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The Ultimate Odd-Lotters?

Social Security is a pay-as-you-go system. "Reserving" budget surpluses to support the system is a fantasy, and the spurious notion that Social Security taxes are contributions toward the retirement benefits of each worker is ricocheting against the politicians that have promoted it for so long. Current workers will receive negligible returns, particularly in comparison to private investments. The "solution" of government-directed investments in private enterprises is a very bad idea for many reasons. What is needed is a forthright acknowledgment that Social Security is an income transfer program.

In its *Mid-Session Review*, the Office of Management and Budget (OMB) estimated that the Federal budget will be in surplus by $39 billion during the current fiscal year, ending this September 30th. As recently as last February, the OMB projected a deficit of $10 billion. This improvement mainly reflected better than expected economic growth, and the OMB's revised outlook calls for a surplus of $54 billion in fiscal 1999, and increasingly large annual surpluses thereafter. According to the OMB, these will total about $1.8 trillion over the next 10 years, with about half of this total to be realized in the years 2006, 2007, and 2008.

The notion that the National Debt will be $1.8 trillion lower 10 years hence is, of course, a fantasy. The OMB projection assumes not only that there will be no recessions during the next 10 years, but also that the politicians will neither find some "unmet needs" to spend money on nor cut taxes.

None of these seems very probable, but it is not at all unusual for the budgeteers' projections for periods far in the future to be highly optimistic. What is unusual is the OMB's description of its projected surpluses as "Reserved Pending Social Security Reform."

Say What?

The OMB's posturing is just that. There is no mechanism in place for "reserving" surpluses. A surplus is a surplus — the amount by which current receipts exceed current outlays. The language presumably reflects President Clinton's repeated assertion, first given in his State of the Union speech last January, that "I propose that we reserve 100 percent of the surplus — that's every penny of any surplus — until we have taken all the measures necessary to strengthen the Social Security system for the 21st century." The difficult choices needed to "fix" Social Security will clearly offend some voters, while cutting taxes and establishing new spending programs (the politicians' usual response to budget surpluses) are time-tested paths to re-election.

A seldom asked question in this regard is whether the President is simply trying to play the role of a stern parent, telling Congress to "eat your vegetables before you can have dessert," or if running budget surpluses will, in and of themselves, accomplish anything toward improving the outlook for Social Security.

The answer would appear to be mainly "eat your vegetables first." The federal budget surplus or deficit, as commonly discussed and understood, combines 1) the difference between general revenues and general spending and 2) the difference between the revenues that are dedicated for specific purposes and spending on those purposes. The latter are paid into and out of so-called "trust funds." The Social Security trust fund is by far the largest "fund" (others include funds for highways and airports).

The Trust Fund Myth

For most of its history, the Social Security trust fund amounted to little more than a working balance. This is because the system was designed to operate on a pay-as-you-go basis, with benefits to be paid from taxes.

It was only after the last major fix, when the tax rate was increased to its present rate, that receipts began to exceed benefit payments by significant amounts. This was not planned — in 1983, when the tax rate was increased to its current level, the projected levels of price inflation were higher, and projected employment levels were lower than what transpired. The trust fund now totals over $600 billion. However, even that considerable sum is only a small fraction (perhaps 5 percent or so) of what has been estimated as "Social Security wealth," defined as the present value of future benefits payable to retirees and, eventually, to current workers, less the present value of future taxes to be paid by those workers.

The fact is that such "wealth" does not exist in any tangible sense. Even if the trust fund was equal to that definition of social security wealth, so that all currently promised benefits could be paid without any additional tax payments (*i.e.*, so that future taxes would only serve to increase the benefits eventually due to those paying the taxes), the system would still be facing difficulty. This is because, by law, the trust fund is entirely invested in special obligations of the U.S. Treasury. In short, the trust fund does nothing to ensure that future benefits can be paid — accumulating the bonds simply shifted some of the burden of general spending from the general taxpayer to workers paying payroll taxes, and redeeming the bonds will return the burden to the general taxpayer.

