

Reflections on the Current and Future Status of Social Security

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Overview

The purpose of this article is to address several issues pertaining to Social Security such as the viability of the trust fund; whether “benefits will be there” for future generations; whether Social Security recipients are getting their money’s worth; and whether the program should have a stake in the equity market. To put it another way, the aim of these remarks is to highlight some important facts relevant to a number of controversies that arise when discussing this inherently complex program. To set the stage for such a discussion, consider the following observations:

George Bush: “Social Security is the single most important program in government history...For years politicians have dipped into the trust fund to pay for more spending and I will stop it.” [California Speech: May 15, 2000] Of course, President Bush did just the opposite. Thus, the sacrosanct Social Security surplus was not only spent to mask budget deficits but it was effectively consumed many times over by two prolonged wars, a very generous tax cut and a ravenous prescription drug plan that was not funded. Meanwhile, in his memoir, *Decision Points*, the former President says his greatest regret in office was his failure to privatize Social Security!

Rick Perry: To paraphrase Governor Perry, ‘By any measure Social Security is a failure, a monstrous lie and a Ponzi scheme. Moreover, it is probably unconstitutional and should be left to the states’ [*Fed Up! 2010*] Almost a year later, writing in USA today, Perry observed: “By 2037, retirees will only get roughly 76 cents back for every dollar that is put into Social Security unless reforms are implemented. Imagine how long a traditional retirement or investment plan could survive if it projected investors would lose 24% of their money?” Unfortunately, this carefully crafted statement (written for publication) completely garbles the financial situation Social Security recipients will be facing in 2037 -- as will be explained shortly.

Mitt Romney: “Under no circumstances would I say Social Security has been a failure.” [Presidential debate in California] Yet, on the other hand, Romney has stated: “The American people have been effectively defrauded out of their Social Security...For the last thirty years, the surplus has been spent, not on retirement security, but on regular budget items.” [*No Apology 2010*] While it is certainly true that Social Security recipients have been woefully misled about its funding arrangements, as well as its numerous welfare provisions, it is simply not true that they have been “defrauded” or that their surplus payroll taxes have been stolen. Seriously misappropriated, perhaps, but not stolen!

Introduction

Social Security is a mandatory retirement program with benefits largely determined by the size of an individual’s earnings capacity which also dictates the amount of his annual payroll taxes. In addition, the program embodies a number of welfare components combined with some insurance elements such as disability payments and aid to dependent children. In terms of benefits, those who are very poor receive substantially more than their contributions would technically entitle them to while the rich get meaningfully less than they technically deserve. Most notably, in this regard, non-working spouses receive a generous “spousal benefit” with no contribution required to help pay for this award.

Now, without further ado, we'll turn our attention to some of the major issues that pervade the Social Security landscape.

Viability of the Trust Fund

Among the dozens of issues surrounding Social Security, the exact nature and role of the trust fund is probably the most controversial of them all. Thus:

Social Security is on sound financial footing for years to come despite the retirement of the Baby Boomers and the worst economic downturn since the great depression....It is definitely not the cause of the government's long-term deficits since it is prohibited from borrowing and must pay all benefits out of dedicated tax revenues and savings in its trust funds. [Economic Policy Institute; August 2010]

Social Security is not broke. It can sustain its obligations for roughly 40 years according to the Congressional Budget Office, even if nothing is changed. [William Greider; The Nation; February 11, 2009]

Social Security has been running surpluses for the last quarter-century, banking those surpluses in a special account, the so-called trust fund. The program won't have to turn to Congress for help or cut benefits until or unless the trust fund is exhausted, which the program's actuaries don't expect to happen until 2037. [Paul Krugman; The New York Times; August 15, 2010]

Yes, but on the other hand...

As Office of Management and Budget Director Jack Lew wrote in USA Today a few weeks ago, the trust fund is solvent until 2037. This claim is a breathtaking fraud. The pretense is that a flush trust fund will pay retirees for the next 26 years. Lovely, except for one thing: The Social Security trust fund is a fiction. [Charles Krauthammer; The Washington Post; March 10, 2011]

Neither the redemption of trust fund bonds, nor interest paid on those bonds, provides any new net income to the Treasury, which must finance redemptions and interest payments through some combination of increased taxation, reductions in other government spending, or additional borrowing from the public. [Social Security Trustees Report 2009]

There are no stocks or bonds or real estate in the trust fund. It has nothing of real value to draw down. [David Walker, Comptroller General of the U.S. January 21, 2005]

Paradox or Deception?

