The Case Against Prefunding Social Security with Equities

Macroeconomic Dangers Without Purpose

Thomas Palley

THOMAS MICHl AND I HAVE RECENTLY ENGAGED IN AN EXCHANGE about how best to provide for social security. Both of us agree that social security is a national treasure that should be fully preserved for current and future generations. Both of us also agree that proposals to fully or partially privatize social security through a system of individual accounts would be a huge mistake. Siphoning off revenues from the trust fund would amplify social security’s financial shortfall, and it would also reduce retirement income security. Individual accounts are exposed to overall stock market price risk, individual investor risk associated with making bad investment choices, longevity risk associated with outliving retirement assets, and inflation risk associated with eroding the real value of assets. None of these risks are present in the existing system.

That said, Michl and I disagree over (1) whether the trust fund

THOMAS PALLEY is director of the Globalization Reform Project at the Open Society Institute.
surplus should be invested in equities, and (2) whether government should run large sustained budget surpluses that should also be invested in equities. Michl favors such equity prefunding. I oppose it. This opposition is based on several reasons, the foremost of which is a Keynesian concern that running large, sustained budget surpluses risks imposing significant deflationary pressures that could raise unemployment and lower growth.

One obvious point of disagreement is the issue of the expected future rate of return on equities. Equity advocates believe that future rates of return on equities will be significantly higher than on bonds, just as they have been in the past. I do not believe this will be the case. The logic is that if equities continue to appreciate as they did in the past, at a rate far faster than profits and the economy are growing, it must follow that equity values are rising relative to profits and national income. This is the stuff of asset price bubbles. Such bubbles are never sustainable, which is why I believe it is not possible to realize the type of equity returns bandied about by supporters of equity investment.

The issue of rate of return is only one point of difference, and in my view the least interesting. Instead, there are more profound differences about how the economy operates, the economic impact of sustained budget surpluses, and whether government needs to own the capital stock to provide for social security. This is where discussion can be constructively focused.

Michl claims that low-interest-rate monetary policy can offset the deflationary impact of the large, sustained budget surpluses needed to build a significant ownership share in the publicly traded capital stock. The experience of the 1930s, and Japan’s recent experience with zero interest rates, strongly suggests otherwise. The current recession also suggests otherwise. The federal funds interest rate has been pushed to 1.25 percent, and fiscal policy has been significantly expansionary, yet economic activity remains fragile. Imagine how much worse the situation might
be if the federal government were instead running large budget surpluses.

This argument is buttressed by considering the national income accounting identity, which states

\[
(1) \ [\text{private saving} - \text{private investment spending}] = [\text{government spending} - \text{taxes}] + [\text{exports} - \text{imports}]
\]

The logic of this identity rests on the fact that for every lender, there must be a borrower. Thus, if the private sector wishes to save more than it spends, then either government must borrow (i.e., run a deficit) or foreigners must borrow (i.e., the United States must run a trade surplus. First, consider the case of a closed economy without international trade. Michl’s proposal that government run a persistent surplus requires the private sector to run a persistent deficit. If the economy is to remain at full employment, there must be a persistent and lasting investment-spending boom. The lesson of the twentieth century and the Keynesian revolution in economics, with its emphasis on entrepreneurial animal spirits, is that such persistent booms do not happen. Historically, the private sector as a whole has been a net saver, and government has run deficits to offset those savings and maintain high levels of economic activity. Having government shift to permanent surplus would run counter to this historical condition, likely entailing high unemployment and economic stagnation. The bottom line is that government spending has provided a steadily expanding stream of autonomous demand that has fueled demand growth. Nor will adding the export sector into the analysis avoid this conclusion. Right now the United States is running a trade deficit equal to 3.6 percent of gross domestic product. It is empirically unlikely that this deficit can be turned into a surplus to fund private saving, and if it did, it would likely plunge the world economy into deep recession.

