

Can Economic Growth Save Social Security?

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Here is a fascinating issue. If, because of economic growth, median incomes rise rapidly in the future, won't social security benefits have to be raised as well? As the author explains, growth will create a wealth of new and better goods. Thus, unless the level of social security's real benefits grows at the same rate as the economy, retirees will have to choose between the same-size basket of the goods that growth will have rendered stale and a smaller basket of the new goods. The only way that growth can "save" the social security system is by making retirees poorer.

HEATED though the debate about privatizing part of the social security system is, both sides agree that the problem the system faces can be alleviated by economic growth. With more to go around, the argument goes, it will be easier for a dwindling number of workers to take care of a booming number of retirees. Where the two sides differ is in their assessment of the economy's ability to generate the required levels of growth. While privatizers believe that a private system would

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generate more growth, antiprivatizers generally argue that the problem the social security system faces is not a severe one and that if the current growth rates prove insufficient, their shortfall will not be of much consequence.

President Bush's tax cut has generated an interesting wrinkle, with those in favor of the cut caught in a dilemma. If social security is in such severe straits that it must be privatized, how can a

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tax cut be justified? A recent *Wall Street Journal* op-ed piece ridicules the deficits projected by the trustees of the social security system, arguing that this unfavorable forecast is the result of assuming an unrealistically low rate of growth.¹ With a higher growth rate, the article argues, the system is in no danger.

The only problem with this widely held view is that it is based on a fundamental misunderstanding of what economic growth is. Using growth to close the social security system's projected deficit is the same as reducing retirees' benefits. To see why, we must understand how growth is measured and how it affects the benefits that retirees receive.

Retirement benefits can be measured either in constant dollars or in relative dollars. Because the benefits are adjusted to inflation, the constant dollar or real value of a retiree's benefits is protected. Thus each retiree is assured that month after month and year after year, she will always be able to buy the same goods and services that she bought with her first retirement check. The relative value of the benefits is not protected, however, and growth erodes it. The first check that a retiree gets upon retirement amounts on average to 47 percent of the median after-so-

cial-security-tax wage of a worker. Now suppose that the economy is growing at, say, 10 percent, and wages are growing at the same rate. In eight years the median wage of a worker will double. But the relative value of the retiree's check will be halved, to a mere 23.5 percent of the median wage.

So the question becomes, does the erosion in the relative value of retirement checks matter, given that the real value of these checks is protected? First it must be understood that it is precisely this erosion that "saves" the social security system. Today the workers-per-retiree ratio is 3.45 to 1, and workers pass to retirees 12 percent of what they produce. (Social security taxes are slightly higher than 12 percent, which is why the system currently accumulates a slight surplus.) In thirty years, the ratio of workers to retirees will be only 2 to 1, and the benefits will consume 17 percent of the national product. Thus, without growth, the burden of retirement will increase by more than 40 percent. With 10 percent growth, however, the relative value of the benefits to a retiree who lives another fourteen years ranges from 47 percent of the median wage on the day she retires to a mere 14 percent on the day she dies. On average, this relative value is 27 percent of the median wage, and with this relative value, total benefits to all retirees together constitute the same 12 percent of national product as they are today. The erosion in relative benefits thus maintains the social security system's financial health. But what is its effect on the welfare of retirees?

It is a commonplace to think of the economy as a pie and to think of economic growth as making the pie bigger. If retirees get a smaller slice of a bigger pie, they are just as well off. But for an industrialized economy, the metaphor of the economy as a pie is misleading. If we must use it, then we must also think of economic growth not as the process that makes the pie bigger but as a process that makes the pie better.

Investments in industrialized economies are rarely if ever in-

tended to close the gap between consumers' existing needs and the inventory of existing goods. What investors want is to widen the gap between needs that consumers may not yet have and the supply of goods that do not yet exist. And the evidence of their success is everywhere. It was one thing not to have had a fast computer ten years ago, before Netscape made the use of the Internet widespread. Today even retirees can make good use of it, when prescription drugs can be purchased online and children and grandchildren are reachable by e-mail. Once high-definition television becomes the standard, retirees also will want to enjoy its advantages. Inflation-adjusted retirement benefits permit a retiree to consume each year the same goods that she consumed the year before. But in a growing economy, this is not what consumers need or want. As the pie becomes better, consumers—including retirees—develop a taste for it.

How Growth Is Measured

One of the most amazing things about the term "economic growth" is that even Federal Reserve chairman Alan Greenspan has been misled by it. On the privatization issue, Greenspan stays neutral, but he is a committed member of the growth camp. In Greenspan's own words, with growth the economy will "produce an even greater quantity of goods and services to be consumed in retirement."

