

# Separation of Stocks and Stock

By BURTON G. MALKIEL

The most arresting part of President Clinton's State of the Union message was his proposal to shore up the Social Security system. The president is correct in focusing on this challenge.

In 1950 there were 16 taxpaying workers for every retired person in the U.S. Today there are just over three workers per retiree, and the ratio is expected to fall below two during the next century. If Social Security benefits are to be maintained under present arrangements, substantial tax increases will be required on workers and companies—a burden that will discourage employment. Alternatively, other government receipts will be required or large government deficits will reappear. Small wonder that Mr. Clinton has searched for a magic bullet that might painlessly avoid the hard choices.

There are two parts to the president's proposal. The first is to preserve the budget surplus and allocate a substantial proportion to the trust fund. The second is to shore up the system by investing \$700 billion from the trust fund in the stock market over the next 15 years. Presumably by investing in stocks that historically have produced returns considerably above the yield on long-term Treasury bonds, the trust fund would grow more rapidly, and the date when the fund would run out of money would be pushed out much later in the century.

## Unpredictable Consequences

Mr. Clinton's proposal to invest part of the trust fund in equities is the more radical part of his plan. It is a bad idea with unpredictable and probably damaging consequences. Moreover, simply investing a part of the trust fund in stocks will not provide the extra resources to spare us from making hard choices during the next century.

Having the government invest in private securities runs against the principles of free markets and could well interfere with the efficiency of the capital-allocation process. While the government would undoubtedly propose that the funds be given to an independent or private agency that would invest in a very broad equity index of perhaps thousands of securities, such a plan would necessarily increase the allocation of capital to larger companies at the expense of very small entrepreneurial concerns that lack the liquidity to accommodate large government purchases. Many of these smaller start-up companies are responsible for important productivity improvements.

Moreover, such an investment plan would inevitably be politicized. It would be very difficult for the government to balance its desired social goals with an effective investment strategy—for example, to

discourage cigarette smoking while simultaneously investing in tobacco companies. And once pressures for "clean hands" investing are accommodated, where would the process stop? There are many companies engaged directly or involved indirectly in activities that are repugnant to some interest groups.

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How do you decide if investing in companies that do business in China is a good thing, because it helps open the country up, or a bad thing, because it helps a regime with a poor record of civil liberties? How is the government to vote its shares in a world where shareholder activists propose a variety of restraints on corporate management that allegedly promote certain social goals that may be embraced by the government? While safeguards will be proposed to eliminate these dangers, the possibilities for mischief are enormous. It will be impossible fully to insulate investment decisions from politics.

Another problem is that investing a part of the trust fund in equities would lead to a perceived increase in risk and could make the public feel even less secure about receiving benefits. Over the past 16 years we have witnessed a tenfold increase in stock prices. Part of the reason for this increase has been a dramatic change in valuation relationships. The dividend yield for the market has declined from 6% to just over 1%. Price-earnings multiples have risen from less than 10 to almost 30. No one can forecast what stock prices will do at any time in the future, but clearly valuations are stretched and at some point a severe bear market is a possibility.

A sharp decline in stock prices could lead to anxiety among older Americans and undermine public confidence in the Social Security system. There could be pressure to sell off the equities just as their valuations decreased.

Moreover, as Aleksander Radisich has shown, if a fixed portion of Social Security taxes were invested in the stock market, it might not be possible to capture the large risk premium that equities have provided historically. When employment and wages (and as a result Social Security revenues) are high, the stock market is likely to be high. On the other hand, when equity prices are low during recessions, the funds available for investment are also likely to be low. Thus more money will be invested at high stock prices and less when equity valuations are more attractive.

Investing part of the trust fund in equities will simply result in a reallocation of assets between those held in the trust fund and those held by the public and would not raise returns for the nation as a whole. Presumably, the increased demand for stocks would raise prices and lower future returns while the smaller demand for Treasury securities would lower bond prices and increase yields. But higher Treasury yields would raise federal interest costs and tend to increase the non-Social Security deficit and ultimately the burden on taxpayers.

## Fundamental Issue

Mr. Clinton's proposal misses the fundamental issue concerning the provision of retirement benefits. The nation's ability to provide benefits to older Americans in 2025 will depend not on how we invest the trust fund today, but rather on what the size of the national income will be in that year. That is, the government's ability to pay benefits in 2025 will depend upon the nation's capacity to produce goods and services then.

Changing the allocation of trust fund investments will not add to national savings or private investment and will not increase the country's future productive capacity. To be sure, the increased national savings that could result from smaller government deficits or larger surpluses may well increase private investment and with it the future growth rate of output. But having the government allocate today's trust fund to purchase equities rather than government bonds won't increase future output, nor will it save us from making tough choices in the future.



*Wall Street should say, 'No, thanks.'*

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