Insofar as ownership of "worthless" U.S. government bonds/IOU's is concerned, the Social Security Trust Fund is in exactly the same boat as China. Both hold Treasury bonds that can be redeemed for cash backed by the "full faith and credit" of the United States. Unfortunately, however, Uncle Sam has no store of cash on hand set aside for the redemption of these securities. Still, that does not make them useless *to the holder* even though the money originally paid for the bonds (whether by China or with excess Social Security taxes) was spent on diverse government programs as soon as the money went into the Treasury. And, as always, repayment of the bonds by the federal government will have to come either from general tax revenues or the issuance of new debt. Thus, current and future taxpayers (once again) will be on the hook to make good on the government's Social Security commitments as it cashes out the assets/bonds/ IOU's in the trust fund.

Much of the misunderstanding about the true nature of the trust fund's holdings arises for the following reason: To the extent that its securities may be deemed assets for the trust fund they represent an equal sized liability for the U.S. Treasury. Just consider, for example, if the Trust Fund had decided to loan all surplus payroll taxes to Japan or China, or to invest in private U.S. securities. Under these conditions, the trust fund's holdings would indeed be like a pot of gold and their redemption would have no negative impact whatsoever on government finances.

But instead, Congress willfully used the surplus to mask excessive deficit spending from public view. In the final analysis, all that has been accomplished with this maneuver is to put the Federal government ethically on the hook for paying as much in future Social Security benefits (from general tax revenues or new debt) as the government's bookkeepers say the fund is worth. Meanwhile, of course, they could attribute whatever value to the trust fund they like (even multiplying it by a factor of 10) and it would not make the government's job of paying Social Security benefits any easier to accomplish.

So where do things stand? As it turns out, in combination with future payroll taxes, the existence of the trust fund implies that Social Security will most likely pay scheduled benefits for an additional 25 years until 2036. Note however that the U.S. Supreme Court has ruled that Social Security beneficiaries have no legally enforceable right (*Flemming v. Nestor*, 1960) to the scheduled retirement benefits they have been "promised." Still, because of the mythical aura surrounding the Trust Fund, most members of Congress will act *as if* the fund's special issue bonds are as good as cash in the bank. And, of course, in all likelihood Treasury will find the means to redeem them -- but not until new tax revenues have been raised or new government debt has been issued.¹

To sum matters up, while it is clearly hyperbolic to call the entire Social Security program a "monstrous lie," the popular misconception that there is a pot of gold sitting in the trust fund that can provide the U.S. Treasury with the means to pay benefits certainly fits that description.

Outlook for the Younger Generation

Insofar as future generations of Social Security recipients are concerned, the situation is not nearly as bleak as some American youth believe nor as dire as some politicians have claimed in their behalf. Thus, Social Security benefits (rounded) currently range from \$11,000 to \$29,000 per year depending on one's status as a "low, medium, high or maximum" wage earner. Meanwhile for a youth aged 23 today, scheduled benefits in 2055, at age 67, will range between \$19,000 and \$50,000 in real \$2011 -- again as a function of one's earnings status. This represents an ***across the board increase of around 70% in real purchasing power*** for beneficiaries at all levels.

Without Social Security reform, however, it is expected that future Social Security taxes will only cover about 75% of scheduled payouts after 1936. Nonetheless,

under such circumstances, benefits in real \$2011 will be much better than they are for today's retirees. On the other hand, they will not be as meaningful relative to an economy expected to reach \$36 trillion in constant dollars by 2055 versus a \$15 trillion economy today. This outlook is based on the Social Security Administrations "intermediate case," which projects that real GNP (from 2010 through 2085) will grow at about 2.1% per year, compared to a historic growth rate of around 3.5% for long periods in the past.

To summarize, *even without reform* today's youth will receive substantial benefits from Social Security making it woefully misleading to imply they will be left empty handed in 2035, 2050 or 2085.

Is Social Security a Bargain?

Needless to say, this is a horse of a different color. During Social Security's early years beneficiaries made out exceedingly well since lifetime benefits were quite high in relation to lifetime taxes required to obtain them. Meanwhile, in terms of real purchasing power, benefits have grown enormously over the last 50 years although the ratio of benefits to costs has become less favorable. In this regard we have only to consider a few examples (stated in constant \$2011) from a recent study by Eugene Steuerle and Stephanie Rennane of the Urban Institute.

