Alan Greenspan: Future of the social security programme and economics of retirement

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Special Committee on Aging, US Senate, Washington DC, 15 March 2005.

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Mr. Chairman, Senator Kohl, and members of the Committee, I am pleased to be here today to discuss the issues of population aging and retirement. In so doing, I would like to emphasize that the views I will express are my own and do not necessarily represent those of the Federal Reserve Board.

The economics of retirement are straightforward: Enough resources must be set aside over a lifetime of work to fund consumption during retirement. At the most rudimentary level, one could envision households actually storing goods purchased during their working years for use during retirement. Even better, the resources that would have otherwise gone into producing the stored goods could be diverted to the production of new capital assets, which would produce an even greater quantity of goods and services for later use. In the latter case, we would be raising output per worker hour, our traditional measure of productivity.

The bottom line in the success of all retirement programs is the availability of *real* resources at retirement. The financial systems associated with retirement plans facilitate the allocation of resources that supply retirement consumption of goods and services; they do not produce goods and services. A useful test of a retirement system for a society is whether it sets up realistic expectations as to the future availability of real resources and, hence, the capacity to deliver postwork consumption without overly burdening the standard of living of the working-age population.

In 2008, the leading edge of what must surely be the largest shift from work to retirement in our nation's history will become evident as some baby boomers become eligible for Social Security. According to the intermediate projections of the Social Security trustees, the population 65 years of age and older will be approximately 26 percent of the adult population in 2030, compared with 17 percent today. This huge change in the structure of our population will expose all our financial retirement systems to severe stress and will require adjustments for which there are no historical precedents. Indeed, retirement, generally, is a relatively new phenomenon in human history. Average American life expectancy a century ago, for example, was only 47 years. Relatively few of our citizens were able to enjoy many postwork years.

One consequence of the sizable baby boom cohort moving from the workforce to retirement is an inevitable slowing in the growth of gross domestic product per capita relative to the growth of output per worker. As the ratio of workers to population declines, so too must the ratio of output to population, assuming no change in the growth of productivity. That result is simply a matter of arithmetic. The important economic implication of that arithmetic is that, with fewer workers relative to dependents, each worker's output will have to support a greater number of people. Under the intermediate population projections of the Social Security trustees, for example, the ratio of workers to total population will shrink about 7 percent by 2030. This shrinkage means that, by 2030, total output per person will be 7 percent lower than it would be if the current population structure were to persist. The fact that a greater share of the dependents will be elderly rather than children will put an additional burden on society's resources, as the elderly consume a relatively large share of per capita resources, whereas children consume relatively little.

This inevitable drop in the growth rate of per capita GDP relative to the growth of productivity could be cushioned by an increase in labor force participation, which would boost the ratio of workers to population. Increasing labor force participation seems a natural response to population aging, as Americans not only are living longer but are also generally living healthier. Rates of disability for the elderly have been declining, reflecting both improvements in health and changes in technology that accommodate the physical impairments that are associated with aging. In addition, work is becoming less physically strenuous and more demanding intellectually, continuing a century-long trend toward a more conceptual and a less physical economic output.

Despite the improving feasibility of work at older ages, Americans have been retiring at younger and younger ages. For example, in 1940, the median age of retirement for men was 69; today, the median age is about 62. In recent years, labor force participation among older Americans has picked up

somewhat, but it is far too early to determine the underlying causes of this increase. Rising pressures on retirement incomes and a growing scarcity of experienced labor could induce further increases in the labor force participation of the elderly and near-elderly in the future. In addition, policies that specifically encourage greater labor force participation would also lessen the necessary adjustments to consumption. Workers nearing retirement have accumulated many years of valuable experience, so extending labor force participation by just a few years could have a sizable impact on economic output.

Another way to boost future standards of living is to increase saving.[1] We need the additional saving in the decades ahead if we are to finance the construction of a capital stock that will produce the additional real resources needed to redeem the retirement claims of the baby boomers without having to severely raise claims on tomorrow's workers.

However, by almost any measure, the required amount of saving that would be necessary is sufficiently large to raise serious questions about whether we will be able to meet the retirement commitments already made. Much has been made of shortfalls in our private defined-benefit plans, but the gross underfunding currently at $450 billion, although significant as a percentage of the $1.8 trillion in assets of private defined-benefit plans, is modest compared with the underfunding of our publically administered pensions.

At present, the Social Security trustees estimate the unfunded liability over the indefinite future to be $10.4 trillion. The shortfall in Medicare is calculated at several multiples of the one in Social Security. These numbers suggest that either very large tax increases will be required to meet the shortfalls or benefits will have to be pared back.

Because benefit cuts will almost surely be at least part of the resolution, it is incumbent on government to convey to future retirees that the real resources currently promised to be available on retirement will not be fully forthcoming. We owe future retirees as much time as possible to adjust their plans for work, saving, and retirement spending. They need to ensure that their personal resources, along with what they expect to receive from government, will be sufficient to meet their retirement goals.

Conventional advice from personal-finance professionals is that one should aim to accumulate sufficient resources to provide an overall replacement rate of about 70 percent to 80 percent in retirement. Under current law, Social Security promises a replacement rate of about 42 percent for workers who earn the economywide-average wage each and every year through their careers and about 56 percent for low-wage workers who earn 45 percent of the economywide-average wage.[2] Assuming that taxes are capped at the current 12.4 percent of payroll, revenues will be sufficient to pay only about 70 percent of current-law benefits by the middle of this century. Thus, for the average worker, a replacement rate of only about 30 percent would be payable out of contemporaneous revenues, assuming that benefit reductions are applied proportionately across the board. For a low-wage worker, the payable replacement rate would be about 40 percent. Assuming that the goal is still to replace 70 percent to 80 percent of pre-retirement income, average workers by the middle of this century should be aiming to replace about 45 percent of their pre-retirement income, rather than today's 33 percent, out of some combination of private employer pension benefits and personal saving.

