FiduciaryVest, LLC
Investment Strategies for Fiduciaries

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The Biggest Game in Town: The Social Security Pea May Be Under More Than One Shell

Summary
This article will attempt to find the realities behind the thicket of hard political positions that currently surround the future funding of retirement payments from the Social Security System ("Old Age Benefits," in the antique lingo of the System's legislative history).

Conclusion 1: Despite the see-no-problem talking points agenda of many members of Congress and the purportedly non-partisan AARP, there is in fact a hungry financial elephant in the US living room that could eat, for breakfast, the most creative budgetary maneuvers the US Congress might attempt to pull off since its Great Savings & Loan Cleanup in the 1980s. The burgeoning Social Security funding challenge has deep social and economic implications that are truly long term. But, as this article will purport ***, the tipping-point is disturbingly close at hand.***

Conclusion 2: The System's financial status is far worse than anyone, including the President is talking about. The reason is that the System's reports to the public portray well over one trillion dollars of "assets" in the System's "trust fund," but despite the accounting, ***there are no Social Security trust fund investments that can be liquidated to pay benefits****. About 12 years from now, the System's tax collections will commence being less than its then-current benefit payouts. If the System's trust fund actually did hold marketable investments (as do all but a small fraction of private and governmental pension plans), 2017 would be the point when those investments would simply begin to be converted into cash.*

Conclusion 3: President Bush's proposal would allow, but not require younger-aged workers to set up private accounts for funding a portion of their future Social Security benefits. While controversial, the private accounts concept is at least a rational element in what will necessarily become a mosaic solution. But, ***in order for private accounts to form a part of that solution, there must be a flip side: benefit offsets*** *in proportion to the amount of an individual's payroll taxes that are directed into his/her private account. And, in addition to creating optional private accounts paired with benefit offsets****, the System's retirement age must be ratcheted up now, and periodically, to reflect extending life expectancies.***

Conclusion 4: The Bush proposal would require that separate accounts be locked away until retirement age. There will be no withdrawals for personal financial emergencies, regardless of dire-ness. Since private accounts will only be available to younger workers, their investments will, by definition, be long term. Given that premise, we turn to a well documented fact of investing: ***a static, well diversified portfolio of publicly traded US stocks held over periods longer than 5 years can be expected to grow at an average annual rate in the neighborhood of 11 percent.*** *While there can be no guarantee for this expectation, it is not founded on inscrutable magic. Nor does it involve skill, timing, or luck. And with even greater certainty, such a stock portfolio held over, say 10, 20, or 30 working years, will predictably trounce the return of US Treasury interest rates being credited to the Social Security System's bookkeeping assets. However, in order to protect private accounts from near-retirement-age downswings in market value, a mandatory pre-retirement safeguard should be added to the Bush proposal:* ***automatic, gradual cutback of a private account's stock market exposure, so that, say five years before reaching retirement age,*** *a person's private account*

would be reduced to a zero, or a minimal allocation to stocks from that point forward. (At retirement age, the private account's current value is automatically converted into a monthly-payout annuity that will continue until death.)

I. Problem or No Problem?

Depending on the source of information about the US's national retirement system that we call Social Security, it either: (a) is headed for bankruptcy, or (b) ain't broke and doesn't need fixing. By reflection then, the System is also either the world's largest and longest running Ponzi scheme, or it is a warm and fuzzy social safety net that has provided compassionate economic hope for many millions of Americans. Actually, it is all of the above, and its impact is so significant that everyone might ask how it can be all of those things at once.

To his credit, President Bush pushed the issue to the top of the pile, almost before the Electoral College had met in December 2004 to officially make him a lame duck. In reality, there is so much political dynamite set for detonation upon those who might simply discuss this subject, only a president who walks like a duck could even hope to put it on the Washington agenda. The Social Security campaign is predictably taking on the same characteristics as our leap-year national elections do. The key is to control the debate, so that your side's communications become rational facts, which has the calculated effect of turning the opposition's position into wrong-headed mush. We have established a win/lose format for every discussion that has made the well-worn term "bi-partisan solution" an oxymoron.

