Boomer Blues (Book Review)

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Peter G. Peterson, chairman of the Blackstone Group, a private investment bank, and a former secretary of commerce under President Nixon, has been writing about the Social Security mess for some time. In Will America Grow Up Before It Grows Old?, Peterson shows just how grim the future will be due to out-of-control spending on Social Security and Medicare. His analysis, though off in some places, is often on target. Unfortunately, some of his proposed solutions would create new problems to replace the existing ones.

Peterson makes his case against Social Security's fiscal soundness with words, numbers, and graphs. To convey what the future will be like, he asks the reader to imagine "a nation of Floridas." Today, about one in five Floridians is age 65 or older; by the mid- 2020s this will be true for the United States in general. His beautiful bar graph drives home the point. And while there are currently 3.3 workers per Social Security beneficiary, he notes that by 2040 the ratio will be less than 2 to 1. The implied Social Security taxes would rise from 11.5 percent of workers' payroll today to between 17 percent and 22 percent in 2040. And if Medicare spending rises as fast as it has historically, writes Peterson, taxes for these two programs alone would take more than a third of every worker's paycheck.

Peterson also presents scary data about the federal government's unfunded liability-- the present value of all its future commitments minus the present value of the tax revenue earmarked to pay for these commitments. For Medicare and Social Security alone, this unfunded liability is a whopping $15.3 trillion. Compare this to the value of all the federal government's assets, which Peterson puts at $2.3 trillion. So much for the idea of selling off assets to avoid raising taxes for Medicare and Social Security.

The mess started in 1935, when Franklin Roosevelt introduced a social security program, though there was no popular demand for it, and then required most people in the private sector to join, even if they already had a pension plan. In contrast to private pension plans, which are normally set up on an actuarially sound basis, Roosevelt's Social Security was pay-as-you-go, with current retirees' benefits paid out of current workers' taxes. Oddly, Peterson mentions very little about the historical origins of Social Security and, when he talks about Roosevelt at all, he is way too generous. Rather than seeing the current dilemma of Social Security as inherent in the program's design, Peterson suggests the problem started in the 1960s and '70s. While it is true that what happened then made an awful situation much, much worse, it is also clear that Social Security's pay-as-you-go financing is an insurmountable structural flaw.

Between 1967 and 1972, writes Peterson, Congress and the president raised Social Security benefits by 72 percent (38 percent after adjustment for inflation). President Lyndon Johnson started the boom years. When Wilbur Cohen, Johnson's secretary of health, education, and welfare, proposed a 10 percent hike in Social Security benefits, Johnson replied, "Come on, Wilbur, you can do better than that!" Johnson also introduced Medicare. Then President Nixon added to the problem by getting into a bidding war with Wilbur Mills, a powerful congressman who tried to get the Democratic presidential nomination in 1972. Net result: a 20 percent increase in benefits. Massachusetts Institute of Technology economist Paul Samuelson provided some of the intellectual backing for these policies. Peterson quotes Samuelson: "The beauty about social insurance is that it is actuarially unsound." Samuelson's point was that if real incomes were growing quickly, each generation could get more out of Social Security than it paid in. While contemporary critics call Social Security a Ponzi game, Samuelson beat them to the punch in 1967 by blessing it as one. "A growing nation," wrote Samuelson, "is the greatest Ponzi game ever contrived."

Peterson pushes the popular belief that the current elderly are receiving a windfall from Social Security. "The typical one-earner couple retiring in 1995," he writes, "will get about $123,000 more from Social Security than the average earner and his or her employers ever paid into it, plus interest." But only in a footnote does he say that he used a real (i.e., inflation-adjusted) interest rate of only 2 percent. That's below what you can make on Treasury bills nowadays and well below the long-term 7 percent real rate that the stock market has averaged during the last 70 years.

