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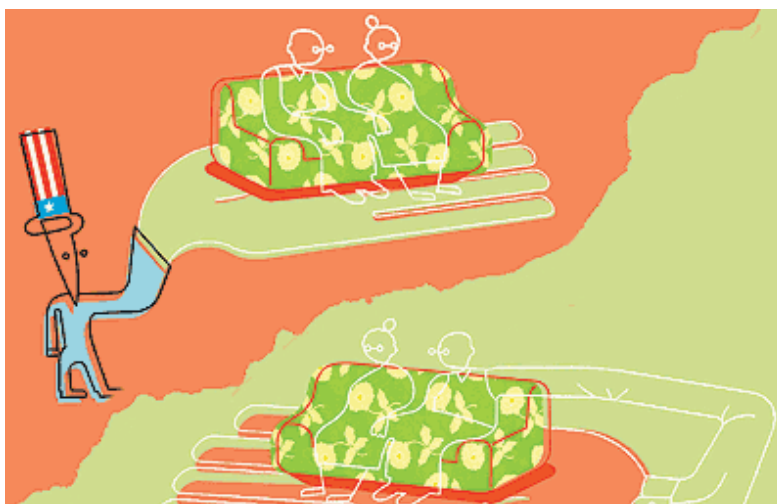
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Reshaping Social Security and the budget

Escaping the shadow of a reckless past

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Will George Bush's economic policy be more prudent in his second term than it was in his first?

LISTEN to the president talking about economic policy nowadays, and it is easy to forget that his first term was the most fiscally reckless in decades. The man who presided over the biggest spending increases since the 1960s is touting his new budget as the "most disciplined proposal since Ronald Reagan". The man who has never vetoed a spending bill boasts about cutting 150 federal programmes. The man who signed an extraordinarily expensive give-away to the elderly is now bent on sorting out the Social Security system.

Has the profligate president seen the light? George Bush's budget and his pensions plan suggest different answers. The budget is not as tough as the president is making out: for instance, his proposal manages to halve the deficit by 2009 only with the help of some dodgy accounting, such as leaving out estimates for the cost of fighting in Iraq and Afghanistan. But with Social Security, Mr Bush seems genuinely committed to sorting out the system's long-term finances. Yet he faces an uphill political struggle to get it through Congress, one made more difficult by the fiscal recklessness of his first term.

Certainly, the new focus on deficit reduction is overdue. At 3.6% of GDP in 2004 and perhaps the same again in 2005, the budget deficit is exacerbating the country's reliance on foreign borrowing

and worsening broader global imbalances.

Halving that deficit over four years, as Mr Bush vows to do, would be a good start, but the real problem lies beyond that time-frame. As Kent Smetters, a former Bush Treasury official now at the Wharton School, points out, the first-term tax cuts and spending decisions have worsened America's long-term fiscal imbalance by three times more than the pensions shortfall that the president is so worried about.

This budget may well make the longer-term mess worse. Mr Bush remains committed not only to making his existing tax cuts permanent (technically the 2001 and 2003 tax cuts expire by the end of 2010) but also to pushing yet more new ones. For instance, the budget wants to introduce special tax-sheltered accounts—"lifetime saving accounts"—that would in effect eliminate the taxation of saving for most Americans. That might be a laudable goal, but it could eventually cost 0.3% of GDP each year.

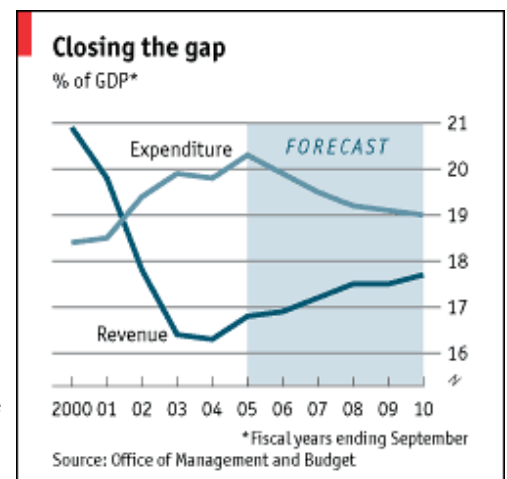
Both the extension of the existing tax cuts and Mr Bush's new proposals have a modest effect over the next five years, but a big one thereafter. Budget watchers at the Centre on Budget and Policy Priorities, a liberal think-tank, reckon that the tax cuts proposed in Mr Bush's budget would worsen America's fiscal outlook between 2010 and 2019 by \$3.3 trillion.

The new tax proposals are unlikely to pass: Mr Bush tried the savings accounts last year—and they got nowhere. But it is hard to work out why a president who wants to overhaul the tax system is proposing more wheezes in advance of such an overhaul. And the budget also excludes tax cuts that are almost certain to occur over the next five years. Include a fix to the Alternative Minimum Tax, which will otherwise clobber almost 30m people by 2010, and even the modest goal of halving the deficit by 2009 becomes elusive.