Current war-camps divide along the following lines:

(1) Citing the Social Security System actuary's 75-year forecasts, using a middle-of-the-road set of assumptions, the President focuses on adopting a new financing scheme that is designed to prevent the System from plunging into negative cash flows about 11 years from now and, in turn, avoiding the System actuaries' predicted "bankruptcy" less than 40 years hence.

(2) The opposition's camp seems to be divided among a couple of different viewpoints: (a) There is no crisis. Not now, not likely ever. The System's actuaries, according to this point of view, are using assumptions about the nation's expected long range rate of economic growth that are draconian, compared to any credible long periods in our history....not a minor point. All forecasts, especially ones that presume to predict 30 years into the future, are hostage to the realism of their input assumptions. In this case, assumptions about the country's future rate of economic growth have a heavy impact on their forecasted amounts of Social Security tax collections. Viewpoint (b) holds that the US government cannot afford to tack on another trillion dollars of debt (give or take a few hundred billion) in order to cover the "transition cost" of the President's plan, because such new debt would balloon the annual operating deficits to proverbial stratospheric levels.

As usual, whenever political stakes are firmly planted into the Washington soil, all three positions have a nucleus that can be defended as rational, plus plenty of room to accommodate opponents who cannot manage to be rational.

So, who cares (and who should)?

We viewed a C-SPAN broadcast of a Maryland Democrat's 2005 town meeting with his constituents on the subject of Social Security reform. The audience was a veritable sea of white hair that framed concerned and angry faces. Their comments reflected what was visible in those faces. The Congressman played his stage to the hilt, managing not to mention that this particular audience was visibly ineligible for any aspect of the President's proposed Social Security changes. Apparently, similar town meetings are occurring in Congressional districts all across the country, with similar results. On the other side, repeated surveys of 20- and 30-something workers shows that their age group has mentally written off Social Security benefits from their financial expectations.

Bankrupt, or doing just fine?

If Mr. Bush's information source, the System's actuary, is not in fact producing unrealistically low economic growth forecasts, then the President is on a proper path by insisting that change must be fairly dramatic and that we had better get on with making it soon, or else risk facing the task of turning the proverbial Queen Mary on a dime. But there is also exaggeration by the President's team. Suppose the System's actuary is dead right about every assumption; even so, the System will never actually reach a point when its final crying dime of benefits is paid out (in 2042). Instead, while it is true that the System's "trust fund" may by then be empty ("bankrupt," according to the President), the government will still be raking in mega-Social Security tax revenues and paying it all out to retirees. Rather than grinding to a halt under this scenario, the System's trust fund will instead simply be under-funded by its dedicated Social Security tax revenues.

Actually, it's worse than they are saying

The looming tax shortfall is far more immediate than the President is talking about (2042). Why? Let's convert government bookkeeping into cash flow facts that anyone running a business or a household would have to deal with, in order to survive financially:

