



Fall 9-1-2001

The Goals of Social Security Reform

Edward M. Gramlich

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Social Welfare Law Commons](#)

Recommended Citation

Edward M. Gramlich, *The Goals of Social Security Reform*, 58 Wash. & Lee L. Rev. 1229 (2001).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol58/iss4/4>

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

The Goals of Social Security Reform

Edward M. Gramlich*

First off, you are probably wondering why a Federal Reserve Governor is talking about Social Security. The answer is that Social Security has relatively little to do with my present life, but, before I became a Federal Reserve Governor, I was head of the Quadrennial Advisory Council on Social Security. It was a body that under the old Social Security Act would be appointed periodically to review the system. I do not know how I managed this, but I became Chair of this Council. While this position took a number of years off my life, I did develop some knowledge and opinions in this area, and I will give some of those opinions today. By contrast, Craig Copeland¹ did not give any opinions. He laid out the issues clearly, and I can use most of what he said to tell you what I think ought to be done. I make no pretense that this is an unbiased or full coverage of the waterfront – it is just what I consider to be the central problems facing Social Security and what I think are some of the approaches that should be pursued.

I think there are two important goals for Social Security reform. One is to preserve this huge system of social protections that has existed for sixty years. These protections are so ingrained in society that I think we tend to take them for granted. In his chart of "Old-Age Poverty,"² Copeland focuses on the central point that Social Security is responsible for a large share of the income of the aged and has been responsible for a significant reduction in old-age poverty.³ I think the reduction is probably not quite as great as he demonstrated in his chart because of some technical behavioral response issues, but no doubt there was a very large reduction in old-age poverty. Social Security is also an important part of income support for the aged until at least the middle income level. Social Security provides protection against work disability, protection

* Member, Board of Governors of the Federal Reserve System.

1. Craig Copeland is a Senior Research Associate at the Employee Benefit Research Institute. See generally Craig Copeland, *Social Security Reform Issues*, 58 WASH. & LEE L. REV. 1203 (2001) (discussing issues involved in Social Security reform without giving opinions as to proper method for reform).

2. See *id.* at 1203 (referencing chart of "Old-Age Poverty").

3. See *id.* at 1203-04 (noting dependence of aged population on Social Security as source of income).

for when the breadwinner in the family dies early and leaves children without support, and full protection against inflation. We have grown accustomed to these protections as a society. I do not think we would want to consider life without them, and I think the first thing we must do is to ensure that we keep these social protections in place.

The second important goal is to raise national saving. The essential Social Security problem as we look forward, as Copeland mentioned, is demographics.⁴ There are going to be vastly fewer workers to pay for the retired population in the future than in the past. This is going to affect mainly people of your age, not mine. And, it is going to be a very big issue for you. The way I would put this is in macroeconomic terms – your generation is going to be paying for this huge retiree population and you will need more capital to help you do that. The new capital will make you more productive and raise your incomes. However, that new capital comes only if the country saves enough to create it.

One can also put the saving issue in terms of rates of return. Because of some basic propositions on how pay-as-you go plans, like Social Security, work and because our system began by giving benefits to retirees in the 1940s before accumulating enough money to pay for those benefits, there was a tax on everybody coming afterwards. The underlying math is forcing the rate of return on contributions to Social Security down toward one percent. There is nothing anybody can do about it at this point; the outcome depends on the basic math, the economics of the system, and the way the government introduced the Social Security system in the 1930s. Contributions to what we might call the present system are going to earn about one percent. If we had new saving, we could invest it in some fashion at the going rate of return on new saving, now about four percent. The key watershed is to generate new saving to give your generation new capital to make you more productive for the future and to achieve better rates of return than currently are possible on contributions to the present system.