According to the authors, a married couple, both earning an average wage of \$43,500, retiring in 1960 would have received \$259,000 in lifetime benefits in return for only \$36,000 in lifetime taxes—a benefit to tax ratio of 7.2 to 1! However, this same couple retiring in 2010 can expect to receive \$559,000 in benefits after paying \$600,000 in taxes, for only a 93% recovery of their "contributions." Finally, if this couple were to retire in 2030, lifetime benefits will amount to \$721,000 versus \$826,000 in taxes, for an 87% recovery rate. (For purposes of discounting both taxes and benefits to their present value, the model assumes a 2.0% real rate of return – which is par for the course on savings accounts/treasury bills. The model also assumes scheduled benefits are going to be paid in full.)

We next want to look at one of America's rapidly vanishing households comprised of a non-working spouse (e.g., a "stay at home mom") which was quite common when Social Security was introduced in 1935. For such couples a "spousal benefit" (which requires no additional taxes beyond what an unmarried participant must pay) is available. Here, for those earning an average wage and retiring in 2010, we find lifetime benefits of \$452,000 versus taxes of \$300,000. The tax recovery rate is 150%. For those retiring in 2030, the ratio of lifetime benefits of \$583,600 to taxes of \$413,000 is also favorable, with 141% of taxes recovered.

In short, although the above results are somewhat uneven, they are not too bad for a benefit that lasts until death and is fully indexed for inflation. For more affluent individuals who would prefer to invest their savings in the stock market, however, Social Security's returns can look woefully uncompetitive, as will become evident below.

Meanwhile, although Medicare is not our main focus in this article, it is the 800 pound gorilla in the room and warrants some discussion. Not only is Medicare growing more rapidly than Social Security, it has a much larger welfare component embedded in it. Thus, in 2010 Medicare's outlays comprised 3.6% of GDP (or \$528 billion) compared to Social Security's 4.9% (or \$713 billion). Over the 75 year forecast horizon, however, Medicare is projected to grow at a 2.8% compound annual rate versus Social Security's 2.4% rate. In 2085, therefore, Medicare will comprise 6.2% of real GDP while Social Security will be a close second at 6.0% of the total economy.

To determine the benefit to cost ratio for Medicare, we once again rely on Eugene Steuerle and Stephanie Rennane's definitive June 2011 study, *Social Security and Medicare Taxes and Benefits over a Lifetime*. As in the case of Social Security, we'll first look at results for a married couple both earning an average wage. According to the author's findings, such a couple, retiring in 2010, will receive lifetime Medicare benefits in constant dollars of \$351,000 compared to lifetime taxes of \$116,000. This implies a very generous benefit-to-cost ratio of 3 to 1. Although the dollar amounts are greater, the benefit-to-cost ratio is the same for a couple retiring in 2030. Moreover, in both examples, it is clearly inferred that 67% of the benefit is "free," or paid for by others.

In Medicare, as well as Social Security, a "spousal benefit" is provided. Thus, in the case of a one earner couple retiring in 2010, lifetime benefits are an identical \$351,000, but the cost in taxes is half as great, or \$58,000. Thus the benefit-to-cost ratio is doubled to an astonishing 6 to 1, suggesting that fully 84% of the benefit is "free." The same 6 to 1 ratio applies for the one-earner couple that will be retiring in 2030.

Alternative Investments for the Trust Fund

Clearly the Social Security Trust Fund would be worth a good deal more today if in past years part of the surplus had been invested in private third party securities such as corporate bonds and common stocks where rates of return are much better than on government bonds. Moreover, these securities could be redeemed (or sold) in the private capital markets without putting any pressure whatever on federal finances or the national budget.

Of course, this is the way trillions of dollars in pension fund assets are invested including hundreds of public pension funds managed by local and state governments -- as well as a few run by the federal government itself. Consider, for example, the Railroad Retirement System (40% in common stocks) or the Federal Thrift Savings Plan offered to over 2 million government employees and heavily invested in common stocks. Then there is the federally administered Pension Benefit Guaranty Corporation that has about \$55 billion invested with a 45% allocation to stocks.

