

POLITICAL PULSE

The 3% Finesse

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Bush's misunderstood benefit offset could be the key to enacting personal accounts in Social Security.

A provision of the **White House** plan to reform **Social Security** with personal accounts revealed last week may prove to be a brilliant finesse that will have profound repercussions on the political viability of the initiative. The plan calls for a benefit offset for workers who elect to have personal accounts, under which their future benefits would be reduced by a dollar amount equal to their cumulative account contributions grown at a notional rate of 3% per annum. A benefit offset prevents double-dipping -- that is, a worker cannot both divert payroll tax dollars into a personal account *and* obtain his full benefits as though he had not done so. It is a necessary feature of any reform plan with personal accounts, and was fully described just this way in the 2002 report of the **President's Commission to Strengthen Social Security**. Yet the offset has been widely misreported in the media -- so often and so negatively that one suspects it must be intentional. It has been wrongly described as a "clawback," a "fee," a "margin loan," a "mortgage" and a "benefit cut." We have yet to see it simply called a benefit offset, which is all that it is.

Obviously, from the viewpoint of a worker paying payroll taxes, the benefit offset sets the hurdle rate for personal account performance. Returns above 3% -- approximately the long-run total real return to long-term bonds -- make a personal account a winning proposition. An account that earned the long-run average real total return of equities at 7.2% would be a home run, resulting in benefits far in excess of current law. Returns at precisely 3% would be a breakeven, meaning that a worker could immunize his opportunity risk by investing his personal account entirely in long-term bonds.

What's politically interesting about this particular formulation of the benefit offset concept is that the 3% rate makes it what is known as an "actuarially fair carve-out." This has the property that the offset makes the system whole against the financing costs imposed upon it when a worker diverts his payroll tax money out of the trust fund and into his personal account. In other words: given the benefit offset, personal accounts would have no effect at all on the system's solvency. The current \$10.4 trillion net unfunded liability to an infinite horizon would remain utterly unchanged.

At first blush, when **President Bush** proposed this personal account plan in the State of the Union address -- while leaving to **Congress** the difficult business of benefit adjustments aimed at improving solvency -- it seemed like a bid to play the good cop in a Mutt and Jeff routine. Bush serves the voters the sugar of personal accounts, while Congress delivers the bitter medicine of benefit adjustments. But how could Bush expect Congress to play along with such an unpopular role for itself? Perhaps the truth is that Bush doesn't really expect that Congress will, and doesn't especially want it to.

Bush's strategy may well be, instead, to treat the creation of personal accounts as an end in itself -- and defer solvency issues for another time, and another administration. The **Democrats** have already mis-positioned themselves perfectly for this strategy, having declared that there is no solvency crisis. All the **Republicans** would have to do now is take the Democrats at their word (after regretfully reciting appropriate disclaimers about their own commitment to long-term fiscal responsibility). That would leave solvency-neutral personal accounts as an *a la carte* item on the legislative menu -- and their appeal to young people, the poor, and minorities may just be too great for Democrats to resist. After all, even a risk-averse worker who invests his personal account entirely in long-term bonds -- and thus could expect only the same retirement benefits from Social Security as under current law -- would significantly better his lot by having acquired property rights in his benefits that could be passed on to his loved ones. For African Americans, who have shorter life expectancies than the average American, that's a substantial benefit.

With the opportunity to immunize through investment in bonds, the risk issue comes largely off the table. So what about the matter of the increase in debt held by the public that would arise from the diversion of payroll tax revenues from the trust funds into personal accounts? The benefit offset holds the key to that, too. By being actuarially fair at 3%, it can be easily explained that the present value of any debt required to fund personal accounts in the short term will be *precisely* offset by the present value of future benefit obligations. Without rule changes there would be a *reported* increase in debt, but the markets can be made to understand that new *reported* debt has simply substituted for another *unreported* debt that already existed.

According to White House sources, this kind of outcome would be seen as an important double victory by the administration. In the short term, phasing in the small personal accounts called for in the White House proposal would not interfere with the President's pledge to halve the deficit by 2009 -- a pledge which, from our conversations, it seems the administration is treating as inviolable. And personal accounts will have been established and demonstrated. While they do not immediately impact *solvency*, they nevertheless contribute *stability* to the system's finances by prefunding benefits with real economic resources -- not promises. From that beach-head, the White House believes it will be a short matter of years until there is a demand to allow the investment of larger fractions of the payroll tax in personal accounts. When the fraction gets large enough, the expected returns from personal accounts invested even partially in equities would become so large that whole new solvency solutions begin to present themselves, along the lines suggested by today's most aggressive reform advocates.

Bottom line: By creating valuable strategic options that can be used in a difficult political battle, the White House has raised the likelihood, at the margin, that personal account legislation will be enacted this year. Personal accounts would remove a "wedge" from the economy's asset allocation process, unblocking a clientele of most-efficient marginal investors -- those saving for the very long term -- from investing in equities. Wholly aside from the increased cash-flows into equities that would result, this clientele effect suggests permanently higher equity valuations in the future, all else equal. Even without this prospect for the future, our model shows equities to be extraordinarily undervalued -- almost 40% below fair value. From these levels, positive policy developments could catalyze a major move, while at the same time most potential bad news has apparently already been discounted. **TM**