The Daily Dish

Financial Engineering and the Fiscal Mess

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Regular readers of Eakinomics know that the United States has a fiscal mess on its hands – high federal debt and large projected deficits that are simply unsustainable. At present, the federal budget simply does not add up and it will get worse. The key question is *how* will the United States make it add up? Higher growth in taxes? Slower growth in benefits and other spending? Both?

Some will say: none of the above. As sure as the sun comes up in the East, they will argue that the United States can invest its way out of the problem. A little clever financial engineering and…poof! The problem is easily solved without those horrible eat-your-spinach tax and spending approaches.

The financial-engineering-as-magic approach usually features investing in equities. Unfortunately, if you aren't going to touch taxes or spending the only way to get the funds to invest is to borrow. That is, the first step is to make the problem worse, perhaps even *much* worse. But don't worry, the advocates will say, the historical return on equities is higher than the interest cost on Treasury borrowing. The borrowing will easily be repaid and there will still be a surplus return to solve the budget problem.

The flaw in this reasoning is that the expected equity return is higher to compensate for the fact that the return is much, much riskier. So, in the end, the financial engineering approach is to make the problem much worse and then gamble one's way out of the financial hole.

A great analysis of this kind of strategy is in a recent paper from the Center for Retirement Research at Boston College. It analyzes a Social Security proposal by Senators Cassidy and Kaine:

> *…the Cassidy-Kaine proposal, which involves creating a separate investment fund*

> *through $1.5 trillion in debt, investing it in equities, letting it grow for 75 years, and borrowing an additional $25.1 trillion to pay benefit gaps in the meantime, producing a total of $26.6 trillion in new borrowing. At the end of 75 years, the fund will pay the Treasury back and use any additional assets to reduce the debt accrued over the 75 years.*

The paper then uses stochastic simulation techniques to examine the outcomes.

Even under aggressive assumptions about the expected return on equities for the next 75 years – 6.5 percent after inflation – it turns out that in 64 out of 100 outcomes the investment fund will not earn enough to pay back all the borrowing. If one assumes a more reasonable 4.0 percent expected real return, the plan would work only 17 out of 100 times.

Yes, the financial engineering strategy is easier. But the most likely outcome will be to make a bad problem worse. The same reasoning would argue for not touching the brakes as one drives off a cliff. Because it's easier! No thanks.