Moreover, it is probably worth noting that such luminaries as Robert Ball (Commissioner of Social Security under three presidents), Nobel laureates Paul Samuelson and Paul Krugman, as well as the Clinton administration have all proposed investing some of the Social Security Trust Fund in common stocks.² This is due to stock's vastly superior long-term returns over government bonds which are exclusively

held by the Social Security Trust Fund. Thus, based on data compiled by Ibbotson Associates, *common stocks outperformed government bonds by a factor of 30 to 1* from Social Security's inception in 1935 through 2010.

It is worth pointing out that the power, or “magic” of *compound growth* lies at the root of such staggering differences in performance. And it is because of such magic that \$1.00 invested in the S&P 500 stock index at the end of 1925 would have grown to \$2,979 (with dividends reinvested) by the end of 2010, whereas \$1.00 invested in long-term government bonds (with interest reinvested) would have only grown to \$91.³

Where Do We Go From Here?

Recall that under current law excess Social Security payroll taxes can only be invested in government securities. Since that law could easily be changed, a number of observers (as noted above) have recommended direct investment of part of the Social Security Trust Fund in common stocks. Still others have recommended the program be privatized by allowing citizens to invest their Social Security taxes in debt or equity index funds of their choice. Investment returns for participants as a whole under such a system could significantly outperform returns on their Social Security contributions. Nonetheless, there are also some legitimate concerns about how such a system would work.

For example, investment strategies (stocks versus bonds) across participants could vary enormously due to differences in risk tolerances among them. Some might invest only in stocks while others would limit themselves entirely to bonds with the remainder doing everything in between. From this it follows that the range of investment results, intended to put a safety net under retirement, could be staggering. Likewise, performance would vary significantly because of important timing differences spanning the dates that various participants entered and left the market. For example, despite the market's stellar long-term performance (such as an inflation adjusted holding period return of a stunning 1,091% for the 18 years 1982–2000) the market limped in with a dismal holding period return of -38% for the 9 years 1965–1974.

Needless to say, an institution with huge resources, and long-term investment horizons, can handle situations like this. But one has to question who would be available to advise millions of inexperienced investors on how to allocate their assets for “optimal performance” (and at what cost) given the dicey nature of risk and return in the capital markets.

Finally, investors with short term time horizons (such as a pending retirement date) could be whipsawed by the short term vagaries of the market far more than an institution with a longer term, and more flexible, horizon. Thus the market's return fell 22% in 2002 only to shoot up 29% in 2003. Just five years later, in 2008, it tumbled 37% followed by a brisk 27% recovery in 2009. Performance like this can be very disquieting when one's retirement nest egg is at stake. In addition, we have to consider the implications of a large segment of the population withdrawing their payroll taxes from Social Security in order to fund private accounts. In such an event, how would billions in benefits continue to be paid to 45 million existing retirees for whom a private account is out of the question?

An alternative approach to earning better investment returns on Social Security's surplus would be to allow direct investment of part of the trust fund in common stock index funds. As an institution with a 75 year planning horizon, the trust fund would be far better equipped (financially and emotionally) to ride out the vagaries of the stock market. Likewise, direct investment involving only one large fund would clearly be easier to administer than setting up individual private accounts for millions.

Such an approach would have drawbacks as well however. For one thing, it would not allow those who desperately want out of the system in order to manage their own savings and invest in stocks. Another objection is a concern by some that the federal government could not possibly leave private industry alone once it controlled so much of its stock. Since we think one's level of concern about this type of risk is largely due to the ideological tilt of the observer, we will just leave it at that. Still, it may interest some readers to know that Alan Greenspan's strong belief that this risk was a serious one is probably the reason President Clinton's proposal to have the trust fund invest in common stocks got tabled.

Of course, it would be interesting to know how the trust fund's investing directly in the stock market could affect Social Security's finances. Fortunately, in this regard, the Senate's "Special Committee on Aging" examined this question in a report dated May 13, 2010. The committee looked at two alternatives: (1) To gradually invest 15% of Trust Fund assets in equities and (2) To gradually invest 40% of Trust fund assets in equities.

In the 15% model it was assumed that equities would be increased by 1.5% per year for ten years and be maintained at 15% thereafter. In the 40% model it was assumed that equities were phased in at 2.7% per year over 15 years and maintained at 40% thereafter.