Among other things this means that the "crunch" will come, not when the trust funds are expected to be exhausted (now projected to happen in 2032), but when payroll receipts begin to fall short of benefit payments (about 2013), when the baby boomers begin to retire in large numbers. At that time the trust fund's "holdings" will have to be cashed in — meaning that the Treasury will have to use other tax revenue to pay them or, more likely, borrow from the general public.

To return to the question at hand — whether surpluses improve the situation — the answer is "yes, but not much." If there are fewer Treasury obligations in the hands of the public, interest expenses will be a smaller drain on general revenues and it will be easier to sell new

issues to replace the special issues cashed in by the trust fund. At best, however, these advantages will only serve to postpone the real problem: benefits under present law are likely to soar to levels that will strain the Nation's ability to meet them on a pay-as-you-go basis.

Requisites for Reform

Genuine reforms mean addressing not only the future levels of benefits, but also the means of financing them.

There is little doubt that benefit levels will eventually have to be curtailed in some fashion. To date, the only reduction in future benefits that has ever been enacted was to increase the age at which workers can retire with full benefits. Reform proposals have included further increases in that age and a reduction in future cost-of-living increases. It is most unlikely that anyone's monthly benefit check will ever be reduced.

There are sound reasons to believe that the present method of calculating cost-of-living increases has over-compensated beneficiaries for price inflation. There does seem to be considerable logic in postponing the age of retirement, given the marked increase in life expectancy and improvements in health since Social Security was established. There is a limit to this, as some workers, especially those with low incomes, often encounter health problems as they reach their 60s.

More fundamental changes are needed. When he signed the Social Security Act in 1935, President Roosevelt said "We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which gives some measure of protection to the average citizen and his family against the loss of a job and against poverty-ridden old age." We have come a long way from that.

For example, it is estimated that a retiree who has always earned the national average wage, and whose spouse never worked, and whose only retirement income comes from Social Security (tax free), will have 80 percent of his pre-retirement disposable income, with none of the expenses such as commutation, apparel, etc., associated with employment. And people wonder why the U.S. has a low savings rate! With working spouses the rule rather than the exception, the prospective retirement benefits of today's workers are much more than Roosevelt envisioned.

That said, we should also note that Social Security provides a guaranteed lifetime pension, indexed for price inflation, and with provisions for survivors and dependents. It cannot be lost to foolish, or simply unlucky, investments. It is very hard to see how these could be replicated in a private system or financed on a basis that is not pay-as-you-go, *i.e.*, as anything other that a pure government income transfer program. Moreover, given that families are considerably smaller and far less stable than they were even when Roosevelt was President, it is most unlikely that the Nation will ever again do without some system of guaranteed support of its elderly citizens.

Nevertheless, and to repeat, the current levels of benefits under current law are very likely to become unsupportable. Our own proposals in this regard would involve a freeze of benefits that current workers could now claim upon retirement with no further earnings, and the establishment of a minimum benefit to be paid no matter what one's earnings history may have been before the freeze. Current beneficiaries would continue to receive their checks and the amount by which future beneficiaries' benefits would be curtailed would depend on how close they were to retirement. The longer one has before retirement, the more time one will have to accumulate savings to supplement one's Social Security check. Increasing the amounts one could contribute to IRAs and similar tax-deferred savings plans would be helpful in this regard

Eventually, everyone would get the same amount — the minimum benefit (with supplements for dependents and survivors) would become the only benefit. This would provide a "measure of protection...against a poverty-ridden old age" that Roosevelt spoke of.

Financing: Is "Privatization" the Answer?

Our proposal would also involve discarding any pretense that Social Security is somehow a savings and investment program, and acknowledging it to be the income transfer program that it has always been. If individual benefits levels were no longer linked to future earnings, there would be no need for the elaborate bookkeeping by employers and the Social Security Administration.

Accordingly, we have proposed that payroll taxes and the corporate income taxes, which are taxes on the major portions of the value added by employers, be abolished and replaced by a straightforward value added tax. This greatly would simplify the tax code while eliminating its current biases against employment and equity finance. The value added tax would be included in general revenues and retirement benefits would be paid out of general revenues. The trust fund charade would cease. Regrettably, we appear to be alone in advocating such sweeping and fundamental reforms.