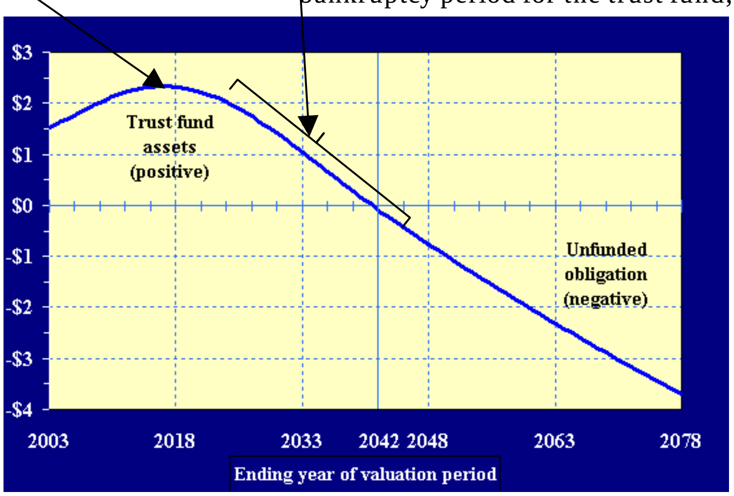
- Social Security's trust fund books right now show more than *$1,500,000,000*,000 of "assets." But, trust fund "assets" are in the form of special US Treasury IOU paper that cannot be bought and sold in the bond market. By contrast, the Treasury raises cash for funding its budget deficits by selling Treasury notes and bonds to marketplace investors.
- Monthly Social Security benefits must be paid with hard cash.
- For most of the years of its history, Social Security taxes have been greater than benefits and expenses paid out. For the next 12 years, the System's net cash flows will continue to be positive, causing the System's books to accumulate more than $2 trillion of IOU assets.
- But, beginning about 2017, the Treasury will have to issue and sell *real* bonds to *real* investors in the marketplace, in order to raise cash, because Social Security's trust fund IOUs are incapable of furnishing that cash.
- The System's funding crisis therefore begins a mere 12 years from now and, after that, without some sort of rescue formula, it will continue to require annual supplements from general tax revenues essentially forever, according to the forecasts.

The simple solution, after 2017: tap the government's general revenues (income taxes, etc.)...as harsh as that may sound, it would be a sort of logical payback to the trust fund for the many years (nearly all of them) when general government expenses exceeded general tax revenues and those deficits were funded in part by draw-downs from the trust fund.

Another solution: the System can sell real bonds to real investors who would demand real interest payments. This would not be a magic bullet, but it would be a way to get the job done off-budget. In order to sell these bonds, the federal government would surely have to guarantee their repayment.

2017 – is when annual Social Security tax collections begin to fall short of benefit payouts, which will force the government to supplement those taxes with other federal taxes or borrowed money, in order to pay full benefits coming due each year thereafter.

2017 to 2042 – is being characterized by the President as a pre-bankruptcy period for the trust fund; actually, after 2017...only 12 years from now, the System can already be called bankrupt (negative cash flows), because the trust fund's "assets" shown to the left of 2042 in this graph cannot be sold to raise cash needed to make up for the System's payroll tax shortfall.



Note: vertical axis measures are in trillions of dollars; source: Social Security Administration

II. Why Is There a Problem?

It is shameful that the Social Security trust fund is the sham that it is. It need not have been. Forty years ago, President Lyndon Johnson, with Congressional approval, but after considerable debate, first put what had been the separately maintained Social Security trust fund “on budget,” in order to reduce the reported amount of federal deficits. Although this practice clearly amounts to sleight of hand....it was tantamount to abandoning Social Security’s trust fund concept.... political support for it since its 1960s introduction has been unanimous among Democrats and Republicans. Such support is understandable. Social Security was then, and remains THE federal cash cow, taking in billions more dollars than it pays out in current benefits and expenses, year after year in very predictable amounts. Clinton-era reported surpluses, except for one year, were actually deficits turned into plus signs, via Social Security’s surplus cash flows.

Federal budgets lump Social Security tax collections together with income tax revenues and all other federal tax collections. Likewise, Social Security benefit payouts are dumped into the expense side of the budget hopper, along with such items as Congressional salaries, money for Iraq and traditional pork projects.

Despite the fact that the Social Security System collected taxes in excess of its benefit payouts each year, those surpluses were swallowed whole by general government operating expenses. At that same time, *each year’s Social Security surplus cash flow was also being accounted for as a new layer of “assets” on the Social Security trust fund’s books.*

In the table below are the net reported Federal budget deficits [col.(1)] (including four years of surpluses), since the fiscal year that ended September 30, 1991. When we subtract the strongly positive net cash flows of the Social Security System [col. (2)], three of those four surplus years become deficits and, for the years when there were already reported deficits, they were actually much worse when we subtract the money that was counted as on-budget cash flow.

