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Remarks by

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Chairman

Board of Governors of the Federal Reserve System

at the

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of the

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I am privileged to accept the Union League of Philadelphia's Abraham Lincoln award This is the first time I have been at the Union League in nearly four decades, but I am gratified to learn that your organization remains as vital and active as it was in the 1950s when I visited friends here with some frequency

Today I would like to address an issue that almost certainly will be at the forefront of American concerns over the next decade our largest federal entitlement program, social security

It is becoming conventional wisdom that the social security system, as currently constructed, will not be fully viable after the so-called baby boom generation starts to retire in about fifteen years The most recent report by the social security trustees projected that the trust funds of the system will grow over approximately the next fifteen years However, beginning in the year 2012, the annual expected costs of social security are projected to exceed annual earmarked tax receipts, and the consequent deficits are projected to deplete the trust funds by the year 2029

While such evaluations are based on an uncertain future, the benefit per current retiree under existing law, adjusted for inflation, can be forecast with some precision over the next thirty years Somewhat less precision is possible for future retirees The price escalation of benefits, of course, is even more difficult to pin down But since price inflation has an equal effect on wages subject to social security taxation, for all practical purposes, the degree of inflation does not have a large direct effect on the net funding of the system over the long run However, the rate of inflation,

because it affects the overall economy, presumably does affect the real wage base from which social security taxes and future benefits are derived

The projection of inflation-adjusted taxes, which are subject to a wider degree of uncertainty than total benefits, is largely driven by real wage growth--that is, wage growth adjusted for inflation--which, in turn, is primarily determined by the growth of productivity Projecting productivity in line with the pattern of the last quarter century suggests a trend of revenue falling far short of the levels required to finance the benefits of the large baby-boomer bulge in retirees anticipated to start at about 2010 I should state, parenthetically, that if recent productivity trends are underestimated, as I suspect they are, for much the same reasons are the projected trends of <u>both</u> real benefits and payroll taxes The real future funding shortfall, therefore, would not be materially effected Our social security problem is, thus, not merely statistical, it is the consequence of a projected shortfall in real resources dedicated to social security In money terms, the current social security trust fund of a half trillion dollars falls far short of the levels required to fund the current obligations to pay promised benefits to those already retired and those who will retire in the years ahead

Social security, unlike fully funded private retirement programs, is largely an intergenerational transfer Today's workers are essentially paying for today's retirees Under the current system, the social security benefits paid to today's workers when they retire in the future will be primarily dependent upon the payroll taxes acquired from future workers Accordingly, if the social security system is to survive in its current form, either real benefits must be curtailed, or real taxes increased The latter

can come from either higher tax rates or higher real wage growth--in effect, higher productivity growth However, as I will be explaining shortly, higher productivity is unlikely alone to do the trick Moreover, increased social security tax rates, of course, are controversial in that many perceive them, myself included, to adversely affect employment

A primary cause of social security's funding imbalance stems from the fact that, until very recently, the payments into the social security trust accounts by the average employee, plus employer contributions and interest earned, were inadequate, at retirement, to fund the total of retirement benefits This has started to change Under the most recent revisions to the law, and presumably conservative economic and demographic assumptions, today's younger workers will be paying social security taxes over their working years that appear sufficient to fund their benefits during retirement However, the huge unfunded liability for current retirees, as well as for much of the work force closer to retirement, leaves the system, as a whole, badly underfunded

As longevity improved far beyond that contemplated by the creators of the system, and productivity growth slowed after 1973, the original premise of the system of intergenerational balance began to fail Today the official unfunded liability for the Old Age, Survivors and Disability funds, which takes into account expected future tax payments and benefits out to the year 2070, has reached a staggering $3 trillion