Defenders of the current system assert that only small changes in the retirement age and cost-of-living adjustments and a small increase in the payroll tax rate will keep the system going indefinitely. How small these adjustments will need to be depends on the future trends of economic growth, which no one can foresee accurately. We should note that the trends of income, employment, and prices that would be sufficient to do so are very optimistic, but not outlandishly so.

However, in the best of circumstances, a continuation of the current system will imply that future retirees will receive relatively little in comparison to what they have or will have paid in taxes during their working years, and especially in comparison to what current retirees are receiving in relation to what they paid in. The notion that benefits represent some sort of investment return on "contributions" for Social Security is a fantasy that owes widespread currency only to its endless repetition by the politicians, but that fantasy has become a nightmare. This is because, when the prospects for today's workers are expressed in terms of a rate of return, that rate will be negative for high-income workers and only slightly positive for lower paid workers (because the benefit formulas "replace" a higher proportion of low-income workers' wages).

This is a very unattractive prospect, especially in comparison to private investments, especially the stock markets of the past two decades or so (see the accompanying article). As a result many favor a reform that would place some of what workers are forced to give up in taxes in private investments. Some would have the government invest directly in common stocks. Others would mandate that a portion of each worker's earnings be placed in various approved investment funds.

In order to continue to pay promised benefits, most such proposals would necessitate larger deductions from workers paychecks. Not only would this discriminate against those who favor current over future consumption, but it would place enormous investment funds under government control. Can anyone doubt that the politicians would quickly seize on the opportunity to mandate "socially useful" investments (*i.e.*, those that cannot attract anyone with their own money at stake) with these funds? Making the government the Nation's largest investor is an extraordinarily bad idea for this reason alone. In addition, and perhaps more importantly, past performance is no guarantee of future results, as they say in the prospectuses.

Market technicians often follow the activities of odd-lot investors (those with

small portfolios who are presumed to be naive and generally wrong about trends). Readers may recall the hoots of derision when President Ford proposed putting some Social Security funds in the stock market. At the time the market was barely recovering from its worst crash since 1929, and the Dow Jones Industrial Average was below 1,000. Now, after what is arguably the greatest bull market in history, the proposal has received serious consideration among academics and politicians. Go figure. ❑

TRENDS IN THE MARKET VALUE OF STOCKS

The total market value of corporate stocks as a percentage of Gross Domestic Product has increased sharply in recent years. By this and other measures, the value of stocks is exceptionally high.

The recent Wall Street volatility has fueled concerns about whether the stock market is "overvalued." No consensus prevails among professional and individual investors on this. Some believe that current stock prices are justified by underlying economic fundamentals, while others worry that the market has become a speculative bubble that may burst at any time (as in last week's meltdown).

This concern is not limited to investors and money managers. Policymakers want to learn how sharp gains in stock prices affect wealth and consumer spending, what these gains imply about investors' expectations about future price inflation and economic growth, and how they should respond in the event of a "correction" or an all-out bear market. Fed Chairman Alan Greenspan warned in December 1996 of "irrational exuberance" in the stock market, and his subsequent comments indicate that he remains uncertain about why stock prices have increased to their recent levels and whether they can, or should, be sustained.

There is no simple calculus for determining whether common stocks are a "good value." Their market value depends on investors' perceptions about future earnings, productivity, interest rates, price inflation, and many other factors — none of which are readily understood or easily forecast. That is why stock prices can be so volatile from one day to the next.

For the stock market and the broader economy, one measure of relative value is the total market value of corporate stocks expressed as a percentage of Gross Domestic Product (GDP). GDP is the value of all the goods and services sold to final purchasers or acquired as inventory during a given period. It is the most widely used measure of national output, and it provides a common denominator for comparing the market value of stocks across the years. This market value is shown as a percentage of GDP in the accompanying chart (the *lower* of the two plotted lines).

