Unwelcome diversion

By Christopher Carroll

January 19, 2005

VICE PRESIDENT Dick Cheney launched the latest salvo in the Social Security reform debate last week with a speech calling for an "honest, straightforward and realistic" discussion of the future of the program.

Unfortunately, the rest of his speech did not meet these goals. In fact, like so much else that has been said on the subject in the last few months, its purpose seemed to be more to confuse than to clarify the options.

Social Security is best understood as a deal among the generations. Suppose you're a middle-aged breadwinner. The essential structure of the system is simple: Every month, you and your siblings send a certain fraction of your salaries to your retired parents (effectively about 12 percent under current law, including your employer's share); in turn, when you get old, your kids will send 12 percent of their salaries to you. The complexities of the actual Social Security system are about implementing details of this idea.

Social Security's looming problem, in a nutshell, is that family sizes have declined. Baby boomers had fewer kids than their parents, so there will be fewer paychecks supporting their retirement.

The Bush administration has suggested that the solution is to allow Americans to divert part of their Social Security taxes into "individual accounts" that can be invested in the private market. The idea is that such accounts would rescue the system because they would earn returns higher than the investment returns on the traditional Social Security system.

If only it were so simple.

The problem isn't that Social Security taxes are being invested badly; it's that they are not being invested at all. Statistically speaking, if you are the breadwinner, your taxes are being sent directly to Grandma (most Social Security recipients are women because men die earlier).

How, then, can President Bush propose creating individual accounts and at the same time promise that there would be no benefit cuts for the currently retired or those "near retirement"?

In essence, the administration plan is for you to continue sending 12 percent to Grandma, but for the government to fill your individual account by borrowing (hence recent news reports that the administration's Social Security reform would involve large increases in the budget deficit).

It's an unfortunate law of economics that you can't get rich by borrowing and then earning a safe interest rate on the borrowed money. Likewise, if the government pays off money it borrowed on your behalf by subsequently imposing higher taxes on you, it hasn't done you a favor.

Of course, it is possible that the new debt used to fill the accounts will not be paid off during the lifetime of current taxpayers; but in this case, "reform" just amounts to passing the buck to future generations. This is
politically astute because the future tax increase is hidden while the individual accounts are visible. But the whole point of Social Security reform should be to stop passing the buck.

The only escape from this logic is to assume that the rate of return on your account will be much greater than the rate the government pays on the money it borrowed to fill that account. And indeed, if you invest your account in something risky (such as stocks), you might earn a greater return. But if this were guaranteed to work, why shouldn't the government borrow, say, $1 million on behalf of everyone currently alive, give each of us a $1 million "individual account" and declare the Social Security problem (along with a lot of other problems) solved?

The answer is that there are no guarantees. In the worst case, you could lose most of the money in your account. (Even diversified investments are risky: The S&P 500 declined by more than 50 percent in real terms between 1969 and 1974.) What you would be left with could be much less than if there had never been any individual accounts. In fact, benefit cuts of the size necessary to make room for individual account contributions could mean that a stock market crash would push a lot of the elderly to the brink of poverty.

It's hard to see why the solution to Social Security's long-term imbalance is for the government to borrow trillions of dollars to create individual accounts. The "honest, straightforward and realistic" fact is that there are only two ways to fix Social Security: Increase taxes or cut benefits. Anything else is smoke and mirrors.

Christopher Carroll is professor of economics at the Johns Hopkins University.

Copyright © 2005, The Baltimore Sun