REPORTED VS. REAL DEFICITS

Fiscal Year Ended 9/30	US Gov’t Reported Deficit or (Surplus) [1]	Social Security Net Positive Cash Flow [2]	US Deficit w/o using Social Security Surpluses [1+2]
1991	$ 270	$ 53	**$ 323**
1992	290	51	**341**
1993	255	47	**302**
1994	203	57	**260**
1995	164	60	**224**
1996	108	66	**174**
1997	22	81	**103**
1998	(70)	99	**29**
1999	(124)	125	**1**
2000	(237)	152	**(85)***
2001	(127)	163	**36**
2002	158	159	**317**
2003	374	156	**530**

All amounts in billions of dollars.

*Fiscal year 9-30-2000 was the only year in which there was an actual surplus,
without dipping into the Social Security trust fund.

End in sight

With or without on-budget accounting treatment, the music will stop at approximately 2017, when the System commences decades of benefit payouts that will exceed its tax intake. Between now and 2017 then, the political medicine will simply become more unpalatable with each passing year in which there is no adopted rescue plan. Indeed, the problem will actually compound every year until 2017. Mr. Bush’s team no doubt realizes that only a lame duck president can effectively deal with this problem. The next lame duck presidency, if there is one, cannot possibly occur sooner than 2013, by which time the System’s tidal wave would be almost ashore.

We are not attempting to be cynical here, but the political reality is that we should look for Congress to agree on at least one element, probably just after the elections of 2012, just 7 years from now: they will surely take Social Security off-budget again, as it originally was, only this time the reason will be to sidestep inclusion of the System’s pending cash flow deficits in the annual budget.

Transitional pains

The Bush private accounts plan (supporters predictably use the buzzword “reform”) will in fact require a significant sooner-rather-than-later federal debt increase in order to fund its transition. Every Social Security tax revenue dollar the Bush plan diverts into investment accounts that are owned by taxpayers will create a dollar of additional current federal deficit that must be funded by issuing additional US Treasury debt.

It is not accurate, however, to characterize this debt-issuance as "transition cost" of the Bush plan. In reality, the new debt that will be needed while private accounts are getting up and running will simply represent earlier than expected funding of a portion of the System's gargantuan future obligations that already exist. [NOTE: This pre-funding plan would, for the first time, work the same way as pension funds that are sponsored by corporations, and, for that matter, state and local governments.] As of now, none of the Social Security System's future payout obligations are pre-funded. Even the interest payments on the additional debt that is issued because of private accounts will not represent transition cost, because we may assume that the investment earnings credited to private accounts (thereby increasing the accounts' benefit payout values) will more than offset the interest cost on the new "transition" Treasury debt.

III. The Devil, You Say

The 2005 Bush plan is the same one he purported in the 2000 election campaign (Al Gore's plan at that time was the Social Security lockbox concept). Thus far in the current debate round, Democrats have mostly clung to the don't-fix-what's-not-broken approach. And because Republican Congress-people are not, of course, equipped with the President's lame duck armor, many of them appear to be quite squeamish about openly supporting the President's plan. The essence of Congress-talk is that a bi-partisan lot of them are writing off the notion of private accounts as a Bush-fetish that will deliver nothing to help with funding the System's looming cash shortfall.

As with most hot political potatoes, the details are the battleground. Following the President's State of the Union address, White House aides released a list of implementation details that will be sent over to Capitol Hill, to face the sausage-making process.