Beyond affecting aggregate demand, sustained budget sur-
pluses also have financial implications in the form of pay-down of the national debt. Such debt is especially valuable for establishing the benchmark default risk-free interest rate, and its elimination would likely increase financial uncertainty and instability. A second financial feature of sustained government surpluses is that they must be neutrally recycled to the private sector without impacting total spending. Michl believes this end can be accomplished through purchases of publicly traded equities, with the private sector then investing the proceeds in new capital. This is the classical loanable-funds theory of investment, to which there are two objections. First, having government purchase equities from households does not ensure that the purchase proceeds end up in the hands of businesses that invest. Such an assumption rests on a fallacy of aggregation whereby it is assumed that institutional divisions within the private sector do not matter. Second, investment spending must rise to absorb government’s saving, but this leads back to the underlying doubt about capitalist economies’ capacity to grow in a steady, sustained fashion exclusively on the back of private capital accumulation.

In addition to these adverse demand-side implications, large budget surpluses could impose significant adverse supply-side effects. These would depend in part on the way in which the surplus was funded. Least distortionary would be a significant estate tax, since date of death is not an economic choice. More distortionary would be higher income taxes. Moreover, income taxes likely have a more negative aggregate demand impact as they hit households without regard to age or standing of lifecycle consumption plans.

Beyond these concerns is the further problem that having government direct large amounts of money toward purchase of equities could drive up stock prices. In effect, government would operate against its own commercial interest because of its size.
This dilemma leads to the fundamental observation that the reason for buying equities is to increase government’s claim over the national income. But that raises the question of why bother with the risky, expensive process of buying the capital stock when government can accomplish this <<need noun, not clear what “this” refers to>> by marginally increasing upper income tax rates.

In an important regard, this observation resonates with the “third way” debate over “nationalization.” Third-way supporters maintain that nationalization is needed only in rare circumstances, since most of the time government can realize its public policy goals through appropriate use of regulation and taxation. The same holds for social security’s small financial shortfall. What is the point of running large, risky budget surpluses to purchase the nation’s capital stock to cover this shortfall when the tax system can accomplish the same outcome far more easily as and when the shortfall arises?

A Possible Reconciliation?

On rereading Michl’s two articles, I now detect two distinct policy issues. The first is the problem of social security’s financial shortfall. The second is the possibility of using social security as a vehicle for significant redistribution of wealth. If redistribution of “ownership” is the explicit goal per se, then it necessarily calls for government accumulation of financial assets. However, in this case, I would argue that the rules of accumulation be structured as follows:

1. Government purchase of assets should be financed through the estate tax—thereby minimizing negative aggregate demand and incentive impacts.
2. The proceeds of the estate tax should be paid directly to the Social Security Trust Fund.
3. The trust fund should be managed at arm’s length from the government and have the authority to accumulate the full range of assets, including equities, private-sector bonds, government bonds, real estate, and foreign assets.

4. Over time, income from accumulated investments could be used to gradually augment social security payments or to reduce the payroll tax rate.

5. The federal government should be free to continue running budget deficits on its own account—currently referred to as the “on-budget.”

This arrangement has several advantages. First, linking the estate tax to social security provides a powerful political justification for the estate tax. Second, reliance on the estate tax minimizes deflationary dangers, and this advantage is reinforced by allowing government to continue running budget deficits. Third, the proposal allows for a reduction in the regressive payroll tax while maintaining social security income. In this it fits with my own proposal (Palley 2002). Fourth, and finally, it allows for expansionary fiscal policy and continued supplies of government bonds. The former can offset any deflationary impact from increased social security saving, while the latter enables government bonds to continue performing their valuable function in financial markets.

However, even with these features, there remains the fundamental question of why bother with a risky, controversial, expensive purchase of the nation’s capital stock. Instead, government could simply raise the estate tax, dedicate the revenue to social security, and use the resulting surplus to permanently reduce or rebate the payroll tax. This approach would effect a relatively more rapid redistribution of income than gradual nationalization of equities. Wealth is only of value because it yields claims on resources and income. This is the fun-
fundamental insight of Milton Friedman’s (1956) notion of “permanent income,” and it is an insight that progressives have yet to appreciate. The ultimate policy goal of a redistribution of income, which is tantamount to a redistribution of wealth, can be accomplished without buying up the nation’s capital stock.

For Further Reading