The digital camera is a good means of understanding what growth is and whether it can correctly be described as increasing the quantity of goods. There is little doubt that, over time, digital cameras will become so much more useful than film cameras that at some point they will render existing film cameras obsolete. They will also make obsolete existing computers that are not powerful enough to handle digital images and existing printers that are not picture-quality. But first they will all have

to be produced. And in order to produce them, capital and labor will have to be diverted from the production of other goods. Some of the capital and labor may be diverted from the shrinking film camera industry, but since most consumers already have film cameras, this industry is smaller than the digital camera industry with its many peripherals will be. Other industries will also have to be tapped, perhaps even industries that currently

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cater directly to retirees. Thus growth does not free labor and capital; it consumes them. And although it may provide people with new possessions, it also makes some of their existing possessions obsolete.

So how can the introduction of the digital camera count as growth? It counts as growth first of all because growth is measured in dollars. If the dollar value of the new cameras and the peripherals they require exceeds the dollar value of the goods they displace, by definition growth has occurred. (Because investors invest to increase value, investment normally results in growth.) It is not necessarily wrong to count the introduction of the digital camera as growth—its benefits are great. But how can this introduction be described as “a greater quantity of goods”? It is not just that there are not more goods. If retirement checks are not linked to growth, retirees will have less. A retiree who started her retirement in the film camera age but lives through the transition to the digital camera will discover that her retirement check permits her to continue buying film, but not the digital camera she needs and its necessary peripherals.

Interestingly, because air quality and other environmental goods are not part of national accounting, not all growth is even

beneficial. Take, for example, the car industry. Automobile technology is not vastly different today from the way it was 100 years ago, yet the industry gobbles up huge investments. General Motors pours some \$6 billion every year into research, development, and engineering. Ford invests similar sums. Where does this money go? Recently much of it has been going toward creating additional models of sport utility vehicles (SUVs), making these low-mpg vehicles attractive to an ever greater number of consumers. GM already has a large line of SUVs, but this year it will introduce a new SUV in its Saturn division and a new Humvee for city use. In the Saturn division alone, the cost of development is forecast at \$1.5 billion.

If economic growth is a misleading term, productivity growth is even more so. SUVs illustrate this fact as well. Labor productivity is measured as dollars per labor hour. SUVs take more labor hours to produce than cars, but their prices are also higher. If the proportional increase in price exceeds the proportional increase in the labor hours, productivity is higher in SUV production than in car production (which is why SUVs are so attractive to manufacturers). Paradoxically, the increasing share of SUVs is recorded as an increase in labor productivity, while the number of vehicles produced per labor hour actually decreases.

The dichotomy between growth that is in the form of new products and growth that is in the form of "more of the same" does not always hold. An example of how consumers may get "more of the same" from something totally new comes from the health industry. The MRI (magnetic resonance imaging) machine is a new product that helps people live longer. Whichever category it belongs to, however, its introduction clearly qualifies as economic growth. Yet its effect can only be to consume capital and labor, first in order to produce the new machines but more importantly to provide for the needs of the additional retirees that these machines will produce. This is clearly not the "ever greater

quantity of goods" that will make taking care of retirees easier, as Greenspan has so optimistically asserted.

Of course, some new products do free resources, and increases in labor productivity do not always mean fewer units produced per hour. Even the automobile industry provides counter-examples. Steel-belted tires, for example, increased the life of tires to such an extent that the production of tires declined dramatically. New cars also require far less maintenance than the cars of twenty years ago. But the belief that growth frees labor and capital as a rule is based on an economy that is static, which our nonagricultural economy is not.

There is no disagreement about the fact that the social security system will not face a deficit for another thirty years. But the workers-to-retiree ratio will start to deteriorate in just ten. In other words, unless benefits are reduced, in just ten years the share of national product that retirees consume will start to increase. Despite the hope that growth will solve the problem, it will not—and cannot. Growth does not free labor and capital, and, as a result, retirees inevitably experience growth as a reduction in their benefits. Such a reduction may be called for, but this is a question of equity rather than expertise. As such, it behooves all Americans to participate in the debate about how to divide the increasing burden of retirement between retirees and workers. The assertion that growth can make the problem of changing demographics go away is simply false.

Note

1. Charles J. Zwick and Peter A. Lewis, "Apocalypse Not: Social Security Crisis Is Overblown," *Wall Street Journal*, April 11, 2001.

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