- *Older workers cannot set up private accounts:* No one who is currently age 55 or older will be allowed to open a private Social Security investment account.
- *The new program is optional, but won't begin soon:* The new accounts will be completely optional and will be available starting in 2009 (just after the next presidential election); the first wave of eligible people would then be under age 45; the remainder would be made eligible during each of the following two years.
- *Only modest amounts permitted to go into the new accounts:* In the first year (2009), workers will be allowed to divert a maximum of 4 percent of pay, but there is a dollar limit: $1,000. This figure will increase by $100 annual increments that are geared to the nation's wage growth figures.
- *Investments offered will be highly diversified and have limited risk exposure:* The investment options menu will not be numerous and will represent broad market portfolios that are similar to the ones now offered to federal employees in their Thrift Savings Plan (which is essentially identical to the popular 401(k) plans offered to employees of businesses). Workers who want a private account but wish to avoid making investment choices will get a portfolio that is proportioned between the stock market and the bond market according to the accountholder's advancing age.
- *Investment management will not be government-run:* The investment portfolios will be contracted out to private money managers.
- *No early withdrawals and no lump sums:* The Social Security savings accounts cannot be tapped for any reason until the accountholder's retirement age. (In the event of pre-retirement-age death, we presume this limitation will apply to surviving heirs.) At retirement age, the account must be used to purchase an annuity that will guarantee lifetime annual payouts that are at least enough to assure above-poverty-level income. If the account value is higher than the amount needed to purchase the annuity, the remainder can be used in other ways and/or passed on to heirs.
- *Benefits will be reduced to reflect SS taxes diverted to private accounts:* Of course, the Social Security System will continue to provide full benefits for workers who do not opt to open private accounts. Those who do open accounts will also receive a System benefit, because they can only divert a limited

portion of their payroll taxes to the private account. In order to integrate the benefit to be paid by the private account with the remainder-benefit to be paid by Social Security, the reduction formula will be: (a) the amount of tax the worker diverts to the private account, plus (b) 3 percent annually (the expected inflation-adjusted return on government bonds). So, **in order for the private accountholder to come out ahead of not opting to have a private account, his/her account must merely earn an inflation-adjusted compound annual return greater than 3 percent.**

- *Benefit floor protection:* If a person's private account fails to achieve the level of investment return that equals the amount of interest paid on certain government bonds over the years the account has existed, then the retiring worker's Social Security benefit would revert to the amount that would have been paid if no private account had been involved. In effect, then (if we've got this straight), the investment risk created in the private accounts is underwritten by the System, i.e., all of us federal taxpayers.

Instead of, or in addition to, private investment accounts, a fix for Social Security benefit recipients could partially come from among the following overhaul techniques:

- *Tie the Age of Benefits Commencement to National Mortality Studies:* One of the System's big problems over its history is the fact that people have, and apparently will progressively live longer. Hence, they will draw retirement benefits for an increasing number of years, *if their eligibility age remains constant*. So, overhaul-legislation could (and likely will) provide for periodic automatic adjustments to the retirement age a person must reach in order to draw a full benefit. The adjustments would logically be made by the System actuaries to reflect changing national mortality statistics and the adjustment process might operate in much the same way as annual retirement benefit adjustments for inflation are produced now. This modification would not be insignificant. We have noted some estimates that the impact of setting back benefit commencement to allow for advancing life expectancy would eliminate fully one-third of the forecasted long term funding shortfall.
- *Remove the Payroll Tax Cap on Wages:* The so-called wage base on which the Social Security payroll tax is computed has always been capped, though it has increased significantly over the years via indexing. The annual cap now stands at $90,000. Although the high-end of US wage earners would in fact get more benefits as a result of an unlimited taxable wage base, the formula for computing benefits has always accrued a lower amount for this upper tier of a person's lifetime covered wage history, so the additional tax collections on high-end salaries will more than offset the System's additional benefit obligation to those people.
- *Increase the payroll tax rate:* Given the current payroll tax rate, this would not be a sensible course. Predictably, however, it will be one of the avenues chosen by Congress, if/when they get in a real crunch. (Actually, as we have demonstrated above, increased taxes of some sort are required; an unbridled run-up in government debt might be the bailout, but the bond market would not likely tolerate that choice.) Even more predictably, Congress will increase the portion of the payroll tax that applies to employers, but not on employees. Such an approach, though phony, will work politically, so it will likely be included in the Congressional sausage machine. [Our readers may recall we subscribe to the notion that businesses do not pay *any* taxes, but instead they merely collect taxes from customers, i.e., all of us, in proportion to our consumption.]
- *Reduce benefit accruals earned in the future:* Talk about a hot, third political rail...this is it. However, President Bush's private account scheme is, or can actually be a first step. As the proposal stands, those who opt to use private accounts will have to forego the portion of future System benefits that would have accrued from the taxes they divert to their private accounts. Seems to be fair enough....you choose to divert some Social Security taxes into an account; in exchange you agree to a reduced Social Security benefit; the account invests in market assets that can fluctuate in value; over the long term, you expect to earn