I think these are the two important goals that we have to promote as we look toward any reform of Social Security. There are lots of ways to make these reforms, but I think it is important not to get lost in the details of this program or that program. Instead, just do this little mental test. What does the proposed reform do about the social protections that we already have and, I think, would all like to retain? What does the proposed reform do about new saving? In the Advisory Council that I mentioned, I proposed my own plan to achieve these two goals in a very straightforward way. I tried to preserve the social benefits of the Social Security program with a modest trimming of the present benefit system while not interfering with the basic social protec-

4. See *id.* at 1203-07 (explaining impact of shifting demographics on Social Security system).

tions. I believe that some trimmings on the benefit side will be a necessary part of any plan. I tried to deal with the new saving by having "add-on" individual accounts on top of Social Security. This is not the only way to get new saving. Alternatively, we could just raise payroll taxes. I think that for various reasons raising payroll taxes is a nonstarter, and I prefer the individual accounts.

As for tax increases, I do not know of anybody in the present Congress on either side of the aisle that would support them. Beyond that, I think there is a deeper issue. The standard approach to reforming Social Security in the twentieth century has been that as we have raised system benefits, we have paid for this growth by raising payroll taxes. Especially as the population ages, the country will have to get off this tax and spend treadmill. A convenient time to do that is now. At some point, we cannot continue chasing the benefit system up with higher payroll taxes, and we might as well get used to trying to generate new saving in some other way.

My preferred way would use "add-on" individual accounts. I am not like some who view introducing individual accounts as a religious matter. I would not invest them with that importance, but I do think that, of the various ways of generating new saving, this is the most feasible and the most economic.

Now that I have given my preferred approach, I will say a few more things that I think we ought to keep in mind as a country as we work toward reform. One concerns the seventy-five-year horizon that Copeland mentioned.⁵ All of his numbers were in terms of this seventy-five-year horizon. We have been using this horizon for a long time, resulting in forecasts seventy-five years ahead. It is obviously very farsighted – we are in effect now realizing outcomes that would have been forecast in the Coolidge administration. Even though the country is looking ahead a long way in using seventy-five-year horizons, there is a sense in which we could still be fooling ourselves. We know what is happening to the demographics in this country: the population is aging and will continue to age after the seventy-five-year period is completed. This means that problems will get worse after seventy-five years. It is now fairly routine to calculate these economic forecasts indefinitely, as most private pension plans now do. I think it would be a good idea to shift to indefinite calculations; that way we do not find that the tax increase needed to balance the system changes every year simply because the calendar advances.

As for individual accounts, I feel that they should be in the form of Social Security "add-ons" and not "carve-outs." The "carve-out" individual accounts divert some share of your present payroll tax to individual accounts. They are "carved-out" of your present payroll tax. There is no new saving in that. You

5. See *id.* at 1211-12 (discussing seventy-five-year horizon for Social Security reform).

are paying the same amount into the retirement system as you were before, and you are not satisfying my second important goal of creating new saving. Consequently, I prefer "add-on" individual accounts. In my Advisory Council plan, I made these "add-on" accounts mandatory, but I would compromise happily if others wanted to make them voluntary. Fundamentally, I think we should not delude ourselves into thinking that carve-out individual accounts are new saving. They are not. We have to put aside money that is not devoted to current consumption for it to qualify as new saving.

Another issue that we need to keep in mind as we look at investment choices is the stock market. Should we put the funds in the stock market as opposed to the bond market? If we look historically at differential returns, the difference between the stock market return and the bond market return has been about four percent per year. Some consultants have recommended downgrading the estimate to three percent. I would cut it more than that. My own thumbnail history of the stock market is that there has been a long rise in equity prices relative to other forms of investment and to other parameters in the whole economy. At this point the "earnings-price" ratio on a general portfolio of stocks is about one percent more than the real rate of return on bonds — essentially the low estimate that Copeland talked about.⁶ We could justify that gap, based on the fact that stock market investment is, on the whole, riskier than bond market investment. Given that, I think we should not credit the trust fund at all if the funds are put in equities. This means that in view of the likely risks, we cannot tell probabilistically whether A or B will be the better investment. I think we should assume that investing Social Security contributions in the stock market will not generate greater risk-adjusted returns than investing the contributions in the bond market, and I do not believe we should credit ourselves for extra returns on stock market investment. The only way we can achieve higher returns is by new saving, whether it goes into bonds or stocks.

