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The 'economic effect' of benefit payments isn't $1.4 trillion or nine million jobs. It's zero.

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AARP—formerly known as the American Association of Retired Persons—recently released a report proclaiming that "Social Security Generates Nearly $1.4 Trillion in Economic Activity and Supports More Than Nine Million Jobs." As great as that sounds, AARP's study is fundamentally flawed.

Last year, Social Security paid out almost $715 billion in retirement, survivors and disability benefits. This money supports seniors, but according to AARP the gains don't stop there. Retirees spend their benefits on food, for example, creating incomes for the supermarket owner and employees, who then spend these incomes, and so on. The report concludes: "Because of the multiplier effect, every dollar of Social Security paid out translates to almost two dollars in spending in the United States."

Sounds like magic. But what AARP overlooks is the money pulled out of the economy through Social Security payroll taxes to fund these benefits. These taxes have what we might call a "divisor effect:" For each dollar of taxes levied, workers have less to spend, and that reduction is passed on throughout the economy. If workers spend the same percentage of their incomes as retirees, then the net economic effect of Social Security isn't $1.4 trillion or nine million jobs. It's zero. The AARP report acknowledges that "A net analysis would subtract the economic effects of payroll taxes from those of the benefit payments." But that acknowledgment comes in a footnote.

The best defense AARP could offer for its reasoning is to claim that retirees spend a greater share of their incomes than workers. Therefore, transferring money from workers to retirees raises spending and, through the magic of the multiplier, still boosts the economy.

In the short term that may be true, though the economic boost at any given time would be far smaller than the trillion-dollar figure AARP touts. But over the long term, the economic effects of Social Security are negative. Spending may give the economy a quick fix. Saving drives long-term economic growth.

This point is fundamental. To quote one randomly-chosen macroeconomics textbook, titled "Macroeconomics," by Olivier Blanchard of MIT: "The saving rate determines the level of output per worker in the long run. Other things equal, countries with a higher saving rate will achieve higher output per worker in the long run." In other words, because of Social Security taxes, today's economy is likely smaller than it otherwise would be.

This isn't just theory. In a research paper published by the Brookings Institution in 1996, economists Jagadeesh Gokhale, Larry Kotlikoff and John Sabelhaus traced the decline in saving rates since World War II to the rise of Social Security and Medicare, which transfer income from savers (workers) to spenders (retirees).

Similarly, when the Congressional Budget Office in 2004 modeled the economic effects of proposed Social Security changes, it found that reforms that would cut benefits without raising taxes—such as the so-called price indexing of benefits—would lead to economic growth. Plans that raised taxes to pay promised benefits would reduce work, saving and economic growth. The entire U.S. economy would be roughly 5% larger in the long run if we adopted the cut-benefits approach instead of the raise-taxes approach, the CBO concluded.

AARP's conclusions about Social Security and the economy point people in a direction—raising benefits by raising taxes—that is most likely to reduce long-term economic growth. Unfortunately, AARP has published similar articles on the purported economic benefits of state and local government pension plans that are just as preposterous. But just as in grade-school mathematics, when you consider only one side of an equation, you're almost sure to get the answer wrong.

Andrew Biggs
Resident Scholar
American Enterprise Institute

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Mr. Biggs is a resident scholar at the American Enterprise Institute and former principal deputy commissioner of the Social Security Administration. He was on the staff of President George W. Bush's Commission to Strengthen Social Security.

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AARP Publishes a Study to Show Only What It Wants to Show

Kudos to Andrew Biggs of the American Enterprise Institute for exposing AARP's sham study showing the economic benefits of Social Security.

The AARP study is intended to demonstrate the economic benefits of Social Security in the hope of staving off any future benefit cuts to seniors. As the study points out, the Social Security trustees inform us that the Social Security Trust Fund—speaking of "shams"—will run out of money (that it doesn't have) in 2033. Whereupon Social Security could only pay about 75 percent of the current benefit level.

AARP wants lawmakers to know that seniors often have low incomes, depend on their Social Security checks and will spend most of it. All of which is true. And so the AARP study tries to calculate the impact of that spending on the economy.

But the AARP study only focuses on the spending side of the equation. It ignores the fact that current workers must pay 12.4 percent of their income in Social Security payroll taxes—one of the most regressive U.S. taxes. That money is promptly redistributed to seniors.

Actually, the study does mention the exclusion—tucked away in the methodology where no one will see it. “Moreover, any ‘net’ analysis would be greatly complicated by the fact that behavioral responses of individuals to the elimination of the Social Security program would be extremely difficult to predict.”

Translation: Measuring the net effect—i.e., the negative impact of the taxes versus the positive impact of the spending—is “complicated,” so forget it.

This would be like a CFO explaining to the stockholders and the media that focusing on the company’s liabilities would be difficult, so he’s only going to highlight the company’s assets.

Before the government can give a senior a dollar, it has to take that dollar away from someone. Many of those who pay those payroll taxes are also middle and lower income people who need, and would spend, that dollar just as much as a senior. The net effect of Social Security is probably closer to zero, and may even be negative, considering administrative costs and the fact that the tax comes from workers, who are more likely to invest it productively.

Most people, and certainly the press, pay virtually no attention to the methodology. They just look at the headline and would not realize that there are real costs to real people. And AARP has no intention of informing them.

AARP has published a study to demonstrate how much the economy benefits when Paul is given a dollar, and completely ignores that Peter has been robbed.

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Today’s PolicyByte was written by IPI Resident Scholar Dr. Merrill Matthews.

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About Andrew Biggs

ANDREW GEORGE BIGGS August, 2013
Resident Scholar
American Enterprise Institute
1150 17th
Street Northwest
Washington, D.C. 20036
(202) 862-5841
andrew.biggs@aei.org

Education
2004-2008 M.Sc. Financial economics, University of London
1992-1995 Ph.D. Government, London School of Economics and Political Science
1991-1992 M.Phil. Social and Political Theory, Cambridge University
1988-1990 B.A. Philosophy (honors), Queen's University of Belfast
1986-1988 Middlebury College

Professional background
2008-present Resident Scholar, American Enterprise Institute
2007-2008 Principal Deputy Commissioner, Social Security Administration
2007 Deputy Commissioner for Policy, Social Security Administration
2005 Associate Director, White House National Economic Council
2003-2007 Associate Commissioner for Retirement Policy, Social Security Administration
1999-2003 Social Security Analyst, Cato Institute
2001 Staff analyst, President's Commission to Strengthen Social Security
1998-1999 Director of Research, Congressional Institute
1996-1998 Assistant communications director, House Committee on Banking and Financial Services

Miscellaneous
Co-vice chair, Society of Actuaries Blue Ribbon Panel on Underfunding in Public Pension Plans (2013)
Research associate, Center for Retirement Research, Boston College
Affiliated researcher, RAND/Wharton/Dartmouth Financial Literacy Research Center
Member, National Academy of Social Insurance
Published in the New York Times, Wall Street Journal, Washington Post and other major publications
Testified before Congress and state legislatures on multiple occasions