Alan Greenspan Should Read His Speeches More Carefully

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INTRODUCTION

Social Security scare tactics are experiencing a revival. On August 27, Federal Reserve Chairman Alan Greenspan concluded that "we have promised more than our economy has the ability to deliver to retirees" and on September 2, President George W. Bush argued that "[w]ith the huge Baby Boom generation approaching retirement, many of our children and grandchildren understandably worry whether Social Security will be there when they need it." And because Social Security and Medicare are supposedly unsustainable, both Greenspan and Bush have supported privatization and benefit cuts. Of course, Greenspan is no stranger to such recommendations, for it was his counsel to President Ronald Reagan that led to Social Security benefit cuts and increases in the retirement age in the early 1980s.

Interestingly, Greenspan apparently did not read his own speech carefully enough. A closer look at his recent remarks and at data from the Social Security and Medicare trustees shows that the Fed chairman's and the president's conclusion are not supported by the facts. Social Security and Medicare are affordable and sustainable. Moreover, Greenspan touched on three important ways to address the systems' long-term financial needs that will not include sharp benefit cuts or privatization.

SOCIAL SECURITY AND MEDICARE ARE AFFORDABLE

When speaking to the world's central bankers in Jackson Hole, Wyoming, Greenspan indicated in his usual enigmatic way that Social Security and Medicare are unaffordable and that benefits need to be cut:

> "If we have promised more than our economy has the ability to deliver to retirees without unduly diminishing real income gains of workers, as I fear we may have, we must recalibrate our public programs so that pending retirees have time to adjust through other channels."

For economists, affordability is a matter of choice. We can pay for something if we choose to do so either by reducing expenditures elsewhere or raising revenues. However, something is truly unaffordable if expenditures will rise to levels that are unrealistically high, i.e. where no amount of expenditure cuts or revenue increases will allow our economy to pay for them – Greenspan's definition of unaffordability.

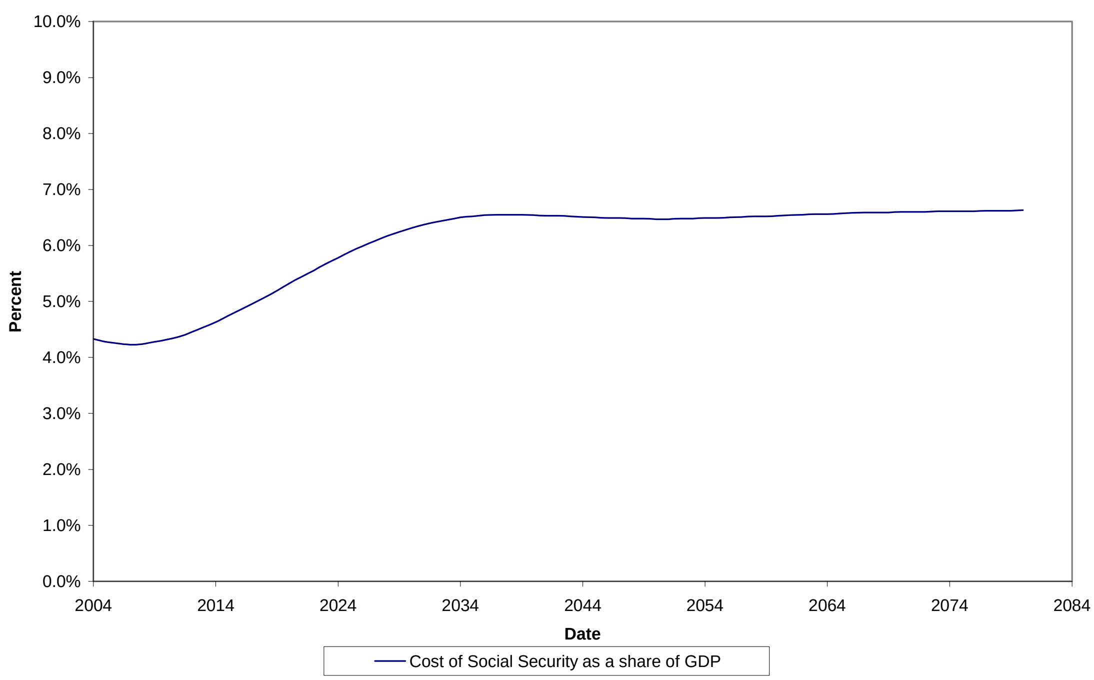
That is, however, not the case for Social Security and Medicare. Let's take a look at Social Security first. We have known for a number of decades that the baby boomers will soon start to retire. Back in the 1980s, the Reagan administration followed the advice of none other than Greenspan, and started to prepare for this by building up the trust fund for Social Security through an increase in the regressive payroll tax and by reducing benefits through a higher retirement age. Under the current projections of the Social