The next thing I would say about individual accounts is that we could use the IRA-type approach in which people just go out and save the money, or we could use the 401(k) approach. In the latter, the money is collected centrally and invested centrally. I vastly prefer the 401(k) approach. It seems to me that with the IRA approach, the difficulties in making sure 150 million people save the amount that they were supposed to save for Social Security would be enormous. I do not see how we could ever police the provision, and I believe it would be vastly easier to collect the money centrally and provide participants with a very constrained set of investment choices, the way the federal government's Thrift Plan now does quite successfully. The investments would be very safe; we would not need to spend a great amount on investor educa-

6. See *id.* at 1211-12 (discussing differences between rate of return on bonds and rate of return on equities).

tion, and we could manage the process in a cost-effective manner. If there are to be individual accounts, I think there is everything to be said for central management of the funds.

Let me just say one thing about benefit cuts. On the negative side, there are some principles that either are noncontroversial or could be strongly defended. One is that I would not change inflation indexing. It is true that old people may face slightly different inflation rates than young people, but these differences are hard to estimate econometrically. In this country we have a tradition of indexing by the Consumer Price Index (CPI); so we should just use the CPI for Social Security. The Bureau of Labor Statistics has made a lot of improvements in the CPI and will continue doing so. I think it is important to retain full indexing by the CPI, and I think that it just is not worth it to go beyond that and to devise a fancier sub-index.

As for benefit cuts themselves, there are ways that we could improve the poverty-reducing efficiency of Social Security. I know Gene Steuerle⁷ will talk about benefit cuts, and I support many of them. A tradition exists that, when talking about cuts in benefits, what we are talking about is not a present cut in benefits for current retirees. Instead, we are talking about cutting the growth of benefits over time so that present retirees are left alone. When you talk benefit cuts everybody thinks, "Oh, goodness, how are we going to explain this in Florida?" Well, we do not have to explain anything in Florida. No one has ever talked about cutting benefits for current retirees and such cuts are not on the table now. There are changes in the structure of benefits over time that would make a major difference actuarially when we look ahead but that would not involve cuts in present-day benefits.

Of all of the things that we could do to change the rate of growth over time, my preference would be to index the retirement age demographically. The idea is that people live a lot longer than they used to and are healthier when they get to age sixty-five. It really does not make sense, I think, to set up a program back in 1938 with a normal retirement age of sixty-five and then keep it at that age forever. If there is any kind of intergenerational equity standard, it might be that people in successive cohorts of the population, when they arrive at age twenty or twenty-five, should be looking at a constant share of their future life expectancy in working and retirement status. That strikes me as the intergenerationally fair way to construct a system. If we did that, we would have the retirement age creeping slowly up at the same rate as overall life expectancy. This would make a huge change in the long-run actuarial forecast of the system, and it would also eliminate a huge source of

7. Dr. C. Eugene Steuerle is a Senior Fellow at The Urban Institute. See generally C. Eugene Steuerle, *Social Security: The Broader Issues*, 58 WASH. & LEE L. REV. 1235 (2001) (discussing possible cuts in Social Security benefits).

forecasting uncertainty. Much of the uncertainty about these forecasts that Copeland demonstrated arises out of the so-called mortality assumption.⁸ We would in effect take that source of uncertainty off the table if we indexed the retirement system for life expectancy.

I think we could make significant progress on answering the question of how to debate Social Security reform with these kinds of rules of procedure. The implications would not, I admit, conform exactly with what any one particular politician is saying these days, but I still think these principles are appropriate and would narrow differences over time.

Overall, I would repeat that Social Security reform ought to focus on two questions:

- (1) Have we protected the present benefit system?, and
- (2) What have we done about new saving to equip younger people with the capital to pay for all these added retirees in the future?

8. See Copeland, *supra* note 1, at 1204-06 (discussing forecasts based on mortality assumptions).