TrendMacrolytics

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Social Security: Politics and Economics

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The inner financial and political dynamics of Social Security reform, and what they mean for markets.

We have been surprised and disappointed that the **Bush administration** didn't reveal more details about its plans for **Social Security** reform at the **White House** economic conference last week, or in the many media opportunities that have followed it. **President Bush's** evasive and contentless statements about it in yesterday's press conference made it abundantly clear that the administration has, for the moment, hit a big snag in the process of building an internal consensus about how to handle the politically sensitive trade-offs required for reform.

The *cause celebre* of the last 24 hours within the policy community has been the idea that the administration is considering raising the cap on wages to which payroll taxes apply, and indeed administration spokesmen (including the president yesterday) have refused to deny it. Such a step would run deeply counter to administration dogma, and the fact that rumors of it would not be immediately slapped down reflects the unpleasant reality that Social Security reform will, inevitably, involve some gored oxen. It's only a question of which ones. With an actuarial liability to perpetuity in excess of $10 trillion, there is no way that doing nothing but adopting personal accounts will be sufficient to right the system, at least not without taking on politically infeasible levels of explicit debt. Even the most aggressive advocates of personal account solutions who claim that neither benefit cuts nor tax increases will be necessary -- the ones called inside the beltway the "free lunchers" -- underpin their proposals with mandated cuts in non-discretionary federal spending (which are the indirect economic equivalent of a tax increase or benefit cut).

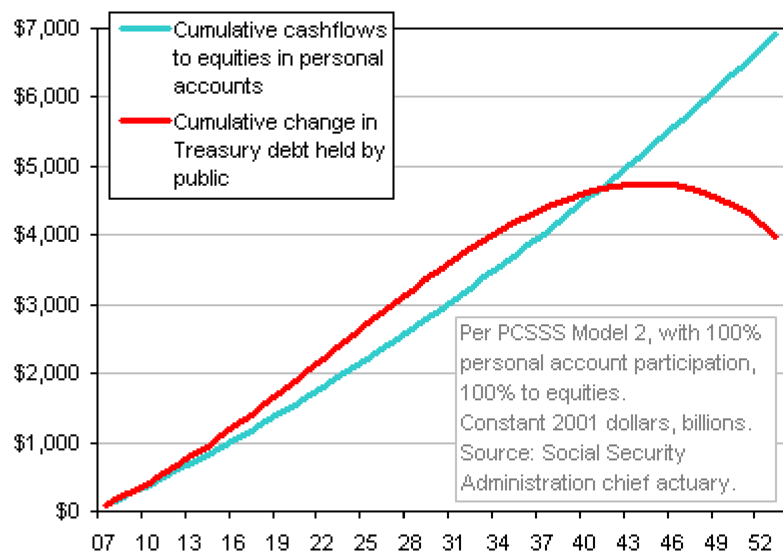
Consider the trade-off dynamics in "Model 2" of the 2001 **President's Commission to Strengthen Social Security**, which, we expect, is pretty much what the administration's eventual proposal will look like. The upside of Model 2 for participants is that it provides for voluntary personal accounts funded by up to 4% out of the 12.4% payroll tax -- but capped at $1,000, meaning that lower earners would obtain a disproportionate advantage. Survivor benefits are increased to the advantage of all, and minimum benefits are increased to the advantage of lower earners. The downside for participants is that lifetime wages used to calculate benefits would indexed to CPI inflation, rather than to wage growth, which would have the effect of considerably reducing benefits to future retirees relative to current law. Considering the entire package of trade-offs, any participant who opts for a personal account -- even if he invests it entirely in Treasury bonds -- comes out ahead versus current law (and remember, current law is unsustainable).

Model 2 restores the Social Security system to permanent fiscal sustainability, completely eliminating today's $10 trillion unfunded liability, according to the chief actuary of the **Social Security Administration**. Government debt issuance would be required to finance the transition in the intermediate term, with a cumulative increase in debt held by the public topping out at $4.72 trillion (in 2001 dollars) in 2041. After that, system surpluses start kicking in, and

that increase in debt is entirely paid down by 2061. After that, continued system surpluses could either fund benefit increases or tax cuts, or be refunded to the **Treasury**.

It is worth noting that the intermediate term increase in debt held by the public under Model 2 is almost entirely due to the adoption of personal accounts, which diverts payroll tax revenues from Social Security's so-called "trust fund." Without personal accounts, maximum intermediate debt is only $19 billion, peaking in 2019. So here is the core of the issue: personal accounts are necessary to generate the returns that make up for net benefit cuts relative to current law, and in turn, debt is necessary to fund personal accounts. As one illustration of how this works, consider the highly publicized proposal of **Peter Ferrara** of the **Institute for Policy Innovation**, which provides for a greater percentage of payroll taxes diverted into personal accounts with no cap, and no benefit cuts. It, too, restores the system to fiscal sustainability -- but requires a cumulative increase in debt held by the public of $26.4 trillion (in 2001 dollars), peaking in 2073 -- unless that debt is reduced by spending cuts exogenous to the Social Security system, as Ferrara calls for.

The inevitable trade-off between personal accounts and debt held by the public holds one important key to understanding the complex way that Social Security reform would affect markets. We believe it will be very positive for stocks, but not entirely in the way that one might assume. It's tempting at first blush to focus on the cash-flows that personal accounts would send into the equity markets. The highest case would be full participation in personal accounts, with 100% allocated to equities -- then $92 billion would come into stocks in the first year, cumulating to over $1 trillion by 2016 and $5 trillion by 2043. But through 2041, that cash-flow would be entirely debt financed. Therefore, all else equal, it would not represent an increase in national savings or capital formation, nor a net change in the national allocation of assets. True savings, investment and capital formation only occur when someone forgoes consumption and, instead, saves the fruits of his production and puts them at risk. Instead, this would be the logical equivalent of a total return swap, stocks for bonds -- a zero-sum paper transaction which would, as such, not have much of a long term effect on valuations, expected returns or interest rates.



But all else would not be equal. First, there is strong reason to think that drawing down Social Security's "trust fund" and assuming new debt to fund the diversion of tax dollars to personal accounts would act as a brake on government spending. **Kent Smetters** of **Wharton** and the **National Bureau of Economic Research** has produced compelling empirical evidence that "trust fund" surpluses have, historically, been treated as what amounts to a federal honey-pot, which has been more than entirely consumed by government spending. Specifically, Smetters has found that, since 1949, "a one-dollar increase in off-budget surpluses is correlated with a roughly $2.76 decrease in on-budget surpluses." In other words, a dollar "saved" in the "trust fund" implies $2.76 spent by government, for a net decrease in national savings of $1.76. To the extent that this runs in reverse in a post-reform world, debt financing of reform could, perversely,

lead to an increase in national savings (without the tax increases that are normally called for by people who usually worry about "national savings").

Second, reform that cured Social Security of its present unfunded liability of $10 trillion would represent a major alleviation of uncertainty about **America's** fiscal future, especially as it offers a template for similar reforms in the even more wretchedly underfunded **Medicare** system. Such an alleviation of uncertainty would engender increased appetite to put both labor and capital at risk in **US** markets, which would lead straightforwardly to higher economic growth rates.

So while we would advise curbing one's enthusiasm at the seemingly juicy prospect of trillions of dollars crowding their way into the equity markets, Social Security reform could nevertheless be quite bullish for stocks and the economy. It remains a big political challenge for the Bush administration, and there will be ample opportunities to get it wrong along the way -- such as, by lifting the wage cap on payroll taxes. Needless to say, we'll be watching carefully. TM