Security trustees, Social Security will be able to pay for all promised benefits until 2042 because of its built up cushion for the predictable retirement of the baby boomers.[1]

As with any other investment account, Social Security invested the money by lending it to the U.S. Treasury. The fact that large shares of this money were used to finance part of the Reagan and Bush tax cuts has nothing to do with Social Security or our ability to afford Social Security, but everything to do with our fiscal choices.

More important than the way we finance Social Security benefits is the fact that projected Social Security benefits will stabilize relative to the size of our economy after the baby boomer generation is gone. From 2004 to 2033 – the period during which most of the baby boom retirement will occur – will likely see an increase in the expenditures of Social Security relative to gross domestic product (GDP) from 4.3 percent to 6.5 percent. As mentioned before, this is the period for which Social Security is already prepared to pay for the additional expenditures, thanks to the trust fund. From 2033 to 2080, Social Security expenditures relative to GDP will rise from 6.5 percent to 6.6 percent by an annual 0.002 percentage points. Thus, Social Security is well prepared for the baby boomer retirement and there is no cost explosion afterwards.

Figure 1: Social Security Expenditures Relative to GDP, 2004 to 2080



Source: SSA, 2004.

Although the story is different in many respects for Medicare, it is similar to Social Security in one fundamental regard: there is nothing in Medicare that makes its costs

[1] The Congressional Budget Office (2004) recently estimated that Social Security could pay full benefits, without any changes to the system, until 2052.

inherently unaffordable. The costs for Medicare are projected to increase from 2.6 percent of GDP in 2003 to 3.4 percent of GDP in 2006, 7.7 percent in 2035, and 13.8 percent over the entire 75-year projection horizon (CMS, 2004).

This is not a trivial amount of money, but it is completely affordable if we choose to pay for it. It is important to remember that at the same time that Medicare expenditures are rising, living standards are growing much faster. Marilyn Moon (2003), for instance, points out that "[i]f the future leads to increased national well-being, additional resource sharing would be affordable. Thus, another way to examine affordability is to focus on whether tax payers will be better off even after they pay higher amounts for Medicare." Based on economic assumptions from the trustees' reports (CMS, 2004; SSA, 2004), inflation adjusted GDP per worker will grow by 66 percent after higher Medicare spending is accounted for. After 50 years, inflation adjusted per worker GDP, after accounting for Medicare expenditures, will be 105 percent higher than today, and in 2080 it will be 190 percent higher. That is, economic growth following higher productivity will allow workers to pay for Medicare, while enjoying substantially higher living standards.