Indeed, when you use a more realistic real rate of return, say between 5 percent and 7 percent, you conclude that Social Security screws almost everyone. This is what Eugene Steuerle, an economist at the Urban Institute who normally uses a 2 percent rate, found when he used 6 percent for some unpublished computations, and what my student Shawn Duffy and I found using 7 percent and even 5 percent. Steuerle found that someone born in 1955 will, if married, a sole provider, and a high earner (making $60,000 in 1993 dollars), receive $750,000 less than he or she paid in. Even an average earner (making $24,444 in 1993 dollars), if a sole worker in a married couple, loses $268,000. If both spouses work, and one earns $60,000 while the other makes $24,444, they lose over $1.2 million. That's right. For such a couple, it's as if the government took more than a million dollars from them the day they retired. Duffy and I calculated that even someone born in 1929 who worked for the minimum wage his entire life and who retired in 1994--supposedly the quintessential Social Security windfall king--would have done better without Social Security. At a 5 percent real rate of return, he would have been over $34,000 better off. At a real rate of 7 percent, he would have been over $100,000 better off without Social Security.

So, although Peterson is thought of as a Cassandra for his warnings on Social Security, he actually understates the problem. The problem arises because the Social Security taxes are spent rather than invested privately.

Just as Peterson's diagnosis is sometimes on target and sometimes not, so are his prescriptions. First the good news. Peterson would end the so-called earnings penalty, the law that requires retirees below age 70 to give up Social Security benefits for every dollar they earn past a modest threshold. For those aged 62 to 64, the "giveback" is 50 cents per dollar earned over $8,280; for those aged 65 to 69 it is 33 cents per dollar earned over $11,520. This program alone, independent of the income tax, imposes a marginal tax rate ranging from 33 percent to 50 percent. Score one for Peterson. Also to his credit, Peterson advocates that the age at which people can receive full Social Security and Medicare benefits be raised gradually from 65 to 70 by the year 2015.

Now the bad news. Peterson would impose an "affluence test" for receipt of Social Security, Medicare, and other benefits. If your income exceeds $40,000, you would lose 10 percent of your federal benefits for every additional $10,000 of income. So a family making $50,000 and receiving $12,000 in federal benefits would lose $1,200. A family making $100,000 and receiving $12,000 in benefits would lose 60 percent of that $12,000, or $7,200.

Aside from the difficulty of enforcing such a plan--Mr. Smith, we just learned that your income last year was $10,000 higher than the previous year; please send us a check for $1,500, which is 10 percent of the cost of your hip replacement--there is a fundamental moral and economic objection. The affluence test is morally objectionable because it penalizes people who make the same income as others their whole life, but who save more and earn a return on these savings.

The economic objection runs along similar lines. The "affluence test" would deter retirement saving, which is, after all, one of the main kinds. Financial planners, tax attorneys, and others would discuss the law in tax and investment newsletters, and someone who saves enough to make over $40,000 a year in retirement is likely to pay attention to such information. Peterson disagrees. It "strains credibility," he writes, to think that people will look ahead so far and so clearly. If he's right--I think he's not--notice that Peterson's proposal relies on people not finding out.

At times, Peterson strains his own credibility through his ambivalence about government's proper role. Waxing eloquent about Americans of past centuries, Peterson writes, "[T]he ethic of individual responsibility taught that if you didn't save, you would bear the consequence personally. The spendthrift who hit bottom could apologize to his family, implore his neighbors, or beg from strangers--but would have no claim on the public purse." Peterson later states that "all groups of federal beneficiaries" must "make meaningful sacrifices" by having some benefits cut. But one page later he tells us he doesn't mean it, advocating that federal benefits for the elderly poor be increased. This, in spite of his own demonstration that Social Security benefits have risen so dramatically for all, including the lowest-income beneficiaries. Peterson also wants the government to "substantially increase spending" on education, worker training, and research and development.

In the end, Peterson fails to draw the important moral from his own tale. He shows how Democratic and Republican politicians made a mess for us with reckless abandon, not seeming to care a whit about any consequences beyond the next election. And what does he conclude? That government should do more.