The Bleak Future of Social Security

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The conventional wisdom among economists and policy wonks supposedly in the know is that Social Security is a great deal for people who are retired but a lousy deal for the baby-boomers. They are half right. Social Security is a lousy deal for baby-boomers--but it's also a bad bargain for a majority of those already retired.

First, look at the boomers. According to Eugene Steuerle, an Urban Institute senior fellow who is an expert on Social Security, someone born in 1955 will, if he or she is married, the sole provider of the couple, 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 the sole worker in the 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. So, yes, the Social Security system--isn't that a great name?--does screw the baby-boomers.

Now look at today's elderly. Although they aren't hurt as badly as the boomers, Social Security is a rotten deal for most of them as well. To see where many economists and policy analysts go wrong, examine the way they estimate the costs and benefits of Social Security. First, they take the amount the person paid in Social Security taxes and the amount the employer paid, and assume that the total would be invested by the employee and earn a specified interest rate. Second, they estimate the present value of Social Security benefits--the value in the present of a stream of future income--using the same interest rate. So far, so good.

But any economist or analyst who uses interest rates to compound returns and to compute present values must answer a crucial question: what interest rate did you use? Eugene Steuerle used a real interest rate of 6% to calculate the hit on baby-boomers. But take Blackstone Group Chairman Peter G. Peterson's recent assertion in the Atlantic Monthly that the average one-earner couple retiring today will get about $123,000 more out of Social Security than he and his employers paid into it. Peterson didn't even bother to tell his readers what interest rate he used. With a little digging, I found the answer: 2%. That's right. Peterson assumed that if the government had left people alone to make their own investments, they would have earned a real rate of return lower than what you can get today in riskless short-term Treasury bills. But the average compound rate of return on stocks between 1926 (before the 1929 crash) and 1995 was 10.5%, and adjusted for inflation was 7.2%, according to Ibbotson Associates, the leading tracker of rates of return on stocks.

Shawn Duffy, one of my students, and I found that if you use a more reasonable rate of return--consistent with the real rates that investors have been able to earn from a portfolio of stocks and bonds--you find that the loss from the taxes collected is substantially greater than those analysts estimate and that the present value of the gain is substantially lower. In fact, even someone 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. Had that person earned a real rate of return of 5% on what the government euphemistically labels 'contributions,' he or she would have been over $34,000 better off without Social Security. At a real rate of return of 7%, which assumes contributions were invested solely in stocks, the minimum-wage worker would have been over $100,000 better off without Social Security.

The loss to a high-income worker, we found, was over $183,000 at a 5% rate of return and, at a real rate of return of 7%, the person lost more than $360,000. That's the price of a very nice house in some of the most expensive regions of the country.

The bottom line is that Social Security hurts almost everyone. It's a bad deal for today's seniors, an even worse deal for baby-boomers, and a sick joke for Generation X. This shouldn't be surprising. Much of the tax revenue the government raises would otherwise have gone into high-return investments, investments that will never take place. That Social Security hurts almost everyone is the fact we should keep most in mind in judging reform proposals. The sooner we get the government to stop messing with our retirement income--if we do so in a way that compensates all potential losers--the better off we will be. Social security has been called a legal Ponzi scheme. This is too kind. Think of it as a Ponzi scheme in which 20% of the proceeds are dumped into the ocean.

If the Social Security issue is framed as a war between the generations, we can forget about fixing it. Governments often pit citizens against each other to frustrate reform. The enemy is not old people. The enemy is Social Security.