Using a rather robust 9.4% nominal rate of return (or a real return of 6.4% after inflation), the committee concluded that the 15% model would reduce Social Security's long-term deficit by 14%, while the 40% model would result in a 25% reduction. Just to be perfectly clear the report also noted that "if one assumes that the investment earns the same as Treasury bonds (2.9% real) there would be no impact on the 75-year deficit."

Despite much in its favor, we expect direct investment of trust fund assets in the stock market is unlikely anytime soon. Recent stock market volatility (as noted above) has given many observers, including President Obama, a serious case of the jitters. As has been pointed out throughout this paper, however, the siren call of the market (based on its spectacular past performance) is very strong. For example, for the 17.5 years, July 1982 to December 1999, the total holding period return on the S&P 500 was an extraordinary 2,261%. Perhaps in reaction to this, the stock market has been virtually flat since 2000 even though corporate earnings have gone up by almost 100%!

As a result, American corporations are now sitting on about \$2 trillion (both here and abroad) in cash reserves. At some point in the future the reinvestment of those

earnings will join forces with the power of compounding to produce the expected result – another bull market. At the very least, therefore, we think certain politicians should stop treating the stock market as though it were a pariah. Thus, it’s almost a certainty that a rejuvenated market will eventually surface, unless the economy and consumer demand have simply stopped growing—indefinitely.

How Much is too Much?

Another question that hangs over these discussions is whether \$1.2 trillion, or 8.2% of GDP, is simply too much money to be spending on the elderly (especially the well-to-do elderly) for two support programs that have significant welfare attributes embedded in them. To turn the question around, however, one might ask whether 8.2% of the nation’s output isn’t a reasonable price for today’s workers to pay for the astonishing economic engine that their parents bequeathed them. Two examples of this generational transfer will serve to make the point, although there are hundreds that would suffice.

The Wright brothers achieved human flight for the first time in 1903. By 1973, just 70 years later, 6 manned flights to the moon had been completed delivering 12 astronauts and a motorized golf cart to the lunar surface. To cite another example, just 43 years after Kitty Hawk, in 1946, ENIAC, the first meaningful digital computer (weighing in at 30 tons!) was programmed to do ballistic research for the U.S. Army. ENIAC was capable of doing *5,000 calculations per second*. Today, 65 years later, we have Deep Blue (best at chess), Watson (best at Jeopardy) and, most telling of all, a super-computer in Japan that can do *8,000,000,000 calculations per second*.

This is the kind of material progress that one generation passes along to the next – not to dismiss the fact that human life expectancy has almost doubled in the last 200 years! So what is the “societal debt” of the most recent generation to the previous one for such a bountiful inheritance? Some have suggested 8.2% of the current year’s GDP, rising to 12.2% in 75 years when the economic pie to be shared will be 5 times as large. Or to put it another way, consider the following:

Social Security and Medicare costs in 2010 were \$1.2 trillion, or 8.2% of GDP, which left \$13.5 trillion on the table to be shared by a population of 315 million. On a per-capita basis this comes down to \$42,857 for spending on all other things—federal, state and local government included.

With no change in scheduled benefits, Social Security and Medicare in 2050 will cost \$4.0 trillion, or 12% of real GDP, which leaves \$31.7 trillion on the table to be shared by a population of 410 million. On a per-capita basis this comes down to \$72,439 for spending on other things. *That is, 1.7 times as much real income (on a per capita basis) than is the case today.*

Finally, with no change in scheduled benefits,” Social Security and Medicare will require 12.2%, or \$8.5 trillion, of projected real GDP of \$69.8 trillion in 2085. This means there will be \$61.3 trillion of real national product remaining to be shared by a population of 481 million. On a per-capita basis, this leaves \$127,443 of real GDP

available for spending on all other things. What this implies, of course, is that *Americans in 2085 will be 3 times better off financially (after Social Security and Medicare have been paid for) than is the case today.*

The Present Value of Social Security's Unfunded Obligations

The following is an excerpt from the 2011 Social Security Trustees Report regarding the present value of the program's unfunded liabilities over the next 75 years, as well as for the "infinite Horizon."

The present value of the open group unfunded obligation for the program over that period [2011-2085] is \$6.5 trillion. The open group unfunded obligation measures the adequacy of financing over the period as a whole for a program financed on a pay-as-you-go basis. On this basis, payroll taxes and scheduled benefits for all participants are included through 2085.....

