TrendMacrolytics

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POLITICAL PULSE

Next Year's Miracle

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Here's the likely shape of Bush's big bet for 2005: Social Security reform with private accounts.

We expect that **President Bush** will unveil the broad outlines of his **Social Security** reform agenda at the economic forum the **White House** is hosting this week in **Washington**. The president will likely frame his proposal as primarily intended to reaffirm a compact between the **American** people and their government, rather than as a "privatization" scheme, or a way to "save" a system in crisis. We expect that the president's proposal will contain the following features.

- **No increase in payroll taxes.** This has already been announced.
- **Reining in expenditure increases.** Rather than further moving back the age of retirement at which full benefits can be received -- an obvious benefit cut that would be easily targeted by opponents -- expenditure burdens will be relieved by *slowing the rate of increase* of overall benefits promised by the system. Presently a major source of expenditure increases is the policy of indexing the determination of first-year benefits to wage growth, rather than CPI inflation (once first-year benefits are established by wage indexation, subsequent COLA adjustments are determined by the CPI). As first legislated in 1972, first-year benefits were indexed to CPI inflation because economists believed that, in theory, wage growth would always outstrip inflation. When the stagflation of the 1970s proved this incorrect, with CPI inflation far exceeding wage growth, new legislation in 1977 indexed first-year benefits to wage growth. Now, in our age of low inflation and rapid productivity gains, wage growth is exceeding CPI inflation again, as theory suggests it should -- so it is now once again believed that expenditure growth can be curtailed by indexing first-year benefits to CPI inflation rather than wage growth. By the way, a cynic may well interpret this flip-flopping legislative history as suggesting a cyclical contrarian sentiment indicator, now pointing to the onset of accelerating inflation -- count us among the cynics.
- **Initially small private account option.** Participants will have the option, but not the mandate, to direct a small portion of their payroll taxes into private investment accounts in which they will have property rights. Of the employee's 6.2% payroll tax, something like one-third to two-thirds would be eligible. It will operate as a conversion of existing payroll taxes, not an add-on above and beyond existing payroll taxes. It is understood that the larger the fraction of payroll taxes that are diverted to private accounts earning market rates of return, the greater will be the benefit to the overall financial stability of the system for a given level of expected benefits. But the scope of the present proposal will be aimed less at saving the world and more at establishing a beachhead for further reform later. It is believed that focus groups show voters favoring private accounts first

and foremost because they establish property rights in future benefits, so even small private accounts are seen as big step in the right direction.

- **Limited investment options.** The **Thrift Savings Plan** of the **federal government** will be the model for the menu of investment options available in Social Security private accounts. TSP offers three stock index funds and a bond index fund run by external managers, and a money market account credited with a blended Treasury rate. This limited and extremely low-cost selection will blunt opponents' charges that private accounts will be excessively risky, or that they would represent a windfall for Wall Street.

- **"Transition costs" will be positioned as "refinancing."** Opponents of reform will harp on so-called "transition costs" -- the intermediate-term borrowing required to replace the revenues diverted into private accounts. The administration will point out that the costs of doing nothing to shore up the demographically bankrupt current system are far greater, and will characterize required borrowing as being like refinancing one's home in order to make necessary improvements.

These broad points will be introduced this week, and after that we believe that the administration will be ready to roll with a fully formed legislative proposal early in 2005 (other key economic agenda items such as so-called "fundamental tax reform" and litigation reform are still, to a large extent, on the drawing board). Getting something as ambitious as Social Security reform with private accounts through **Congress** will be a stretch goal even for a team has racked up a remarkable record of legislative miracles, and even with the **GOP's** expanded majorities in the **Senate** and the **House**. At the moment there is scarcely agreement even among the most enthusiastic supporters of reform. Currently the conservative think tank mafia has gone to the mattresses over the minute differences between their respective pet reform proposals, and the administration can only hope that they'll be able to pull together and support a pragmatic solution when it is put before them. At the same time, it is reported that many GOP legislators are fundamentally unwilling to grasp what they still believe is the "third rail of American politics." And, of course, the **Democratic** minority, the liberal media, and the Wall Street economics establishment can be counted on to actively oppose anything the administration proposes (if you need any economic advice from **Goldman Sachs** over the next several months, you may have to wait on hold a bit while **William C. Dudley** finishes talking to the ***New York Times***). As with the 2003 tax cuts, the key will be for the administration to convert a small number of the opposition in Congress. In the Senate, **Kent Conrad** (D-ND), **Max Baucus** (D-MT), and **Barak Obama** (D-IL) will be likely targets; in the House, **Alan Boyd** (D-FL) and **Harold Ford** (D-TN).

With all these complexities, the administration will be looking to push its Social Security reform proposal fast and hard in 2005, to get it well out of the way before the mid-term elections. Can it possibly succeed? Well, so far no one has made a lot of money betting against the Bush team, even when it's fighting for something -- like the 2003 tax cuts -- that the conventional wisdom had declared dead on arrival. Social Security reform with private accounts is something that Bush genuinely believes in, and will fight for. Third rail be damned -- he campaigned successfully on it in 2000, 2002 and 2004, and he told us in April 2003 that it was his highest economic priority for a hoped-for second term (see "Notes from the West Wing" April 3, 2004). Now he's got something of a mandate, and so this may be another opportunity to bet on a Bush miracle.

We'll discuss the potential payoffs to a bet on this miracle for the economy and the markets in subsequent reports. TM