

## POLITICAL PULSE

### Pyrrhic Victory?

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#### Bush risks throwing away his tax cuts in a gambit to win Social Security reform.

Like a suddenly popular actress who labored in obscurity for years and is momentarily hailed as an "overnight success," inflation has been all the rage in explaining the recent weak patch in the stock market. Last week's surprisingly large jump in core PPI inflation and yesterday's oil spike and the announcement by **South Korea's** central bank that it would diversify its dollar reserves pushed inflation into the headlines just as stocks took a nasty drop. It would be a mistake if the recent concern about inflation were to be laid to rest as suddenly as it arose after this morning's tame CPI report. As readers know well, we've been reporting rising inflation risk for quite some time now -- we've seen it for two years in the steady rise of gold, oil and commodity prices and the steady decline of the dollar, and for the last year in the more than doubling of the rate of core CPI growth. Strange perhaps, but while equity investors may be acting surprised about inflation, it is highly unlikely that equity prices don't already reflect a good measure of awareness of it.

More newsworthy, in our view, and more likely to explain the weakness in stocks that began last week, is the increasing sense of risk to pro-growth tax policy. After **President Bush's** decisive re-election and major gains in **Congress**, it should be a cake-walk to make permanent the 2003 cuts in income, dividend and capital gains taxes. That's the prospect that stocks were celebrating in the fourth quarter of last year. Instead, President Bush has put that prospect at risk by saying last week that he would be open to raising the cap on wages subject to payroll taxes, as part of his initiative to reform **Social Security** with personal accounts. If that was intended to bring **Democrats** running to the negotiating table to talk about reform, it seems not to have worked so far. From what we hear, all it has done is signaled to deficit hawks in the Republican party that it's time to start figuring out how to get a piece of the tax-hike action for *their* pet issue. For stocks, the fourth quarter's hopes are turning into the first quarter's risks.

There were hints of these risks a month ago, and we suggested that they were probably not much to worry about (see ["Policy Paranoia"](#) January 24, 2005). It may very well still be the case that this apparent opening of the Pandora's Box of tax increases is just the storm before the calm that typifies the **Washington** legislative process, especially under this administration (see ["Waiting for the River"](#) January 18, 2005) -- and that everything will turn out just fine. That's still our baseline prediction. But in the meantime, risk is mounting, and equities are reflecting it, even though they come into this episode already significantly undervalued (see ["A Question of Value"](#) February 14, 2005).

Our **White House** contacts seem confused by all this, at best. Some maintain that Bush's reported openness to a hike in the wage cap was, in essence, a blooper -- he was badgered into it in the heat of the moment during a press roundtable, and didn't really mean it. But if that's the case, then why -- after a whole week has passed -- hasn't there been a statement to clarify it? Others maintain that Bush's statement was, as has been widely speculated, an overture to

Democrats -- on the theory that it will be easier to steamroll them once they are at the negotiating table than if they continue to boycott the discussion of reform.

We have also heard from within the White House that raising the wage cap could be a reasonable price to pay for reform with personal accounts. We disagree. As proposed, a worker earning \$100,000 would only be eligible to contribute \$1,000 each year to his personal account. If the wage cap were hiked from the current \$90,000 to \$100,000 (and assuming the hike applied to the entire OASDI tax), then the worker would pay \$620 more in explicit payroll taxes and another \$620 more in implicit payroll taxes paid by his employer. Considering that the worker is effectively paying \$1,240 to make a \$1000 investment -- and additionally, as a personal account holder, he would forgo some regular Social Security benefits, too -- we calculate that he would require a 6.1% lifetime average annual *real* return on his personal account just to break even. The most optimistic view from within the White House on this would be to say that, for the worker who is confident that his account will earn more than 6.1%, this would represent no tax increase at all, but rather a net benefit (after all, the historical real annual return to stocks is 7.2%). And, of course, for workers earning *below* today's cap of \$90,000 in the first place, this would indeed be no tax increase. But the more one earns, and the higher the wage cap is raised, the worse it gets. A worker earning \$110,000 would face a break-even rate of 7.8% if the wage cap were set at \$110,000. It would be 9.0% at \$120,000 and 9.9% at \$130,000. At higher levels, the break-even rate would even further exceed the long-term real historical returns of equities.

What's more, all these numbers assume one has a full working career over which the compounding of returns can overcome the penalty of having to invest more than \$1,000 to earn a return on \$1,000. With only, say, twenty years to invest, even the worker earning just \$100,000 has to exceed the historical return of equities to break even. How many 22 year olds are there making \$100,000?

One White House contact points out correctly that all these numbers are too pessimistic to the extent that a higher wage cap would be accompanied by commensurately higher Social Security benefits (the numbers cited above take account of this). While it's abstractly better to get more benefits than not, there's less here than meets the eye: the progressive nature of the benefit formulas dictates that the present value of the marginal tax burden will virtually always be greater than the present value of the marginal benefit.

At the very best, the idea of raising the wage cap in exchange for personal accounts creates winners and losers. The less money one earns, the younger one is, and the more one values personal accounts, the more a winner one is. The more money one earns, the older one is, and the less one values personal accounts, the more a loser one is. And some consolation in terms of economy-wide growth impact is the fact that a higher wage cap is only an increase in taxes on *marginal* labor earnings for workers whose wages fall in the band above the current \$90,000 cap and below whatever the new higher cap might be -- so disincentives to marginal labor contributions would be limited to *that* population. But for *that* population, the tax rate on marginal income would rise by 12.4 percentage points, effectively more than repealing the Bush tax cuts of 2001 and 2003 -- unless the opportunity to invest in personal accounts were regarded as an overriding benefit. At worst, completely eliminating the wage cap would impose strong marginal disincentives on high-income earners. They would have more dollars subject to the higher tax rate, and the least proportional offset from personal accounts. Risking a slowdown in economic growth with a massive tax-hike like this would not only be foolish fiscal policy, it would be foolish reform: there's no better way to hasten the doom of Social Security than to impair the growth of the economy that supports it.

For all the angst and apparent chaos -- and for how impossible achieving Social Security reform appears right now -- our White House contacts at the center of the reform initiative tell us that they consider themselves to be "ahead of plan" at this point. They act like men on a mission, and they inspire confidence that it can be achieved. We remain cautiously optimistic about reform, and all the positive economic impacts it could entail if done right -- with our biggest caution being the risk that these men on a mission will achieve a Pyrrhic victory. If reform entails tax increases -- or if the process of reform kills the opportunity to make the 2003 tax cuts permanent -- it will have come at too high a price.

**Bottom line:** As risks to the 2003 tax cuts rise, stocks have to give up some of gains of the fourth quarter during which those risks receded. We are still hopeful that a chaotic legislative process can resolve productively, and believe that stocks go into this period of risk already strongly undervalued. Like last year's stock slump ahead of the November election, a prolonged period of heightened policy risks could lead to an equally prolonged period of disappointing equity performance -- but the damage is not likely to be deep from these already undervalued levels, and the potential for positive resolution is strong. 