Another measure that reflects the continued, and possibly increasing, annual shortfalls after 75 years is the unfunded obligation extended over the *infinite horizon*. The extension assumes that the current-law OASDI program and the demographic and economic trends used for the 75-year projection *continue indefinitely*. Over the infinite horizon, table IV.B6 reports that the projected OASDI open group unfunded obligation is \$17.9 trillion.

Table IV.B7 disaggregates the infinite horizon unfunded obligation of \$17.9 trillion into components for past, current, and future participants. The present value of future cost reduced by future non-interest income *over the next 100 years* for all current participants equals \$21.4 trillion.....

This accounting makes clear that if some generations receive benefits with a present value exceeding the present value of their payroll tax contributions and other receipts on their behalf, other generations must receive benefits with a present value less than the present value of their payroll tax contributions and other receipts on their behalf.

These unfunded obligations of \$6.5, \$17.9 and \$21.4 trillion (based on a 2.9% discount rate) are tossed about with great abandon by various observers of the Social Security landscape. Their point, invariably, is to illustrate on what shaky ground the future financing of Social Security resides. In an attempt to clear matters up, however, we first have to recognize that Social Security is now 100% pay-as-you-go insofar as the federal government is concerned. Thus, the trust fund could hold \$50 trillion in special issue government bonds (versus the \$2.6 trillion it now holds) and that would not make paying future Social Security benefits any easier for Uncle Sam – simply because American taxpayers are still going to have to come up with the cash to redeem those bonds!

To look at the matter from a slightly different perspective, however, consider the following: Constant dollar Social Security benefits will grow from around \$718 billion in 2010 to \$4.180 trillion in 2085, or at a 2.4% compound annual rate. If real GDP grows at a real 2.1% rate (as the Trustees have projected) it will climb from \$14.7 trillion in 2010 to \$69.7 trillion in 2085. That is, it will be 4.8 times as large in 2085 as in 2010. Based on these projections, total Social Security benefits over the next 75 years will total \$150 trillion versus total real GDP (over the entire 75 years) of \$2,689 trillion. Thus, unfunded Social Security benefits (as presently scheduled) will require 5.6% of total GDP over the next 75 years. Of course there is no way in creation that the federal government could set aside \$6.5 or \$16.9 or \$21.4 trillion to fund these future obligations.

Parenthetically, just to highlight the demographic challenges facing Social Security consider the following: Between 2010 and 2085 the working population (age 20-64) will grow by 37 %, from 188.9 million to 258.0 million. Meanwhile, the elderly population (age 65 and older) will grow 166%, going from 40.9 million in 2010 to 108.6 million in 2085!

Meanwhile, of course, Social security is not the only unfunded liability confronting American taxpayers. Thus, critical Social Security benefits are provided to our aging population just as a critical education is provided to our youth. Of course, both are necessary even though both are as unfunded as our next manned flight to the moon. Indeed, the total cost of educating America's youth currently requires about 5.7% of GDP, or \$835.2 billion. If future growth in education spending were to match the 2.1% annual rate of GDP growth, then in 2085 the cost will be \$3.9 trillion. That is about equal to the \$4.2 trillion in projected Social Security benefits for that year. Moreover, the total 75 year cost of educating America's youth through 2085 will be \$153 trillion versus Social Security's cost over the same period of \$150 trillion.

Once again, however, Social Security is not the only benefit provided to the elderly. There is Medicare as well. Thus, as Robert Samuelson pointed out in a July 28, column in The Washington Post:

By now, it's obvious that we need to rewrite the social contract that, over the past half-century, has transformed the federal government's main task into transferring income from workers to retirees....These transfers have become so huge that, unless they are checked, they will sabotage America's future....Older Americans do not intend to ruin America, but as a group, that's what they're about. On average, the federal government supports each American 65 and over by about \$26,000 year (about \$14,000 through Social Security, \$12,000 through Medicare. At 65, the average American will live almost 20 more years. Should these sizeable annual subsidies begin later and be less for some?"

* * *

Endnotes

(1) In an attempt to lay concerns about the Social Security Trust Fund's viability to rest, the following "Q and A" has been posted online by the Social Security Administration:

Q. Why do some people describe the "special issue" securities held by the trust funds as worthless IOUs? What is SSA's reaction to this criticism?