As shown, in 1952 the market value of corporate stocks equaled $173 billion, or 50 percent of GDP. Total market value, interrupted by brief downturns, increased relative to GDP during the 1950s and 1960s. Some of these temporary reversals were followed by recessions. Others were not, including sharp downturns in 1962 and 1966 (although the economy slowed to the point of near-recession following the 1966 downturn). By the end of 1968, stocks were worth slightly more than 100 percent of GDP, or twice their relative value15 years earlier. This postwar peak would not be attained again until 1995, nearly three decades later.

After 1968 stocks plummeted in both absolute terms and as a percentage of GDP, especially during 1973-74. Their value decreased below 50 percent of GDP and remained relatively low for the next 10 years. By the end of 1982 the market value of equities had dropped to 38 percent of GDP, a postwar low.

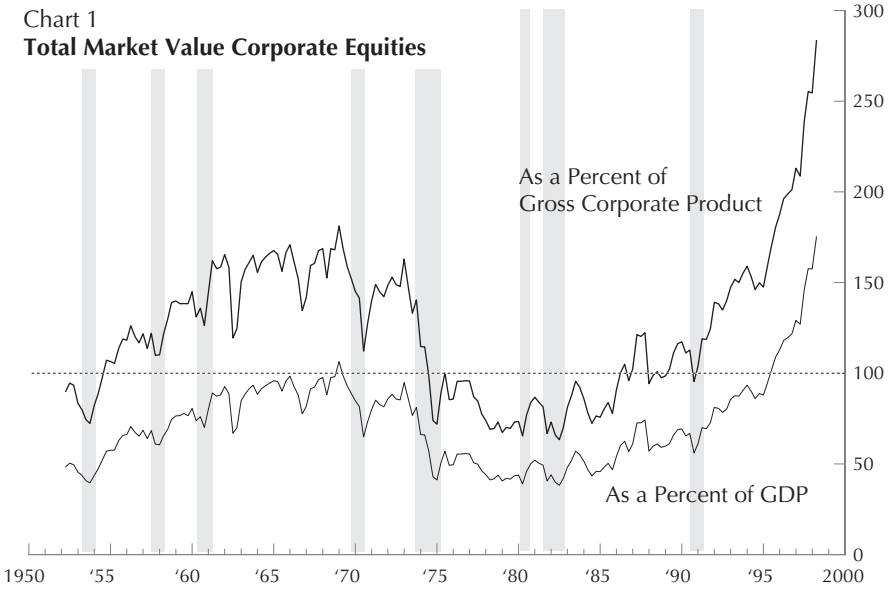
The market value of stocks began to increase again after 1982, when the current bull market began. This upward trend was interrupted by the October 1987 stock market crash and again during the 1990-91 recession. Since the beginning of 1995, the market value of common stocks, as a percentage of GDP, has increased at an extraordinary rate. At the end of the first quarter of 1998, the market value of stocks stood at 175 percent of GDP — twice as high as four years ago. It also is much higher than the previous postwar peak reached in 1968, when the market value of stocks equaled 106 percent of GDP. Clearly, this ratio suggests what most other measures of relative valuation have indicated for some time, namely, that stock valuations are exceptionally high.

On the other hand, the share of GDP produced by the corporate sector has increased during the past 40 years, which in itself might account for a portion of the long-term increase in the value of corporate equities in relation to GDP. Plotted as the upper line in the accompanying chart is the market value of equities as a percentage of gross corporate product, the share of GDP produced by the corporate sector. Between 1960 and 1988, it increased from 56 percent of GDP to nearly 62 percent of GDP.

As can be seen, there is little difference in the trend of this ratio compared to the broader ratio based on GDP (the lower line). The increase in the corporate sector's share of GDP has been slight, and can account for only a scant portion of the long-term rise in the relative value of stocks. Since 1992, for example, the market value of stocks has increased by 119 percent relative to GDP, compared with an increase of 103 percent relative to gross corporate product.

