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Statement of

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before the

Subcommittee on Social Security

Committee on Ways and Means

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I am pleased to appear before the Committee to testify on Social Security reform. I speak for myself, as past chair of the 1994-96 Quadrennial Advisory Council on Social Security, and not in my current status as a member of the Federal Reserve Board.

Let me first engage in some retrospection. At the time I and other members of the Advisory Council spoke before your Committee last year, our report was just out and there was much publicity about the fact that we couldn't agree on a single plan, but had three separate approaches. Since that time it strikes me that there has been a coalescence around the middle-ground approach I advocated. After our report, both the Committee for Economic Development (CED) and Senator Moynihan came out with plans which adopted some of the features of my plan. Two weeks ago the National Commission on Retirement Policy (NCRP) came out with a similar plan, again adopting some features of my plan. In political terms the center seems to be holding--since our report there has been increased interest in sensible middle-ground approaches, and I would encourage this Committee to work in that direction.

In trying to reform Social Security, the middle-ground approach has two goals. The first is to make affordable the important social protections of this program that have greatly reduced aged poverty and the human costs of work disabilities. The second is to add new national saving for retirement—both to help individuals maintain their own standard of living in retirement and to build up the nation's capital stock in advance of the baby boom retirement crunch.

My compromise plan, called the Individual Accounts (IA) Plan, achieves both goals. It preserves the important social protections of Social Security and still achieves long term financial balance in the system by what might be called kind and gentle benefit cuts. Most of the cuts would be felt by high wage workers, with disabled and low wage workers being largely protected from cuts. Unlike the other two plans proposed in the Advisory Council report, there would be no reliance at all on the stock market to finance Social Security benefits, and no worsening of the finances of the Health Insurance Trust Fund.

The IA plan includes some technical changes such as including all state and local new hires in Social Security and applying consistent income tax treatment to Social Security benefits. These changes go some way to eliminating Social Security's actuarial deficit.

Then, beginning in the 21st century, two other measures would take effect. There would be a slight increase in the normal retirement age for all workers, in line with the expected growth in overall life expectancy (also proposed by the CED, Senator Moynihan, and the NCRP). There would also be a slight change in the benefit formula to reduce the growth of Social Security benefits for high wage workers (also proposed by the CED and NCRP). Both of these changes would be phased in very gradually to avoid actual benefit cuts for present retirees and "notches" in the benefit schedule (instances when younger workers with the same earnings records get lower real benefits than older workers). The result of all these changes would be a modest reduction in the overall real growth of Social Security benefits. When combined with the rising number of retirees, the share of the nation's output devoted to Social Security spending would be approximately the same as at present, eliminating this part of the impending explosion in future entitlement spending.

These benefit cuts alone would mean that high wage workers would not experience rising real benefits as their real wages grow, so I would supplement these changes with another measure to raise overall retirement (and national) saving. Workers would be required to contribute an extra 1.6 percent of their pay to newly-created individual accounts. These accounts would be owned by workers but centrally managed. Workers would be able to allocate their funds among five to ten broad mutual or index funds covering stocks and bonds. Central management of the funds would cut down the risk that funds would be invested unwisely, would cut administrative costs, and would mean that Wall Street firms would not find these individual accounts a financial bonanza. The funds would be converted to real annuities on retirement, to protect against inflation and the chance that retirees would overspend in their early retirement years.

Some observers have objected to mandating new retirement contributions now, when there is a welcome prospect of federal budget surpluses.

The NCRP, for example, uses both the surpluses and the Health Insurance Fund to help finance individual accounts. I see some problems with that approach, though it does lessen the political difficulty of mandating additional pension coverage. Another option might be to rely on the already extensive private pension system to fill gaps in the existing pension coverage of workers. Tax qualification rules might be changed to include a provision that requires the full participation of all corporate employees in order to qualify for favorable tax treatment.

The Social Security and pension changes together would mean that approximately the presently scheduled level of benefits would be paid to all wage classes of workers, of all ages. The difference between the outcome and present law is that under this plan these benefits would be affordable, as they are not under present law. The changes would eliminate Social Security's long run financial deficit while still holding together the important retirement safety net provided by Social Security. They would reduce the growth of entitlement spending. They would significantly raise the return on invested contributions for younger workers. And, the changes would move beyond the present pay-as-you-go financing scheme, by providing new saving to build up the nation's capital stock in advance of the baby boom retirement crunch.

As the Congress debates Social Security reform, I hope it will keep these goals in mind and consider these types of changes in this very important program. Thank you very much.