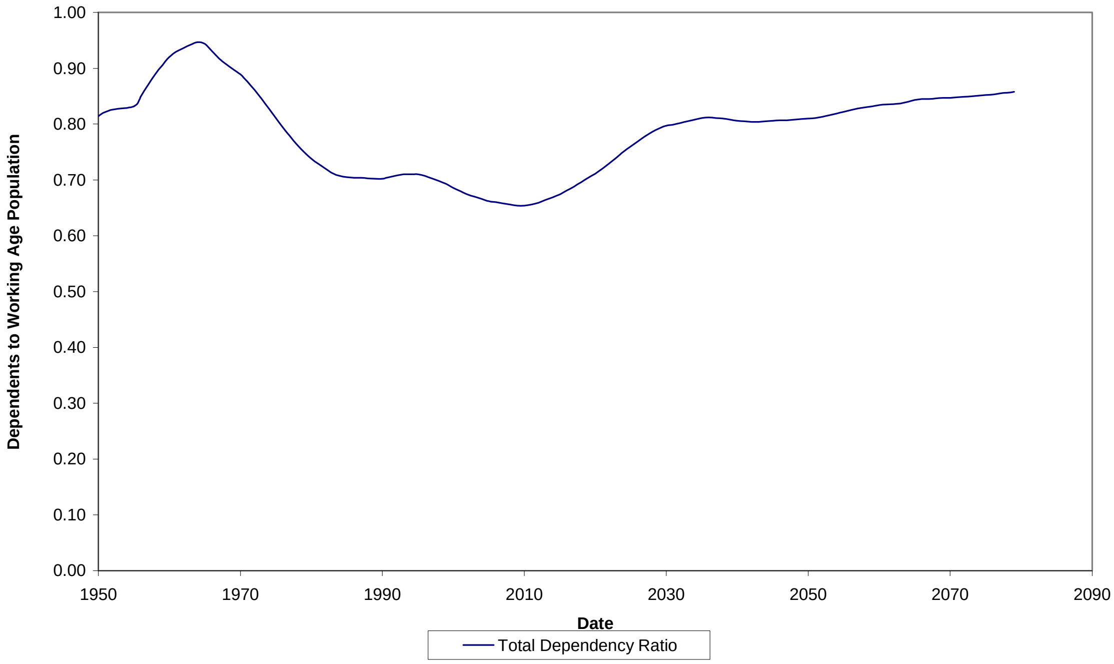
It is also worth noting that Medicare costs are "admittedly very difficult to forecast," as Greenspan said. For example, in 1994 the Medicare trustees projected that the Part A trust fund would remain solvent for seven years, until 2001. In 2004, they projected the Part A trust fund would remain solvent for 15 years, until 2019 – a change of 15 years with just one more year of information. Actual Medicare expenditures can vary widely from the projections for a variety of reasons, including changes in economic conditions, changes in health care practice, and changes in law. Longer projections lead to greater uncertainty, raising concerns about the wisdom of making radical policy changes or benefit cuts based on such long term projections.

THERE IS NO POPULATION TIME BOMB

But how does this square with the notion of an ever-aging population? Greenspan pointed out that "the percentage of the population that is over 65 is poised to rise markedly…" and that "the growth rate of the U.S. working-age population is expected to decline substantially…"

Are we getting older and having fewer children? Yes, we are. However, with respect to the affordability of Social Security and Medicare, the two trends actually work in opposite directions. Living longer means that more money is needed to pay for old age benefits, while fewer children means that less money is needed for education, child care, and other child-related expenditures. To illustrate this point, we use the total dependency ratio of people below the age of 20 and over the age of 65 relative to the people in the working-age population. From 2004 to 2034, the total dependency ratio is projected to rise from 67 dependents to 81 dependents for every 100 people at a working age (figure 2). After that, the increase slows to a crawl, as there will be an expected 86 dependents for every 100 working-age people in 2080. This is still below the level of the 1960s, when there were 95 dependents for every 100 working-age people. There is absolutely nothing explosive about the population trends that would make old age insurance systems, such as Social Security or Medicare, unaffordable. On the contrary, as the costs for caring for people over 65 will rise, the costs for caring for children will likely decline.

