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PRESIDENT MISLEADS ON SOCIAL SECURITY RATE OF RETURN

by Jason Furman

In Kentucky on June 2, the President stepped up his efforts to promote his Social Security plan with a claim that private accounts provide a substantially higher return than traditional Social Security without any added risk. The President said:

> "Right now, when we collect your money, if you're a youngster out there working hard and paying into the system, you'll be displeased to know you get about a 1.8 percent return on your money, which is pitiful, rate of return. Heck, you can put your money in T-bills and do better than that… A conservative mix of bonds and stocks, for example, can yield over a period of time 4.5 percent rate of return. And that difference between the 4.5 percent somebody gets or the 1.8 percent you're now getting [through Social Security] over a 30-year period is a lot of money."[1]

The President's statement was highly misleading. It went beyond the somewhat more careful statements he has previously made on this matter.

Coincidentally, the Center on Budget and Policy Priorities released a paper June 2 analyzing this issue in detail (http://www.cbpp.org/6-2-05socsec.htm). That analysis summarized results universally accepted in the economics profession, including by Nobel Prize winner and eminent conservative economist Gary Becker, by conservative Harvard economist (and former *Wall Street Journal* contributor) Robert Barro, and by the investment house Goldman Sachs. For example, in a recent analysis entitled "Seven Myths About Social Security Reform," Goldman Sachs explained that "after adjusting for these two factors [transition costs and risk, which are described below], *the difference in returns between personal saving accounts and the current system disappears. There is no free lunch available via privatization*" (emphasis added).

The President's remarks rested on three fallacies.

Fallacy #1: Ignoring Transition Costs

In saying that people could even put their money in Treasury bills and do better than Social Security does, the President implied that workers could put their money virtually anyplace other than

[1] White House Press Office, "President Discusses Strengthening Social Security for Rural America," June 3, 2005.

Social Security and be assured of getting a better return. If this sounds too good to be true, that's because it is.

If everyone pulled their payroll taxes out of Social Security and put them into private bonds, *someone would still be left to foot the annual $500 billion bill for the 45 million people who currently benefit from Social Security*. Once these additional costs are factored in, the apparent free lunch of higher returns without additional risks disappears.

The fallacy of the President's comparison of returns in the financial markets to returns from Social Security was analyzed in detail in an award-winning economics paper several years ago by economists Olivia Mitchell of the Wharton School, a member of the President Bush's Commission to Strengthen Social Security and a supporter of private accounts, John Geanakopolos of Yale University, and Stephen Zeldes of Columbia University. They found that "the popular argument that Social Security privatization would provide higher returns for all current and future workers is misleading, because it ignores transition costs." Their paper states: "A popular argument suggests that if Social Security were privatized, everyone could earn higher returns. We show that this is false."[2] In a recent article, Harvard economist Robert Barro agreed, writing that,

> "Advocates of personal accounts cite the low rates of return in the current system, but this is misleading. Prospective returns to young people are low mostly because we gave benefits to older generations of retirees who did not contribute their share of taxes to pay for them. One way or another, the burden of this generosity has to be borne by the young." [3]

Fallacy #2: Ignoring the Additional Risks Associated with Stock-market Investment

In stating that Social Security's 1.8 percent return is pitiful compared to the 4.5 percent return that would be expected on a mix of stocks and bonds, the President committed another basic error — he ignored the additional risk that is associated with investing in the stock market. Conservative economist Gary Becker, another supporter of private accounts, has written that, "There are no freebies from such investments since the higher return on stocks is related to their greater risk and other trade-offs between stocks and different assets."[4]

A recent study by leading financial expert and Yale economist Robert Shiller (author of *Irrational Exuberance*) finds these risks are substantial. Shiller estimated that workers who opted for the President's private accounts would lose money between 32 and 71 percent of the time. (Under the President's proposal, workers who opt to have some of their payroll taxes diverted to private accounts would have their Social Security benefits reduced in return; if their private accounts earned, on average, more than 3 percent a year above the inflation rate, they would benefit from having

[2] John Geanakopolos, Olivia Mitchell, and Stephen Zeldes, 1999, "Would a Privatized Social Security System Really Pay a Higher Rate of Return," National Bureau of Economic Research Reprint No. 2266.

[3] Robert Barro, "Why Private Accounts Are a Bad Idea," *Business Week*, April 4, 2005.

[4] Gary Becker, "A Political Case for Social Security Reform," *Wall Street Journal*, February 15, 2005.

elected the accounts, but if their accounts earned less than that amount, they would come out behind.)[5]

The risks associated with the stock market are the reason that when the Congressional Budget Office analyzes rates of returns under Social Security proposals that include private accounts, CBO adjusts the rates of return to account for the increased risk that is associated with stock-market investment.

Fallacy #3: Ignoring the Insurance Benefits of Social Security

Finally, in describing the return on Social Security, the President implied it is an investment program and should be analyzed as such. A critical feature of Social Security, however, is the social insurance that it provides. About one-third of payroll taxes go to fund Social Security disability insurance and survivors insurance. Comparable insurance products would be extremely expensive to buy in the private insurance market, if one could find such products at all. Social Security also provides an inflation-indexed annuity: Social Security benefits are adjusted each year for inflation and are paid until death, regardless of how long a beneficiary lives. These features of Social Security provide a valuable form of insurance against the risks of inflation and of outliving one's savings.

As with any type of insurance, a "rate of return" is an inappropriate standard for measuring the value that these features of Social Security provide. For example, when one buys automobile or homeowners insurance, one is not looking for a good rate of return, since one's money will be returned only if one has an accident or one's home is vandalized or damaged in a fire or other such event. Indeed, no one would decide *not* to buy homeowner's, auto, or health insurance because those products generally produce a lower rate of return than investing in the stock market.

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[5] Robert Shiller, "The Life-cycle Personal Accounts Proposal for Social Security: An Evaluation," March 2005.