Remarks of Janet A. Yellen
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to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or next year but instead decades or even further in the future. We have had the luxury of elevating the priority of these longer term issues because the fundamentals of the U.S. economy are extremely sound. This assessment, offered repeatedly by the President and other Administration officials, remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped the effects of the Asian crisis. It has taken a toll on U.S. exports, which, according to our estimates, are down about $30 billion at an annual rate, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system. That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which has recently been the highest in two decades, and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system, namely the design of a new financial architecture; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the Vice- President have participated over the last five months in a number Social Security fora, whose purpose has been to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to

strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support for tackling reform. Certainly, the Administration remains committed to its pledge to leave every penny of the surplus intact until reforms are enacted. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of the proposed initiatives were paid for so that they would not deplete projected surpluses.

It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. The system has enjoyed dramatic success in reducing the poverty rate among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a pension plan: It is a family protection plan, and nearly 1 in 3 beneficiaries are not retirees. For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled for some period before retirement.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2032, the Trust Fund is expected to be depleted, after which time contributions would still be sufficient to pay about 75 percent of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report, the 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect.

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem, and many ideas have been and will be put on the table to address it.

The President has emphasized that at this stage in the national debate he remains open- minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of the debate. However, the President has set forth five principles to guide the reform process, reflecting his judgement about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger. However, several comprehensive proposals

have been advanced that include such individual account carve-outs.

A second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in 1935, the life expectancy of a 65 year old American was about 13 years. Today, life expectancy for a 65 year old is 18 years and rising. At the same time, people are retiring earlier. In 1950, the average age for first receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover, $130 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by roughly a year or reduce the taxable payroll gap by about 0.1. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on--a secure base for retirement planning. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to discuss some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the pure defined-benefit structure of Social Security or to move at least partly in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the Trust Fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But

this comparison is misleading in at least two crucial ways.

First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden. This is often referred to as the "transition problem." Surpluses in the unified budget--used either to augment the Trust Fund or to fund individual accounts--could at least partially mitigate the transition problem, by bringing additional funds into the Social Security system.

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier assets than does the Social Security Trust Fund. These riskier assets--equities in particular--have paid higher returns than government bonds over nearly all long periods of time in the United States during the past century. Between, for example, 1959 and 1996, the S&P 500 returned an average 3.84 percent more per year than bonds in the Trust Fund. There is no guarantee, however, that the equity premium in the future will match its historical average. And equity investments involve substantial risk over shorter time periods. For example, on three occasions during the past 70 years, the S&P 500 index has declined more than 35 percent over two years, while Japan's Nikkei index has fallen over 60 percent since 1989. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the Trust Fund or individual accounts-- would have positive effects on saving or rates of return for the nation as a whole. If such investments merely represented a swap of bonds for equities, there would be a corresponding swap of equities for bonds in private portfolios. If the total supplies of equities and bonds were unchanged, this exchange would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. They doubt that the government has the will to renounce the use of growing annual surpluses in the Social Security system. Some also argue that for many Americans without private retirement accounts, individual accounts established by the government could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could not be funded out of the surplus forever, so a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions. One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits while allowing scope for equity investments. Balancing flexibility against protection is a difficult problem.

Another justification that is given for allowing individuals to choose portfolio allocations is to minimize government involvement in financial markets. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as individual accounts with lower administrative cost and greater sharing of the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities but still ensure that the government did not gain too much influence over the economy. Depending on the share of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing the rate of return while minimizing risk? How would stock proxies be voted?

In the Federal Thrift Savings Plan, governance issues have been handled successfully by insulating investment managers from political calculations, narrowly defining their goals, and permitting investment only in index funds. However, the Thrift Savings Plan involves far less money than Social Security does, and it is essentially a collection of individual accounts managed by the government rather than a government-owned Trust Fund. In considering these governance issues, we may benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan will begin investing in private securities in early 1999. Equity purchases will be restricted to indexes, the fund will not be allowed to hold more than 30 percent of the voting shares of any firm, and investment decisions will be made by a board charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries.

Critics of individual accounts raise a number of concerns beyond the ones I have already mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. For example, proposals to contribute a flat percentage of the payroll tax to individual accounts benefit high income workers the most. In contrast, proposals to use budget surpluses to make equal dollar contributions to individual accounts could be highly progressive.

Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. The administrative cost of the current Social Security system is extremely low, representing less than one cent of every dollar of contributions. Investing part of the Trust Fund in equities would raise that cost only slightly, with the additional expenses probably amounting to less than a few basis points of each dollar invested. But the cost of directing the appropriate contributions to millions of individual accounts and managing the assets in those accounts could be much higher. In Chile and the UK, for example, the administrative costs of individual accounts may reduce retirement income by 20 percent or more. And in the United States, even passively managed index funds incur expenses that average around 60 basis points per year, according to a recent Department of Labor study. Moreover, analysts note that many proposals for individual accounts involve accounts that would be quite small, especially when they were first created, so that any fixed cost per account could absorb a significant share of the annual investment return for many people. The Federal Thrift Savings Plan incurs costs of about 10 basis points per year, but it allows for only a small range of investment choices, and all of its participants work for the same employer. Restricting investment options or services in individual accounts would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

If individual accounts are introduced as part of the solution to Social Security's actuarial imbalance, the question will arise whether to require people to convert their account balances to annuities when they retire. One advantage of requiring annuitization is ensuring that individuals do not outlive their assets. Such a step may be especially important if withdrawals from individual accounts substitute for some part of traditional Social Security benefits, which automatically take the form of annuities. Requiring annuitization also minimizes the problem of adverse selection, which raises the price of private annuities today and reduces their use. But people may want to bequeathe some of their accumulated wealth, and requiring annuitization would restrict their ability to do so. Balancing these various objectives is another difficult problem.

In addition to proposals concerning individual accounts, uses of the budget surplus, and the investment policies of the Trust Fund, negotiations on Social Security reform may entail consideration of options regarding changes in the retirement age. As I mentioned earlier, and as you know, at the same time that people are living longer, they are retiring earlier. The increasing share of life spent in retirement--which is evident in other industrialized countries as well--is in part a natural reaction to higher income. But it may also be partly a reaction to public policies that unduly encourage retirement at specific ages. Social Security reform plans have been proposed that would phase in more rapidly the currently scheduled increase in the normal retirement age to 67, raise the retirement age beyond 67, or index the retirement age to life expectancy. Examining these proposals should be part of the public debate. But in the interest of fairness, we must look closely at the likely impact of any reform in this area on those Americans in physically demanding

jobs or with disabilities.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

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