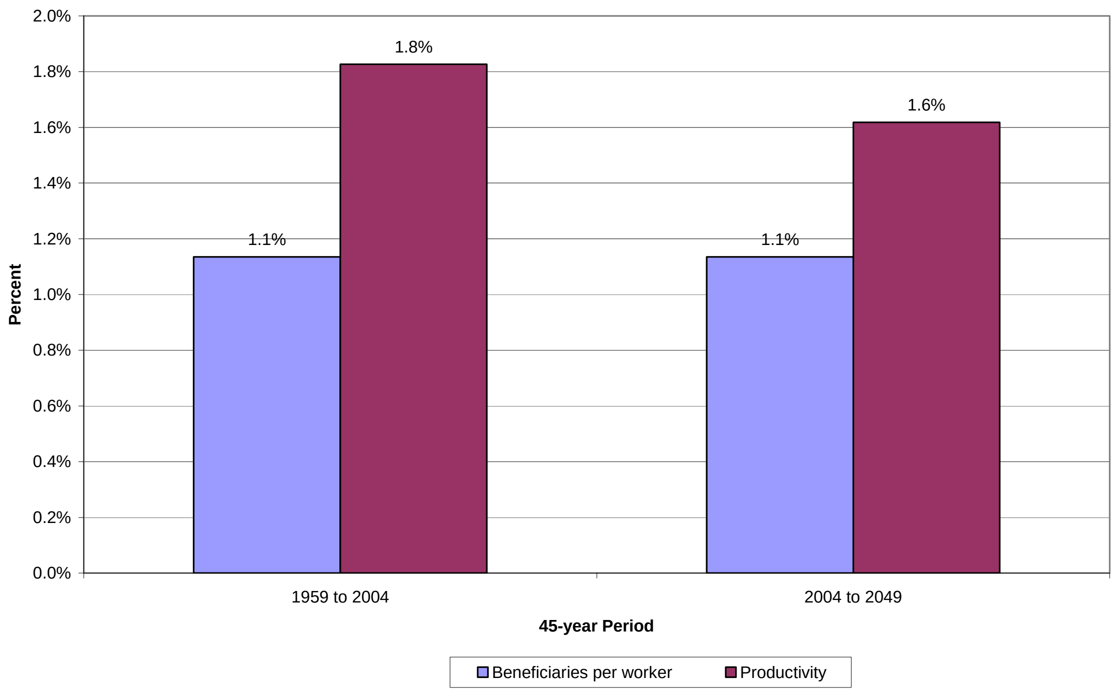
Figure 2: Total Dependency Ratio, 1950-2080



Source: SSA, 2004.

Instead of looking at the total dependency ratio, which does not account for the number of actual workers or beneficiaries, it matters for Social Security and Medicare how many workers need to pay for a given number of beneficiaries. As society is aging, it is no secret that there are more beneficiaries for each worker. However, at the same time, workers are becoming more productive and it should become easier to take care of more people. Comparing past and future trends in the ratio of beneficiaries to workers and productivity growth shows the same picture. Productivity growth has outpaced changes in the beneficiary to worker ratio and will continue to do so. For the next 45 years, productivity is expected to increase 43 percent faster than the beneficiary to worker ratio (figure 3). Through 2080, the difference is even starker. Productivity is projected to grow twice as fast as the beneficiary to worker ratio (SSA, 2004). A similar picture holds for Medicare’s future. Under this program, the beneficiary to worker ratio is expected to rise by about 0.9 percent per year, compared again to productivity growth of 1.6 percent (CMS, 2004). That is, even with the higher costs for Social Security and Medicare, workers will be able to enjoy vastly higher standards of living, as discussed earlier.

Figure 3: Average Annual Changes in Beneficiary to Worker Ratio and Productivity



Source: SSA, 2004, and author's calculations.

FUNDING NEEDS CAN BE ADDRESSED WITHIN THE SYSTEMS

Social Security and Medicare are affordable and sustainable. This does not mean that their long-term funding needs won't have to be addressed. This can be done within the parameters of the system. In his recent speech, Greenspan mentioned three possibilities for funding the long-term cost of Social Security and Medicare: faster employment growth, higher productivity, and measures to reign in health care inflation. For instance, he rightfully acknowledged the importance of employment and productivity growth:

> "The resources available to fund the sum of future retirement benefits and the real incomes of the employed will depend, of course, on the growth rate of labor employed plus the growth rate of the productivity of labor."

FASTER EMPLOYMENT GROWTH

First, employment growth can make a difference, since it raises the number of tax payers. One potential obstacle to employment growth is that population growth will slow. However, even the Social Security trustees assume that the working-age population will continue to grow in the long-term, albeit at a much slower rate than in the past (SSA, 2004). Moreover, the employed share of the working-age population was 62 percent for the first half of 2004, down from 64 percent in late 2000. In the United States, more people as a share of the working population have already been employed than is currently the case and there is a lot more room to grow. Other countries, such as Sweden, have achieved employment to population ratios of close to 80 percent. Instead, the Social Security trustees assume that the employed share of the population will increase to 65 percent over the next 20 years and that it will remain there in the foreseeable future.