A. Money flowing into the trust funds is invested in U. S. Government securities. Because the government spends this borrowed cash, some people see the current increase in the trust fund assets as an accumulation of securities that the government will be unable to make good on in the future. Far from being "worthless IOUs," the investments held by the trust funds are backed by the full faith and credit of the U. S. Government. The government has always repaid Social Security, with interest. The special-issue securities are, therefore, just as safe as U.S. Savings Bonds or other financial instruments of the Federal government.

Clearly the above answer misses the point about why so many observers claim the trust fund's special issue Treasury bonds are akin to "worthless IOU's." Thus, there is only a trivial probability that the government will fail to meet the trust fund's obligation to pay retiree benefits through 2036. Rather, *the core issue is where will the money come from* if not from the imposition of new taxes, spending cuts elsewhere, or the sale of additional public debt.

(2) Here is the actual language, of Messrs. Ball, Samuelson, Krugman, Muralidhar and Clinton expressing their support for investing part of the Social Security Trust Fund in common stocks:

Social Security could improve earnings by investing some of its assets – up to 20%, say – in equities, as just about all other public and private pension plans do. [Robert M. Ball; Commissioner of Social Security in the Kennedy, Johnson and Nixon administrations; The Washington Post; October 15, 2007]

If stocks are deemed to be worth their genuine risks, private accounts are NOT the optimal program. The U.S. government's common fund should buy indexed funds and any capital gains should be shared by all Social Security participants pro rata. [Paul Samuelson; In a letter to the writer; January 26, 2005]

I favor eventually investing part of the Social Security surplus in broad stock indexes. [Paul Krugman; The New York Times; August 26, 2001]

The United States has a unique opportunity to maintain Social Security as a partly financed system, and one critical step is to invest the trust fund and future surpluses in a portfolio of global assets (as opposed to lending the money to the

government. [Arun Muralidhar—author of “Rethinking Pension Reform” with Franco Modigliani—The New York Times; January 7, 2007]

The best way to keep Social Security a rock-solid guarantee is not to make drastic cuts in benefits; not to raise payroll tax rates; and not to drain resources from Social Security in the name of saving it. Instead, I propose that we make the historic decision to invest the surplus to save Social Security. Specifically, I propose that we commit 60 percent of the budget surplus for the next 15 years to Social Security, investing a small portion in the private sector just as any private or state government pension would do. This will earn a higher return and keep Social Security sound for 55 years. [Former President Bill Clinton; State of the Union Address; January 19, 1999]

(3) The historic (long-term) advantage of investing in common stocks versus corporate or government bonds has been one of the main points addressed in this article. As further evidence of this, consider the following: Over the 85 year period spanning 1925-2010, there have been 61 non-identical 25 year holding periods when one could have invested in either common stocks or corporate bonds. Note, however, that over this entire time span there has been only one 25 year period in which stocks did not outperform bonds. Thus, the best 25 year total return for stocks was 5,238% versus 1,336% for bonds. Likewise, the worst 25 year return for stocks was actually a gain of 319% compared to a 45% gain for bonds. Needless to say, these results speak volumes about the impact of reinvested earnings (compounded) on the long-term advantage of investing in common stocks.

As a matter of fact the future of Social Security as well as the stock market are inextricably linked to growth of the U.S. economy and the “magic” of compounding. For example, in a 1967 column in *Newsweek*, Paul Samuelson observed that “Social security is squarely based on what has been called the eighth wonder of the world--compound interest. A growing nation is the greatest Ponzi game ever contrived. And that is a fact, not a paradox.” Parenthetically, in a 2005 letter to this writer, Samuelson further noted: “In the 1960's the baby boom growth in population provided a Ponzi wind at our backs. By contrast, the 2005-2050 decline in populations in U.S. Japan, Italy, etc. provides a REVERSE Ponzi wind against our fronts. At Yale George Bush could have learned all this.”

Along these same lines, Louis Woodhill, in the September 21, 2011 issue of *Forbes*, observed that “Social Security is not a Ponzi Scheme [and] is viable in its present form if we average 3.5% real annual economic growth. ***This would not be the case if Social Security were a Ponzi scheme.***” In still another article, in the April 13 issue, Woodhill pointed out that “Social Security reliably captures about 4.6% of GDP [and] accordingly, the real asset of Social Security is not the so-called trust fund, but the present value of its share of future GDP.”

Setting Ponzi aside, the economy’s ability to grow at more than 2.1% (which is the rate that the Social Securities Trustees are projecting) would make an enormous difference --

both for the fate of Social Security and Medicare, as well as for the lives of our grandchildren and their children.