If Mr Bush's determination to cut taxes come what may seems unchanged, his control of spending is not as draconian as he claims. His budget promises that discretionary spending—the money that Congress appropriates on an annual basis—will rise by less than the rate of inflation over the next five years. To make room for increases in defence and homeland security spending, other domestic spending will be frozen in nominal terms.

Unfortunately, Mr Bush has laid out how to do this only for 2006 (after then he offers no breakdown by department or programme). In 2006, defence spending is scheduled to rise by 5% and homeland security spending by 3% while other programmes are to be cut by 1%. The pain is spread widely, from the elimination of rail subsidies to reducing the myriad of community development programmes.

Congress will howl about this, but many of these things are ripe for the chopping block. Indeed, some conservatives are whingeing that Mr Bush is still throwing money at his pet priorities, such as community health centres. But the real point is that even if Mr Bush was more savage, it would barely change the long-term fiscal picture: domestic discretionary spending outside defence makes up less than 20% of federal spending.



Real restraint means tackling the "mandatory" spending programmes, from farm subsidies to Medicare, whose cost rises automatically from year to year. Mr Bush has made an effort: he wants to cut mandatory spending by \$137 billion over ten years, with the biggest cuts (\$60 billion) coming in federal contributions to Medicaid, the state-run health plan for the poor. He also proposes to cut farm subsidies by \$8 billion, to the fury of Republican senators from farm states.

All good stuff, but in the end the only way to reduce mandatory spending is to reshape the two big entitlement programmes for old people: Medicare and Social Security. Medicare, the health

programme for the elderly, currently eats up round 2.5% of GDP (or 13% of all budget spending); that is likely to triple over the next five decades. Mr Bush's budget does nothing to stop this and it also shows how much damage the Medicare drug-benefit in his first term did. The ten-year cost from 2006, when the benefit kicks in, will be around \$1 trillion.

Social Security first

The only justification for excluding Medicare cuts from the budget chopping block is a political one. Mr Bush wants to throw his energy at Social Security. Here there is also an enormous mess—a projected hole of \$3.7 trillion over the next 75 years. Getting pensions reform through would not only be a big fiscal achievement. It might open the door to later reform of Medicare.

And Mr Bush's approach to Social Security reform looks sensible. Although the centrepiece of his proposal is to allow people to divert four percentage points of their payroll taxes from Social Security into individual accounts, he does not pretend (unlike many conservative ideologues) that these accounts will by themselves solve the hole in the system's finances. The individual accounts, he argues, must be part of an overall reform to put the plan on a sustainable financial footing. Doing so implies benefit cuts, a higher retirement age, or finding more revenue. The only solution that Mr Bush has rejected outright is a straightforward hike in the payroll tax.

Similarly, the emerging details of the White House's plan for private accounts show a preference for prudence over ideology. This is no give-away to Wall Street. The accounts are relatively modest in size. They are to be managed by the government (with the investments subcontracted to big money managers). And for all the talk about empowering individuals, there will be rules to guard against risky behaviour. Individuals will have limited investment choices. They will not be able to withdraw their money before retirement. At retirement, an individual will have to annuitise enough of his account balance so that his account income (plus his remaining Social Security benefit) keeps him above the poverty line.

Unfortunately, Mr Bush's rather well-thought-out plan is hitting a political brick wall. Democrats are implacably opposed. They accuse Mr Bush of manufacturing a crisis to shred Social Security, and of introducing a system that will hurt the poor. He is playing roulette with people's retirement, as one Democratic senator has it.

Once again, Mr Bush's first-term record, which saw such large tax cuts for the rich, might warrant some suspicion about his motives. But some of the Democrats' complaints look misplaced. Social Security may not be in crisis, but it is better dealt with now than later. And the poorer Americans Democrats claim to represent would benefit from a well-designed retirement system with private accounts.

More worryingly for Mr Bush, Republicans are also nervous. In some cases, the problem is simply cowardice: they are worried about the electoral consequences of dealing with Social Security. But others have more justified qualms about the federal borrowing required upfront to make up for the money diverted away from the system into private accounts—some \$750 billion over the next decade, by the White House's calculations, and rather more in the decades thereafter. Of course, the new accounts would also mean that the government's long-term liabilities went down, but some lawmakers who supported accounts when the budget was in surplus are now worried.

Mr Bush may be able to make some judicious compromises. For instance, he could change the structure of the new accounts to include an add-on component as well as a carve-out; or he could pay for it all with higher tax revenue as well as lower benefits. But his first-term record and his determination for ever more tax cuts have made Social Security reform more difficult—as well as more necessary.

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