To illustrate the point that the United States could manage to achieve higher employment growth than projected consider the following: Since the late 1940s, this share has on average grown at 0.1 percentage points per year. If this trend continued for the next 75 years, employment would grow on average by 0.45 percent per year instead of the 0.35 percent assumed by the trustees – a 25 percent increase. As a result, the employed share of the population would rise to 70 percent in 2080. Further, in the 1990s, the employed share of the population grew by 0.2 percentage points annually. If this trend holds for the next 75 years, employment growth would be 0.60 percent per year and the employed share of the population would rise to a still-realistic 77 percent. Hence, there is room for employment growth to be almost twice as high as the Social Security trustees assume.

It is thus a question for public policy to raise employment levels faster than projected, given that the United States indeed has room to grow more quickly in this area. Greenspan's favorite policy answer is to raise the retirement age again. By all accounts, this will not raise employment and will most likely hurt those who need the benefits the most. A large share of those nearing retirement suffer from severe health problems that stand in the way of continued work. Thus, older workers would find themselves between a rock and a hard place. They could retire with fewer benefits or continue working with health problems (Weller et al., 2004). Alternatively, employment growth could be boosted through better child care provision, more flexible work time arrangements, and better continuing education programs, among other things.

PRODUCTIVITY GROWTH

Even though Greenspan acknowledged the importance of productivity growth, he dismissed this point by trying to win an argument that nobody is having. He argued that nobody should expect productivity growth to stay at or even accelerate from its current above-average levels:

> "But, for a country already on the cutting edge of technology to maintain this pace [of productivity growth] for a protracted period into the future would be without modern precedent."

And later in his speech:

> "But, as I noted earlier, history discourages the notion that the pace of [productivity] growth will continue to increase."

Most economists agree that the acceleration in productivity growth will likely not last. In the last two years, productivity grew by more than 3 percent annually, compared to a historical average of 1.8 percent over the past 45 years. Typically, it is assumed that for the future, productivity growth will end up well below the accelerated pace of the past few years and closer to the historical average.

Interestingly, the assumed rate of productivity growth from the Social Security and Medicare trustees falls *below* this range. Not only do the trustees assume that the acceleration of the past few years will end, but that productivity growth in the long-run will be substantially lower than it was in the past. They project that it will slow down to 1.6 percent, a decline of 13 percent. Cumulatively over a 75-year period, this amounts to a difference in productivity levels and living standards of 16 percent. Yet, even with this assumed productivity slowdown, workers will be able to afford to pay for promised Social Security and Medicare benefits and enjoy substantially higher living standards as discussed earlier. Moreover, there is much room for the economy to surpass the expected low level of productivity growth.

Wouldn't the next logical step be to focus on policies that could enhance future productivity growth? Greenspan (2004) even provides an area for improvement, "upgrading … primary and secondary school education." In addition, public policy could spend more resources on research and development in promising new technologies or on badly needed infrastructure upgrades, such as broadband technology. Faster productivity growth will not happen overnight following policy changes, but it also does not have to. Currently, productivity growth is still strong and workers paying for Social Security and Medicare will need faster productivity growth, the most in the medium to long-term future when policy changes now will have an effect.

