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The Council of Economic Advisors Flunks the No Economist Left Behind Test: Response to CEA Memo

Last week the President's Council of Economic Advisors (CEA) issued a memo that responded to the concern that the Social Security Administration's (SSA) projections for stock returns are inconsistent with its projections for economic and profit growth (2-4-05). The basic problem is that the projections assume that stock returns will be roughly the same in the future as they were in the past, 6.5 percent annually, even though real profit growth is projected to be only half as fast in the future, and current price-to-earnings ratios are approximately 50 percent higher than their historic average.

As was first pointed out in a 1997 paper[1], the combination of slow profit growth and high price-to-earnings ratios will make it impossible to get the same returns in the future as in the past, unless price-to-earnings ratios rise to ridiculous levels, or alternatively if stock prices first crash, allowing for higher returns on money invested following the crash.

Given current price-to-earning ratios and the trustees' profit growth projections, the implied real return on stocks is approximately 4.6 percent, approximately 2.0 percentage points below the return assumed by the SSA. This return means that the gross return on a private account held in a mixture of stock and bonds will be close to 4.0 percent, with a net return (after deducting administrative fees) of 3.7 percent. This is not much higher than the 3.0 percent return assumed for government bonds and will not provide any substantial gains to those who hold private accounts, given the clawback formula proposed by the Bush administration.

There is no plausible way to escape this logic. For example, reasonable assumptions on earnings from foreign investment will not substantially raise the rate of profit growth (see Letter to Martin Feldstein, March 15, 1999 [http://www.cepr.net/Social_Security/letter_to_feldstein2.htm]).

The CEA's memo does not even begin to address the real issues on stock returns. It argues that the returns to stock ownership will be 6.5 percent because a 3.5 percentage point premium for holding stock rather than government bonds "is consistent with long-run historical experience." The memo repeats this point, asserting that "stock market

1621 Connecticut Ave., NW Suite 500 Washington, DC 20009
Tel: 202-293-5380 | Fax: 202-588-1356 | www.cepr.net

returns are determined … by the return investors require to bear the risk that comes with equity ownership."

However, investors' desires do not directly generate stock returns. Stock returns must come from either dividends or capital gains.[2] If investors consider the stock return implied by the trustees profit growth projections to be too small, then they would respond by selling stock. This would lead to a fall in the P/E ratio, which would mean that money invested in the stock market *after this plunge* would get a higher rate of return. Of course, no reasonable person would recommend investing in the stock market at present, if they anticipated the crash implied by the CEA's logic.

This point could be clearly demonstrated if the SSA produced projections of stock returns, based on projections of dividend yield and capital gains, which in turn are derived from projections of profit growth and current price to earnings ratios in the stock market. This is exactly what the SSA does in deriving its projections for wage growth, labor force growth, and other key assumptions in the trustees' report. There is no reason why SSA should be any less rigorous in its assumptions on stock returns, if stock investment is to play a role in the program. (Getting these projections was the basic point of the "No Economist Left Behind Social Security Test," [http://www.cepr.net/publications/ss_economist_test.htm]).

Two years ago, the Bush administration persuaded Congress to approve its Medicare prescription drug bill relying on cost projections that it knew to be false at the time. Congress should not again be asked to make decisions on an essential social insurance program based on inaccurate numbers. Congress should refuse to consider any proposal for putting Social Security funds in the stock market until the administration allows the actuaries at SSA to rigorously derive a set of projections of stock return from the profit growth projections used in its analysis of the program.

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[1] Baker, D. 1997. "Saving Social Security With Stocks: The Promises Don't Add Up." Century Foundation. [http://www.tcf.org/4L/4LMain.asp?SubjectID=1&ArticleID=400]

[2] For purposes of analysis, share buybacks can be seen as identical to dividends in giving a portion of corporate profits directly back to shareholders (see Diamond, P. 1999. "What Stock Market Returns to Expect for the Future?" Center for Retirement Research. [http://www.bc.edu/centers/crr/ib_2.shtml]).