GENERATION X
Does Bush Understand His Social Security Plan?

By John Geanakoplos

Social Security is the third rail of American politics. So why hasn't George W. Bush been harmed for proposing to transform it into a system of private accounts? Probably because his plan relies on simple and seemingly compelling logic. Today, retirees get a measly 2 percent rate of return (in the form of Social Security benefits) on the money they paid into the system (via payroll taxes). Since even ultrasafe bonds offer much better returns, Bush says, people would be better off investing their money themselves. In an era of dizzying stock market heights, this argument has the virtue of being timely. Unfortunately, it does not have the virtue of being true.

Under Social Security, the money you put into the system during your working years doesn't actually sit there collecting interest, waiting for you to claim your checks at age 65. Most of it goes back out as benefits for today's retirees. This is why Social Security is called a "pay-as-you-go" system:

Today's workers pay for today's retirees; when today's workers retire tomorrow, tomorrow's workers will pay for their benefits; and so on.

It's an imperfect design. In an ideal world, each generation would pay for its own benefits. In other words, each worker would pay into the system, have his or her money accumulate interest (either as part of one giant trust fund or in individual accounts), and then take it back out upon retirement. Indeed, when FDR created Social Security in the 1930s, he envisaged a system more or less along those lines.

But there was a problem. It was the Great Depression; many elderly people literally faced starvation. They had made virtually no Social Security contributions, but Roosevelt felt they needed relief. So Congress decided to pay the destitute elderly of the '30s and early '40s with the contributions of contemporary workers, with the understanding that those workers would get their retirement benefits from the next generation of workers, and so on. As a result of this decision, the first generation of Social Security recipients got a windfall-receiving full benefits after paying little into the system.

Of course, once Congress started paying out full benefits, it couldn't stop. The elderly of the 1950s, '60s, and '70s hadn't paid enough into the system to cover full benefits, either, since their working lives began before 1937, the year the government started collecting Social Security payroll taxes. So each of these generations got a windfall, too. You might think this pattern finally ended in the '70s, when the first wave of people who began working after 1937 -- and thus paid Social Security taxes for their entire working lives-started to retire. But Congress raised benefits for retirees, so the transfer continued even longer. In today's dollars, the "windfall" to these generations totaled a staggering $10 trillion.

Was it a bad decision to start this cycle? Only if you think it would have been preferable to let those elderly people suffer or to force the workers in the '30s and beyond-who really didn't have the resources-to bear the cost of their parents' retirement all on their own. Consider a concrete example, similar to one I have written about with fellow economists Olivia Mitchell and Stephen Zeldes. Your father reaches retirement age, but he has no savings. Letting him starve isn't an appealing option, but neither is bearing the cost of his retirement all on your own -- it's simply too much. Assume, to borrow an example I that reflects the real Social Security numbers, his retirement would soak up 12 percent of your lifetime earnings.) That leaves one other choice: You can spread the cost across the generations, promising to support your father in exchange for an implicit promise from your children to support you. That way your father gets what he needs to retire (12 percent of your lifetime earnings), while you and your children get what you need (12 percent of the lifetime earnings of successive generations). Everyone shares the cost of supporting the first father, but if anybody stops paying, it is his own father who is left holding the bag.

What does this have to do with Bush's Social Security plan? When Bush bemoans Social Security's "2 percent
rate of return," he is making a relatively straightforward calculation, comparing the money today's workers will take out of the system upon retirement to the money they will have put in over their lifetimes (all adjusted for inflation). But this ignores the burden of paying for previous generations of retirees. To use our example, Bush is showing you how much money you take out of the system compared to how much you put in, then complaining about what a lousy return you got on your investment -- all the while neglecting to mention that some of your money was spent sustaining the previous generations that got the windfalls.

If Bush made an honest comparison—that is, if he included the money paid out to previous generations as part of your benefits-then your rate of return would look much higher. After all, if previous generations profited by $10 trillion from Social Security, it is a mathematical certainty that future generations must lose $10 trillion. In a pay-as-you-go system, the contributions of one generation are the benefits of another generation, and one generation's loss is another generation's gain. This generation's loss shows up as low rates of return.

You can see this by returning to our example one more time. Remember, everybody in your family is getting retirement benefits equal to 12 percent of the lifetime earnings of his or her children. But this is not the best return on your investment: Had you salted the money away in government bonds, you would have garnered interest -- let's say 4 percent. Instead, the "return" on your investment in this retirement system is merely the growth in wages from one generation to the next. Historically, wages have increased by a little less than 2 percent per annum, accounting for inflation and population growth. And so your rate of return is just 2 percent.

There are ways out of this cycle. We could, for example, simply shut down the system and let all workers start investing their money in private accounts. Their rates of return would shoot up, depending on how well they played the market. But, of course, that would saddle current middle-aged workers and retirees with the entire multigenerational transfer bill of $10 trillion. Their situation would be the reverse of the '30s generation's: They'd have spent a lifetime paying into the system but would get nothing out of it. Alternatively, the government could shut down the current system but promise to pay full benefits to these people until the new accounts have run for enough years to cover full benefits. But this doesn't get rid of the $10 trillion burden -- it just shifts it to the government, which in turn would pass it on to workers through higher taxes. So if the rate of return on Social Security went up, it'd only be because people were losing money elsewhere. Take into account the money lost elsewhere, and the effective rate of return on Social Security would still be—you guessed it -- 2 percent.

A closer look at Bush's plan shows that he cannot do better for most Americans. His plan diverts the temporary surplus in the Social Security trust fund (right now, contributions exceed benefits, because so many baby-boomers are still working) and uses it to start private accounts that will accumulate interest. But the surplus is already earning interest; the trust fund invests its surplus in government bonds at market rates. So, in moving the funds to private accounts, Bush is not actually getting a better investment—he's just shifting it. Now, it's possible that people would invest their money in stocks, which tend to yield higher returns over the long run. But those higher returns come with higher risk. Account for risk, and the real rate of return is the same as before for any American who already owns stocks and bonds. (For those Americans who have no funds to invest in stocks outside of Social Security, private accounts might help by letting them diversify.)

More to the point, though, Bush doesn't do anything about the $10 trillion intergenerational debt. It's still there. How will it get paid? It's hard to be sure, since Bush has refused to provide the details of his plan, but he know the following: He says he won't cut benefits for current retirees and those about to retire, while future workers -- those who retire 30 years from now -- will have substantial investments. Most likely, then, the burden would fall on those in between: The trust fund, bereft of the surpluses (which Bush used to finance accounts), will be insolvent, and the people retiring ten or 15 years from now won't get their benefits. So, in the final analysis, Bush hasn't really improved the rate of return on Social Security at all. He's given some people more money, at the cost of giving others less. Nothing fuzzy about that math.

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