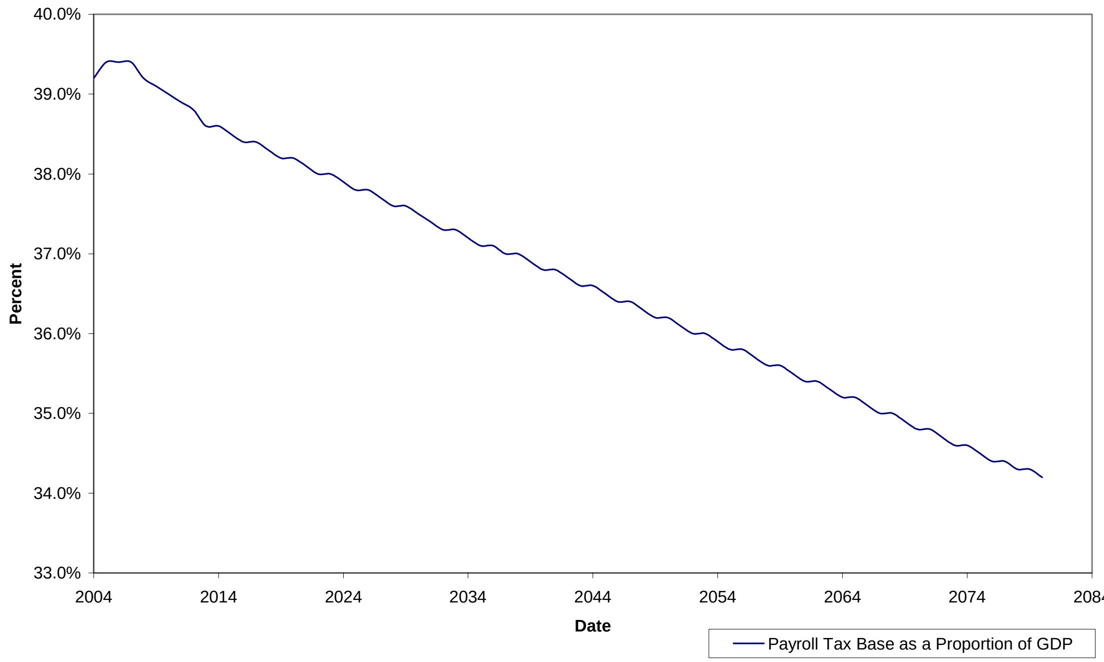
A non-negligible obstacle to Social Security and Medicare enjoying the full benefits of faster employment and productivity growth is the fact that the way workers are being compensated today has changed from the way they were compensated when the programs were initially introduced. Less compensation comes in the form of wages and salaries that are subject to taxation, and more compensation comes in the form of other benefits that are not subject to taxation. In addition, rising income inequality, among other factors, has pushed more and more income beyond the cap for incomes that are subject to Social Security taxation. Currently, only the first $87,900 is taxed. Earnings beyond this amount are no longer subject to Social Security taxation, but they are still subject to Medicare taxation. As a result, Social Security's tax base has been declining and is expected to decline further (figure 5). From 2004 to 2080, the share of GDP that is subject to Social Security taxation is expected to decline from 39 percent to 34 percent. A number of proposals have been made to stabilize the tax base for Social Security, either as a constant share of total earnings or as a share of GDP.

REIGNING IN HEALTH CARE INFLATION

Greenspan touched upon health care inflation, although he acknowledged that "future Medicare costs are admittedly very difficult to forecast." Medicare's future depends crucially on controlling costs for health care. A large part of Medicare's rising costs is health care inflation above and beyond overall price increases (CMS, 2004). The

Congressional Budget Office (2003) estimated that if health care costs rose at the rate of inflation, Medicare expenditures would amount to 6.4 percent of GDP in 2050. However, if health care costs rose on average 2.5 percentage points faster than inflation, Medicare expenditures would amount to 21 percent in 2050. This is a problem that faces all health insurance providers. Many observers, including the CBO (2003), though, acknowledge that curtailing medical care cost increases will be a crucial aspect to addressing the funding needs of Medicare. Because Medicare is the nation's largest health insurance provider, it may actually be able to influence health care inflation. For instance, it could take advantage of its purchasing power to get better discounts on health care products, such as prescription drugs, and encourage better quality care.

Figure 5: Payroll Tax Base as a Proportion of GDP, 2004-2080



Source: SSA, 2004.

CONCLUSION

It has become fashionable to try to scare workers by saying that Social Security and Medicare will not be around for them. Greenspan and Bush both reiterated this argument recently. Because these old age social insurance programs are supposedly not affordable and sustainable, benefit cuts, such as a higher retirement age, and privatization are proposed. However, the numbers from the Social Security and Medicare trustees do not support the notion that Social Security and Medicare are unaffordable. The figures show that the programs are inherently affordable and that there is no population time bomb that will lead to an economy-wide cost explosion.

A look at the numbers makes it abundantly clear that financing Social Security's and Medicare's promised benefits is a matter of choice. The economy and workers will have sufficient resources to pay for the insurance benefits that workers rely on for their retirement income security, even if the economic assumptions of the trustees prove true. At the same time, there are policy changes that could improve the long-term financial outlook for Social Security and Medicare without undermining the protections they afford. Greenspan mentioned faster employment and productivity growth and reduced health care inflation as alternative policy goals to benefit cuts in the same speech in which he called for reduced benefits. A reasonable policy debate should focus on how we can achieve faster employment and productivity growth as well as reduced health care costs instead of cutting what are already bare bones benefits.

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