investment gains that produce more retirement benefits than the portion of Social Security benefits you gave up; bottom line, although your Social Security benefit is reduced, you have more retirement benefit than someone your age who chose not to set up a private account.

V. FiduciaryVest's Recommendations

(1) *Bag the Plan to Outsource Private Account Investment Options:* White House designers of the private accounts plan have seemingly walked into the jaws of a political trap by proposing that the investment offerings for those private accounts will be managed by private firms (read by political opponents as "Wall Street Fat Cats"). Then again, perhaps the White House has crafted this part of the Administration's proposal as red meat for Congress to publicly skewer and barbeque for the voters back home, while leaving the basic plan in place. As we feel sure Congress will find, the way to avoid both the reality and the appearance of legislation that might line Fat Cats' pockets would be to offer only index funds for use in the private accounts. In addition, because an index fund does not have active, decision-making management, an investment unit set up within the Social Security Administration could operate such funds just as well as anybody on Wall Street and at a very, very low cost per dollar of assets. In addition, the necessary turnover within any index fund is marginal, so the daily trading required to run these eventually gargantuan funds will not likely have noticeable effect on liquidity of the investment markets.

(2) *Keep the investment options simple and limit frequency of switching:* It appears the Administration may be on course to keep the proposed private accounts' investment options in the "basic" categories, including some age-specific "life-cycle" mixtures. That would be good. This program should avoid, as much as possible, creating "have" and "have-not" sub-classes of workers, based on their individual investment savvy. The super-long-term nature of the private accounts will also make it most appropriate to allow only one re-alignment of accumulated account balances and new-money contributions per calendar quarter. Even that infrequent option for switching balances should, we think, be limited to a minimum-maximum percentage range of the private account's overall value, per switch.

(3) *Reduce benefits by more than the amount attributable to the taxes diverted to a private account:* A few years after a presumed successful launch of private accounts, Congress could enact an additional benefit trade-off that would kick-in on some of the retirement benefits that are delivered by a private account, above some threshold level. Although today, there is considerable snorting and pawing in the sand by politicians about the riskiness of using any sort of private investment accounts, the fact is that any 25 to 35-year-old who diverts some tax money into the stock market for the next 35 to 45 years is virtually assured of earning a return that is far in excess of US Government bond interest income over those same years. [If this axiom turns out to be false, then we can rightly assume that all bets will be off...the US economy will have experienced a deep and prolonged decline; in such a scenario (which would have to occur without any historical precedent), today's younger workers would be facing far greater financial straits at retirement age than a piddling comparison between whether their private investment account accumulations have fallen short of whatever they might have gotten from a Social Security System which was already teetering, before the economy tanked so severely.]

The facts and figures presented in this paper were taken from the Social Security Administration's web site and other sources believed to be accurate, but are not guaranteed; FiduciaryVest's interpretations of those facts were developed without prejudice to a particular point of view, pre-conceived conclusion, or partisan position. Disagreement with anything presented in this paper will be welcome. Please send comments to gregg.buckalew@fiduciaryvest.com.