The required increases in private saving would be less to the extent that Social Security tax increases are part of the solution. However, to avoid any changes in replacement rates, the Social Security tax rate would have to be increased from the current 12.4 percent to about 18 percent at the middle of the century.

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Once we have determined the level of benefits that we can reasonably promise, we must ensure that we will have the real resources in the future to fulfill those promises. When we evaluate our ability to meet those promises, focusing solely on the solvency of the financial plan is, in my judgment, a mistake. Focusing on solvency within the Social Security system, without regard to the broader macroeconomic picture, does not ensure that the real resources to fulfill our commitments will be

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[1] Additionally, we could borrow from abroad, which would build up the capital stock. In so doing, however, we would also build up a liability to foreigners that we would have to finance in the future.

[2] The replacement rate is the ratio of Social Security benefits to wages in the year preceding retirement.

there. For example, if we build up the assets in the Social Security trust fund, thereby achieving solvency, but offset those efforts by reducing saving elsewhere, then the real resources required to meet future benefits will not be forthcoming from our economy. In the end, we will have accomplished little in preparing the economy to meet future demands. Thus, in addressing Social Security's imbalances, we need to ensure that measures taken now to finance future benefit commitments represent real additions to national saving.

We need, in effect, to make the phantom "lock-boxes" around the trust fund real. For a brief period in the late 1990s, a common commitment emerged to do just that. But, regrettably, that commitment collapsed when it became apparent that, in light of a less favorable economic environment, maintaining balance in the budget excluding Social Security would require lower spending or higher taxes.

Last year, Social Security tax revenues plus interest exceeded benefits by about $150 billion. If those funds had been removed from the unified budget and "locked up" and Congress had not made any adjustments in the rest of the budget, the unified budget deficit would have been $564 billion. A reasonable hypothesis is that the Congress would, in fact, have responded by taking actions to pare the deficit. In that case, the end result would have been lowered government dissaving and correspondingly higher national saving. A simple reshuffling from the unified accounts to the lock-boxes would not have, in itself, added to government savings; but higher taxes or lower spending would have accomplished that important objective.

The major attraction of personal or private accounts is that they can be constructed to be truly segregated from the unified budget and, therefore, are more likely to induce the federal government to take those actions that would reduce public dissaving and raise national saving. But it is important to recognize that many varieties of private accounts exist, with significantly different economic consequences. Some types of accounts are virtually indistinguishable from the current Social Security system, and the Congress would be unlikely to view them as truly off-budget. Other types of accounts actually do transfer funds into the private sector as unencumbered private assets. The Congress is much more likely to view the transfer of funds to these latter types of accounts as raising the deficit and would then react by taking measures to lower it.

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Failure to address the imbalances between our promises to future retirees and our ability to meet those promises would have severe consequences for the economy. The most recent projections by the Office of Management and Budget show that spending on Social Security, Medicare, and Medicaid will rise from about 8 percent of GDP today to about 13 percent by 2030.[3] Under existing tax rates and reasonable assumptions about other spending, these projections make clear that the federal budget is on an unsustainable path, in which large deficits result in rising interest rates and ever-growing interest payments that augment deficits in future years. But most important, deficits as a percentage of GDP in these simulations rise without limit. Unless the trend is reversed, at some point these deficits would cause the economy to stagnate or worse. Closing the gap solely with rising tax rates would be problematic; higher tax rates rarely achieve a comparable rise in tax receipts, and the level of required taxation could in itself severely inhibit economic growth.

In light of these sobering projections, I believe that a thorough review of our commitments - and at least some adjustment in those commitments - is urgently needed. The necessary adjustments will become ever more difficult and larger the longer we delay. No changes will be easy. All programs in

3 The projections for Medicare and Medicaid should be viewed as highly uncertain. Health spending has been growing faster than the economy for many years, the growth fueled, in large part, by significant increases in technology. How long this trend will continue is extremely difficult to predict. We know very little about how rapidly medical technology will continue to advance and how those innovations will translate into future spending. Technological innovations can greatly improve the quality of medical care and can, in some instances, reduce the costs of existing treatments. But because technology expands the set of treatment possibilities, it also has the potential to add to overall spending - in some cases, a great deal.

In implementing policy, we need to be cognizant that the uncertainties - especially our inability to identify the upper bound of future demands for medical care - counsel significant prudence in policymaking. The critical reason to proceed cautiously is that new programs quickly develop constituencies willing to fiercely resist any curtailment of spending or tax benefits. As a consequence, our ability to rein in deficit-expanding initiatives, should they later prove to have been excessive or misguided, is quite limited. Thus, policymakers need to err on the side of prudence when considering new budget initiatives. Programs can always be expanded in the future should the resources for them become available, but they cannot be easily curtailed if resources later fall short of commitments.

our budget exist because a majority of the Congress and the President considered them of value to our society. Adjustments will thus involve making tradeoffs among valued alternatives. The Congress must choose which alternatives are the most valued in the context of limited resources. In doing so, you will need to consider not only the distributional effects of policy changes but also the broader economic effects on labor supply, retirement behavior, and national saving. The benefits to taking sound, timely action could extend many decades into the future.