The Federal Reserve Board

Testimony of Governor Edward M. Gramlich

Social security reform

Before the Committee on Finance, U.S. Senate

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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 our Advisory Council released its report in early 1997, 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 were similar to my plan and adopted some of its features. Earlier this year 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, I have stressed the importance of 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.

The Individual Accounts Plan

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 over time. 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, limiting 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 have objected to these add-on individual accounts because they seem like a new tax. First off, I should point out that since the accounts will be returned to the individual in the future (with investment earnings), they are very different from a tax. Indeed, if people who already have significant pension saving beyond Social Security want to reduce their private contributions and preserve their disposable income, there is nothing to stop them. Finally, as a further sweetener it may be possible to let those who can certify the existence of their own private pensions opt out of these add-on accounts, and thus save Social Security the administrative costs. Whatever is done, the basic idea is to raise national saving for the people who do not have much pension saving beyond Social Security, and this scheme seems well-suited for that.

Federal Budget Surpluses
A welcome new development since our Council issued its report is the arrival of surpluses in the overall federal budget. Some observers have suggested using these surpluses in some way to build up the individual accounts. One example is your own bill, Mr. Chairman.

While the advent of these overall surpluses lessens future interest payments and the overall growth of entitlement spending, I see some problems with "using" the surpluses for Social Security. A first problem from a budget standpoint is that the surpluses already are being used in that way. The overall surplus is more than accounted for by the OASDI surplus, which is already used to finance future Social Security benefits, so there is double-counting in using these federal surpluses again for retirement programs, whether to finance individual accounts or to finance future Social Security spending. The second problem is that use of the surplus in such a way does not generate new national saving, and I continue to think that that should be an important part of Social Security reform. Hence I would not favor taking any additional steps to use the surpluses to raise future retirement benefits.

Conclusion
The Social Security and pension changes that I have recommended 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 financed, 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.

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