Thus, at a 2.1% growth rate, ***real GDP will rise from \$14.7 trillion in 2010 to \$69.8 trillion in 2085.*** At 6.0% of GDP, Social Security will represent a \$4.188 trillion expense compared to \$0.713 trillion in 2010. This also implies that Social Security is expected to grow at a 2.4% compound annual rate for the next 75 years. If, on the other hand, GDP were to grow at its long-term historic rate of 3.5%, it would reach \$194 trillion by 2085 and Social Security would represent only a 2.2% share versus today's 4.9 %.

The same is true for Medicare which is projected to grow at a faster 2.8% rate for the next 75 years. Thus, spending on Medicare will rise from \$0.528 trillion in 2010 to \$4.328 trillion by 2085. That is from 3.6% of GDP in 2010 to 6.2% in 2085. But, once again, if GDP were to grow at 3.5% (as it did for most of the 20th century) Medicare would consume only 2.2% of it in 2085. Of course compound interest is so powerful that just a 3.0% real rate of growth would do wonders for the American economy and its social safety nets.

We'll conclude this excursion with a final example of just how formidable the equation $S = (1+i)^n$ can be. In a 2008 article in *Newsweek*, Treasury Secretary Lawrence Summers was quoted as predicting that a typical Chinese citizen would experience a "10,000%" (or 100 fold!) rise in living standards during his lifetime. Since life expectancy in China stands at 72, this implies a real compound annual growth rate of 6.6% in output. Of course, China has been growing at a much faster rate for the last two decades. Still, given that China's GDP in 2010 was \$6 trillion, a literal extrapolation of Mr. Summers' conjecture would imply China's real GDP in 2082 will reach \$600 trillion. Meanwhile, if the American economy continues to drag along at only a 2.1% annual rate for the next 72 years, our real GDP will only reach \$66 trillion by 2082, versus \$15 trillion today.

We can do better than that, however. Indeed, we have only to recall that Chinese civilization has been around for over 5,000 years. Meanwhile, if we continue to creep along with a 2.1% rate of growth for the next 1,000 or so years, our economy will max out at 15,555,216,397,857,300,000,000 dollars regardless of how China performs. Just to be clear, ***that's 1,061,065,239 times the size of 2010's GDP*** of \$14,660,000,000,000. What this all means in terms of energy consumption, greenhouse gases and global warming, is anybody's guess. And, of course, we haven't even considered compound growth rates and terminal output for the world's other 199 countries! (Parenthetically, \$1 growing at 2.1% becomes \$32,574 in 500 years. And ***\$32,574 squared results in \$1,061,065,239 in 1,000 years.***)

All joking aside, the more serious lesson here is that projections involving compound rates of change for 50 or 75 years ahead are hyper-sensitive to the slightest modification in the assumed growth rate and should always be taken with a teaspoon of salt. Thus, estimates of how Medicare and Social Security will be performing in 2050 or 2085 may only be slightly more reliable than estimates of how climate change will be

affecting the earth by then. Still, as rational observers, we have no choice but to make the best estimates we can.

Finally, we have avoided the temptation of commenting in this article on the myriad ways that Social Security and Medicare might be reformed. It is not as if we are unaware that major reform is called for, however. Indeed, some of the foremost advocates for reform are the program's Trustees themselves--and sooner rather than later it turns out. Thus, in their May 2011 report, the following clarion call for action was issued:

Reluctance to resolve the Social Security and Medicare shortfalls is understandable, as doing so involves slowing the growth of program benefits, increasing the age at which individuals become eligible for benefits, or increasing the taxes and premiums that support these programs. Failure to enact such measures, however, will not shield participants collectively from adverse effects. One way or the other the imbalance between scheduled benefits and future revenues must be resolved.

In the past, policy makers have been reluctant to significantly reduce the benefits of those who have already begun to collect them. In a practical sense, therefore, changes adversely affecting younger generations are likely to be much more severe than indicated in these simple illustrations. The costs that will be borne by younger generations will grow significantly each year that a new cohort of baby boomers joins the benefit rolls.

We believe that the essential message conveyed by these reports is clear and will not change, absent legislation: that the vital Social Security and Medicare programs face real and substantial challenges, and that elected officials will best serve the interests of the public if financial corrections are enacted at the earliest practicable time.

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