Another possible factor effecting the higher valuation of equities relative to GDP is the growing importance of foreign earnings to U.S. corporations. The value of production by foreign operations of U.S. corporations is not included in the calculation of GDP, but accounts for a substantial share of some companies' output. Exxon, for example, generates more of its revenue and earnings from outside

Chart 1
Total Market Value Corporate Equities



Stock Market Crashes and the Business Cycle

As we noted in a previous discussion of "What Does and Does Not Happen When Stock Markets Crash" (*Research Reports*, January 13, 1997), there have been many episodes when the stock market experienced a marked reversal yet no recession followed (see chart below). As often noted, the leading *index of common stock prices* has "forecast sixteen of the last eight recessions."

The economic fallout from financial crashes seems more closely tied to underlying business conditions. For example, at all but one of the times when the stock market plummeted without an ensuing recession, the Cyclical Score of AIER's Leading Indicators of Business-Cycle Changes stood well above the 50 level that indicates recession. The Dow's plunge last October, when the Cyclical Score stood at 76, had no discernable effect on business activity (and was short-lived).

Rather, it is general economic weakness that has preceded contractions in economic activity — in the absence of which even violent stock market behavior usually has not been followed by broad economic collapse.

Despite their many "false signals," however, stock prices remain a useful leading indicator of business-cycle conditions. Inasmuch as many of the other leaders now also have deteriorated markedly from their cyclical highs, a significant stock market reversal in such circumstances could be reason for greater concern.

the U.S. market than from its domestic operations.

If such output were included in GDP, the market value of stocks in relation to GDP probably would have increased somewhat less. However, there is no reason to think that such an adjustment would significantly change the broad trends indicated in the chart. By virtually any measure, the market value of equities is remarkably high in relation to U.S. economic output.

Some analysts have suggested that exceptionally favorable economic conditions justify these high valuations. As Mr. Greenspan observed last month, "To a considerable extent, investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of earnings growth over the longer term have been undergoing continual upward revision by security analysts since early 1995. These rising expectations have, in turn, driven stock prices sharply higher and credit spreads lower, perhaps in both cases to levels that will be difficult to sustain unless the virtuous cycle continues."

In addition, the aging of the baby boomers almost surely is fueling stock market advances. The oldest baby boomers now are in their fifties, and many are preparing for retirement. To the extent that they are investing retirement funds in financial assets, this inflow into capital markets will pressure stock prices upward. Of course, when the boomers retire and begin to divest, stock prices may be pressured downward. The boomers face one inexorable circumstance: they will be selling their stocks to a smaller generation of savers (the Generation Xers). That is, they could find themselves selling into a weak market. Demographic factors are not, however, necessarily decisive. As with all predictions involving the future, forecasting reliably future retirement rates, savings rates, population growth, etc., is virtually impossible. If, say, the next generation participates in the equities markets to a markedly greater extent that the current generation, the boomers might at some point in their retirements find themselves in a sellers' market. To be sure, the graying of the baby boomers is a significant economic event. But no one knows to what extent it may have affected the bull market of the past 15 years or how much it will affect future market trends.

As Herbert Stein once remarked, a trend that is unsustainable will end. The data in the chart indicate that the total market value of equities was extraordinarily high at the end of the first quarter. At what point this valuation becomes "unsustainable," however, is far from clear. The historical record does not tell us what the "right" valuation is, only that current valuations are exceptional. They could remain so for a long time.

Or not. In recent days the stock market has posted sharp losses, suggesting that the long anticipated "correction" may be underway. As of this writing, the Dow Jones Industrial Average is down by 8.5 percent from its peak in mid-July. The S&P 500 has decreased by 8.9 percent, and the Nasdaq is down by 11.2 percent. It remains to be seen whether this will be a sustained downturn or a temporary one on a par with the downturn that occurred in May and June. In relation to GDP, the total market value of stocks is almost certainly lower now than it was earlier this year, but is still sharply higher than it was a few years ago. ❑

PRICE OF GOLD

	1996	*1997*	*—— 1998 ——*	
	Aug. 8	*Aug. 7*	*Jul. 30*	*Aug. 6*
Final fixing in London	$387.60	$321.00	$290.00	$287.80

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