The social security trustees currently project taxes and benefits, under existing, and of necessity, quite tentative economic assumptions, that imply that fully funding

social security for the next 75 years would require an immediate and permanent increase in social security taxes of about 2 2 percentage points of taxable payrolls on top of the current 12 4 percent tax rate, assuming that such an increase would not impede economic growth Of course, benefit reductions of a similar magnitude, or a mix of tax hikes and benefit cuts, could also bring the system back into long-term actuarial balance, at least statistically. These types of program adjustments, which on the surface seem quite modest, might nonetheless be perceived as transforming what has until recently been a largely popular, subsidized, intergenerational transfer system into something quite contentious Moreover, the longer action is deferred, the greater will be the necessary tax increases or, more likely, benefit adjustments required to achieve the goal of long-term actuarial balance

Clearly, something has to give The question is what? We cannot hope to grow our way out of the problem An immediate and sustained increase in annual productivity growth of about two percentage points apparently would be needed to close the long-run funding gap without an increase in taxes or a cut in benefits The improvement in productivity growth must be this large because higher productivity raises future benefits as well as current and future tax receipts However, given that we struggle to devise economic policies that might raise productivity growth by a few tenths of a percentage point per annum, a gain of two full points seems beyond the reach of credibility

Nonetheless, this issue does underscore the critical elements in the forthcoming debate, since it focusses on the core of any retirement system, private or public

Simply put, unless social security taxes increase, or as I just indicated, more likely, benefits are adjusted, domestic savings must increase. Potential beneficiaries must further abstain from consuming all of their incomes Enough must be set aside over a lifetime of work to fund the excess of consumption over any non-social security income a retiree may still enjoy. At the simplest level, one could envision households saving by actually storing goods purchased during their working years for consumption during retirement Even better, the resources that would have otherwise gone into the stored goods could be diverted to the production of new capital assets, which would, cumulatively, over a working lifetime, produce an even greater quantity of retirement goods and services In short, we would be getting more output per worker, our traditional measure of productivity, and a factor that is central in all calculations of long-term social security trust fund financing

Hence, the bottom line in all retirement programs is physical resource availability The finance of any system is merely to facilitate the underlying system of allocating real resources that fund retirement consumption of goods and services

The basic premise of our current largely pay-as-you-go social security system is that future productivity growth will be adequate to supply promised retirement benefits for current workers At existing rates of saving and investment this is becoming increasingly dubious Accordingly, there are a number of initiatives, at a minimum, that will surely have to be addressed As I argued at length in the Social Security Commission deliberations of 1983, with only marginal effect, some delaying of the age of eligibility for retirement benefits will become increasingly pressing For example,

adjusting the full-benefits retirement age to keep pace with increases in life expectancy would keep the ratio of retirement years to expected lifespan approximately constant and would help to significantly narrow the funding gap Hopefully, other modifications to social security benefits also will be judged as necessary Moreover, it is becoming increasingly recognized that the Consumer Price Index overstates increases in the cost of living, and thus indexing social security benefits to the CPI goes far beyond the intent of the Congress to insulate retirees from inflation In that regard, the recently released report from the Boskin commission makes a valuable contribution to the emerging consensus on this issue

But, unless future taxes and/or benefits are sufficiently adjusted, there is no substitute for increased domestic savings and investment currently. To be sure, for relatively short periods of time we can finance part of domestic investment in plant and equipment with foreign savings as we are doing today History, however, tells us that there is a limit to how far that can go We are also apparently increasing the productivity of our capital It is possible that the maturing of emerging technologies, and further substantial deregulation of industry and finance, will, in themselves, improve the growth rate of productivity without large capital investment and savings But, it would take implausible improvements in capital productivity from current rates to close very much of the social security funding gap from this source

The necessary boost in domestic savings need not be derived from an improved social security system, but certainly a reduction in the social security funding gap would itself move in that direction In a sense, it could create a virtuous cycle

with higher savings engendering higher productivity growth which, in turn, would narrow the funding gap still further. Of course, additional saving can be achieved through a reduction in the overall federal government budget deficit, and intensified efforts to encourage private household and business savings

Some have argued for a provision in law to require the social security trust funds to invest in higher yielding, private securities, especially equities, rather than in U.S Treasuries only A higher rate of return, it is alleged, would help solve the social security funding problem That may in fact be the case, but if so, what would happen to private retirement programs?

