new Commission, I had publicly advised the Bush Administration—as I advised the Clinton administration and members of Congress on both sides of the aisle—that a strong coalition for reform must be built from the hearts of both political parties. It cannot and should not be done through a majority of Republicans buttressed by a sliver of opinion from Democrats. And it shouldn't be done with an eye to any preordained outcome. Resolution of this issue must be truly bipartisan and represent all interests and approaches.

Unfortunately, even though the Commission is chaired by Daniel Patrick Moynihan, one of the most distinguished men I have ever known, the new Commission is not designed to bring disparate opinions together. I believe President Bush passed up a real opportunity to try to bring the country together—Democrats and Republicans, business and labor, rich and poor, young and old—to strengthen Social Security for future generations. The new Commission, with its skewed mandate and one-sided membership, will likely further divide us as a people. The creation of this Commission moves us no closer to resolving this

critical matter. Indeed, I fear that the Commission may move us further away from consensus.

### **My Outline of Reform**

In the end, we'll need to strengthen both retirement savings and Social Security if we are to come together on this matter. I'd like to suggest a path that we might follow together to lead us out of this maze. And I say "together" because all of us will have to unload some heavy and cherished philosophical freight to get us where we need to go.

First, we need to address this issue soon—before the fiscal crunch is upon us and before the on-budget surpluses are drained by large tax cuts or spending increases. If the non-Social Security surpluses are used up without our strengthening Social Security, the prospects for reform will be dim.

Using our on-budget surpluses for the nation's premier social program is certainly as important as many of the tax and spending proposals now under consideration. President Clinton urged us to use some of the surpluses to save Social Security first. Let's not put Social Security last in order of priority for the non-Social Security surpluses.

Second, the left side of the political spectrum will need to give up the notion that future Social Security benefits can never be reduced—even modestly. The average Social Security retirement benefit payment has grown many-fold since the system was created, and these increases have served to significantly reduce poverty among the elderly. Given the demographic challenges and the pension and health care costs increases we face, these replacement rates probably are not sustainable, particularly for middle to higher-wage earners. Modest measures should be taken to keep Social Security benefit levels from growing as rapidly as the economy.

Third, the left must give up the notion that mandatory retirement savings proposals are out of the question. Social Security was always intended to be part of a three-legged financial stool in retirement, together with private pensions and savings and investments. But pensions and savings are weaker than they should be.

A savings plan to supplement Social Security would advance fund a higher share of our retirement system and would improve retirement security. While I would strongly prefer a voluntary system, we will likely need to make retirement savings mandatory for workers through wage-related withholdings and the provision of tax incentives to increase the value of these savings for lower- and middle-income workers. Therefore, part of the advance funding solution that I believe we need should be through enhanced retirement savings.

Fourth, on the other side, those on the right will need to abandon an article of faith—that private retirement savings accounts should be carved out of Social Security benefits. Some have proposed that we use a portion of the Social Security system's own resources to help fund private saving. These proposals

would, for example, “carve out” about one-sixth of the Social Security payroll tax and let workers use it for private savings accounts. President Bush generally endorsed such a proposal. But this almost always entails a dramatic reduction in guaranteed benefits. Eroding the foundation of Social Security puts retirement, disability and survivors’ insurance at risk and increases the pressure on savings and investments because of the weakened foundation.

Fifth, the right must abandon its notion that future Social Security revenues should never be increased—even modestly. Over the next several decades, Social Security taxes are projected to decline by more than 10 percent as a percentage of GDP. With a doubling of the senior population, more revenue over the long term will be needed, not less. Payroll tax rates could be increased by a few tenths of a percent, the income ceiling on payroll taxes raised modestly and/or general revenues used to strengthen financing. We must face up to the reality that a growing share of our future economic growth will be needed for older Americans.

Sixth, given the demographic challenges we face, we need to advance fund not only the new individual savings accounts, but also more of our Social Security system. This will entail more resources for Social Security to further build up reserves. To reduce the burden on future generations, a somewhat smaller share of our Social Security system should be funded on an intergenerational basis. Modest steps in this direction over the next two to three decades should not be disruptive to individuals or the economy.

And seventh, we need to maximize rates of return for both Social Security and the new retirement savings accounts. Advance funding more of our retirement system through both larger Social Security reserves and individual retirement saving accounts is an important step, but to maximize returns, these funds should be invested in broadly diversified funds. And to avoid the potential politicalization of these investment decisions, I recommend that both Social Security reserves and individual saving accounts be invested in identical investment vehicles.

Such an approach—more pre-funding through individual retirement accounts and a larger Social Security Trust Fund—with both invested in a mix of bonds and equities—has something for both the left and the right to hate. And an approach that couples somewhat higher taxes with somewhat lower benefits also has something for the left and the right to hate. But everyone will have to give up some cherished beliefs if we are to deal with future challenges in a forthright and responsible manner.

In conclusion, let me say that in the United States, we face significant but manageable challenges to assure retirement security for future generations. Meaningful and responsible change to our social insurance system must take place, but coming to consensus will not be easy. To be successful, we need to help bring all Americans together for the greater good. And in the end, everyone will have to give a little.

The Social Security system is the crown jewel of American social policy. While coming to consensus on change is imperative, I personally believe that the changes we adopt will end up largely within the core values of our present system. Ensuring greater retirement savings is a very important priority for our country. But the adjustment to changing times cannot mean an abandonment of unchanging principles. We need to work to ensure that the United States has a social insurance system for ourselves, our children and our grandchildren that is as reliable, universal, progressive and equitable as the current system has been for our parents and grandparents.