Economics focus

Debt and dotage
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Should the American government borrow trillions to finance pension reform?

THE rest of the world may be fretting about America's enormous budget deficit; but if George Bush is worried, he hides it well. Along with tax reform (discussed on this page on November 27th), the reform of Social Security, America's public pension system, tops Mr Bush's economic agenda for his second term. The main question so far seems to be how much more America will have to borrow in order to transform Social Security from a tax-financed scheme into one based partly on private accounts.

So far, Mr Bush has set out only his broad principles, not details. Any reform must lead to the creation of individual accounts in which Americans can save for their retirement. It must not cut pension benefits for today's retirees or for those nearing retirement. And it must not lead to higher taxes.

Most proposals focus on allowing employees to divert some of their payroll-tax contributions into private accounts. Because Social Security is a pay-as-you-go system, in which today's payroll taxes (12.4% of earnings, split evenly between employer and employee) pay for today's pensions, any such diversion creates a gap in the government's books, which must be made up somehow—through higher taxes or savings or, most likely, higher debt. What is more, like most rich countries' pension schemes, Social Security promises pension payments that far exceed its likely revenues, by around $4 trillion, in present-value terms, over the next 75 years.

On December 6th a White House spokesman confirmed that Mr Bush's plans would indeed mean more borrowing. How much more depends on the details. At the modest end of the current proposals is an idea put forward in 2001 by the Commission to Strengthen Social Security, which Mr Bush appointed. This would allow individuals to switch four percentage points of their payroll-tax contributions, up to a maximum of $1,000, into individual accounts. Their promised benefits from Social Security would be cut, though by less than the amount of diverted revenue plus interest. To plug the long-term hole in Social Security's finances, promised benefits would be cut for everyone. Extra borrowing of $1.5 trillion-2 trillion over the next decade would be required, but the state pension programme's unfunded liabilities would eventually be wiped out.

Some conservative Republican Congressmen are pushing a more dramatic idea. They would like to divert up to half of payroll-tax contributions to individual accounts. Some of them would guarantee that total benefits (ie, public plus private) would not be cut, and would rely on spending cuts elsewhere in the budget, high investment returns and tax revenue from higher economic growth to make the numbers add up. Meanwhile, the government would have to borrow much more than under the commission's plan: $5 trillion over the next decade alone. By way of comparison, America now has $4.3 trillion of government debt outstanding.
All this new debt sounds frightening, but advocates of reform say that borrowing now will help stave off problems in the future. If Americans have individual accounts and therefore receive less from the state when they retire, Social Security's future liabilities will be reduced. It is worth borrowing now and paying interest in order to bring this about. To make this purpose clear, Republican lawmakers want borrowing related to Social Security not to be counted in the government's normal accounts.

Opponents are aghast. Big increases in borrowing, they fear, will widen America's already gaping budget and current-account deficits and push interest rates up. Trying to hide the profligacy by fiddling the government accounts (one or two critics have muttered "Enron") will fool no one.

Who is right? In theory, creating private accounts need not make the hole in the government's finances bigger than it already is. The government is merely reducing its implicit future liabilities and increasing its explicit current liabilities. If financial markets are efficient, they should spot this and ought not to demand higher interest payments on government bonds. The current-account deficit (the difference between national spending and national income) need not widen because national saving would be unaffected by the reform. Although the government would be borrowing more to make up for the money diverted into individual accounts, private saving would rise by exactly the same amount.

**Promises and commitments**

In practice, the macroeconomic consequences might be less benign. First, it is not clear that financial markets will treat explicit government debt in the same way as implicit future promises to tomorrow's retirees. It is much easier to renege on the latter than to default on the former: Wall Streeters have probably assumed that some of that $4 trillion gap in Social Security will not be filled in any case.

Second, it is hard to be sure about the effect of debt-financed reform on national saving. It is possible that saving might rise, if the very existence of private accounts encourages low-saving Americans to take responsibility for their retirement and put aside more money. It is also possible that Americans might save less, if they believe that individual accounts are a more reliable means of support in old age than the existing system.

In any event, the creation of private accounts will not in itself eliminate the unfunded liabilities implicit in today's pension system. That, however, is what the politically alluring proposals from some Republicans in Congress seem to assume. But as Gregory Mankiw, head of Mr Bush's Council of Economic Advisers, said recently, there is no free lunch: if the sums are to tally, and if higher taxes are off limits, benefits will have to be cut. The question is whether Mr Mankiw's boss will listen.