If social security trust funds are shifted in part, or in whole, from U S Treasury securities to private debt and equity instruments, holders of those securities in the private sector must be induced to exchange them, net, for U S Treasuries If, for example, social security funds were invested wholly in equities, presumably they would have to be purchased from the major holders of such equities Private pension and insurance funds, among other holders of equities, presumably would have to swap equities for Treasuries But, _if_ the social security trust funds achieved a higher rate of return investing in equities than in lower yielding U S Treasuries, private sector incomes generated by their asset portfolios, including retirement funds, would fall by the same amount, potentially jeopardizing their financial condition This zero-sum result occurs because of the assumption that no new productive saving and investment has been induced by this portfolio reallocation process

Proceeding further, one must presume that in such a circumstance, in order to induce the private sector to exchange their equities for Treasuries, equity prices must rise, and bond prices fall But, this would create great market tension. Bonds and equities are merely the paper claims to income earning assets, and the value of the income stream is not determined by short-run changes in the supply and demand for securities Rather, equity prices must, in the long run, reflect the underlying earnings of the corporations on which the equities are a claim, as well as society's need to be compensated for postponing consumption into the future and its perception and attitudes toward risk as a consequence of uncertainty about the future. Indeed, the total market value of debt plus equities, is, to a first approximation, likely to be unaffected by a shift in the balance of paper claims

One might expect that this tension between the altered relative supply of equity and debt claims, on the one hand, and unaltered overall economic value of the nation's companies, on the other hand, would be resolved by an increase in the issuance of equity securities, relative to bonds This could reverse much, if not all, of the price shift in favor of equities However, to complicate the issue still further, it is not clear as to whether, and to what extent, bond prices would rise as corporations cut back on debt issuance Certainly with the social security trust funds no longer investing all of their surplus in U.S. Treasuries, the federal debt held by the public would rise, presumably placing downward pressure on bond prices. At best, the results of this restricted form of privatization are ambiguous

Thus, the dilemma for the social security trust funds is that a shift to equity investments without an increase in domestic savings may not appreciably increase the rate of return of social security trust fund assets, and to whatever extent that it does, would likely be mirrored by a comparable decline in the incomes of private pension and retirement funds

I should stress that this does not mean that at least a partial privatization of our social security system does not provide a potentially viable solution to current funding problems There are a number of thoughtful initiatives that, through the process of privatization, could increase domestic saving rates These are clearly worthy of intensive evaluation Perhaps the strongest argument for privatization is that replacing the current unfunded system, which apparently discourages saving, with a fully funded system, is that such a change could boost domestic saving But, in any event, we must remember it is because privatization plans might increase savings that makes them potentially viable, not their particular form of financing

The types of changes that will be required to restore fiscal balance to our social security accounts, in the broader scheme of things, are significant but manageable More important, most entail changes that are less unsettling if they are put into effect in the near term rather than waiting five or ten years or longer

Minimizing the potential disruptions associated with the inevitable changes to social security is made all the more essential because of the pressing financial problems in the Medicare system, social security's companion program for retirees Medicare currently is in an even more precarious position than social security The

financing of Medicare faces some of the same problems associated with demographics and productivity as social security but faces different, and currently greater, pressures owing to the behavior of medical costs and utilization rates Reform of the Medicare system will require more immediate and potentially more dramatic changes than those necessary to reform social security.

We owe it to those who will retire after the turn of the century to be given sufficient advance notice to make what alterations in retirement planning may be required The longer we wait to make what are surely inevitable adjustments, the more difficult they will become If we procrastinate too long, the adjustments could be truly wrenching. Our citizens deserve better.