

### Your Social Security “Investments”

Social Security is about to move to the front burner. It is debated with great emotion but with very little understanding of how the system works. Everyone who works and earns a wage pays into Social Security. Most of us view this vehicle as at least part of our personal retirement plan, usually along with our other retirement investments. Most of the assets CornerCap manages are retirement plan assets for corporations and individuals. Most of our communications to our clients is focused on helping them to understand how their retirement assets are performing. How are your Social Security “investments” performing? This commentary attempts to help you understand what the Social Security system is likely to do for you, or to you, for the remainder of your life.

### From Safety Net to Social Noose

Social Security was born during the Great Depression when 25% of the workforce (mostly men) was unemployed at the time. Many people thought the capitalist system had failed. The answer in such desperate times was government programs. The program was introduced by the Roosevelt administration in 1934. It was set up as a fund of last resort to help those in great need. Even in a time when most people were suffering economically, the system reflected the basic generosity of the American people toward their needy fellow citizens.

*Our society must make it right and possible for old people not to fear the young or be deserted by*

*them, for the test of a civilization is the way that it cares for its helpless members.*

Pearl S. Buck, Nobelist, novelist (1892-1973)

Like so many government programs that start out well intended, this one suffered from the law of unintended consequences. When Social Security began, approximately 20 workers contributed for every person who was retired. Now, because of the increasing coverage of various groups and because people are living longer, there may be only two workers for every retiree. That number is going to decline slowly; there may be only about 1.85 workers per retiree by 2080.

According to the latest report from the Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds, 47 million people receive social security checks. In 30 years, that number may grow to 77 million people. Currently, 20% of the recipients who are 65 and over rely on Social Security as their only income. There are a number of Social Security concepts that are out of date. Just to note one, the retirement age has been set at 65 since inception. Only very recently has it started creeping up. The idea of retirement at 65 was set in 1874 when a railroad company set up the first private pension plan. At that time, 65 was believed to be the oldest age one could safely operate a train. The world moves on, but government programs are always difficult to change (or kill).

### The Ponzi Scheme

The money for current Social Security payments to older citizens comes from the current workers who

are now paying into the system. Your payments are not being set aside for you. They are being paid out to people who have already retired. Over the years, excess amounts have been paid into the system, but the government spends these excess tax dollars on other things in the federal budget.

Contrast this to the private pension system. In 1974, Congress passed the Employee Retirement Income and Security Act (ERISA). That law forced companies with a pension plan to fund that plan with a trust containing real assets—stocks, bonds, cash, real estate. This fund is managed separately from the company’s operations and investments. Government guidelines dictate how much money must be in the fund to keep it fully funded, so that if the company goes broke, the pensioners will still get what they were promised. Funds must have enough assets to cover those pensions. If they do not, they must contribute new cash on a timely basis to meet the future obligation.

If companies reported the status of their pensions the way the government reports on Social Security, then the pension officers and financial executives of those companies would surely be in prison. The people in Washington have no intention of discussing the pension system in anything approaching a fair representation. They talk about a “trust fund” and a “lock box” as though these terms mean something. There is no trust fund, and if the lockbox is opened, all you will find in it is an IOU from the government. The fund is on a pay-as-you-go basis. Money that comes in goes out immediately.

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For decades, most of the pension funds in the U.S. operated in the same unfunded manner as Social Security, but then a number of major companies went broke. The retirees found themselves to be nothing more than general creditors of their company, and their pensions disappeared. Of course, the government has the power to raise taxes to pay for the funding of Social Security, and that is exactly what must happen if its promises are to be met.

Social Security started as a low cost supplementary pension system for the truly needy. It has turned into little more than a Ponzi scheme. Such investment schemes take their name from Charles Ponzi in Boston in 1920. He used money contributed by new investors to pay enormous returns to early investors. Such a Ponzi scheme can continue so long as the number of new investors increases fast enough to pay off old investors. There is never an unlimited supply of new investors, and with regard to Social Security, the new investors (i.e., taxpayers) are dwindling while the old investors (i.e., retirees) are multiplying. Eventually, Ponzi schemes must fall from their own weight.

### Wealthy Welfare

The system has created real inequities among age groups. Most people who now draw benefits never think of themselves as abusing the system or being on welfare. If you ask the average retiree, he will tell you, "Look, I paid in for years, and I'm entitled to collect. I earned it!" In fact, this is generally not true. Many older retirees today have gotten back all their contributions and a decent return on the money in just a few years. After that time, they

have been on "welfare"—meaning that the government is supplying them funds that they did not really "earn."

But for younger people, the outlook is grim. For every person who made a greater than market return on Social Security, like the vast majority of older current Social Security recipients, there must be a young person who is going to make an equal below-market return. As with all "investing," there is no free lunch. In the end, somebody is going to pay the bill. For the most part, the bill will have to be paid by the children and future generations of the current Social Security beneficiaries.

The debate is hot and heavy on what to do about this future bill. Much of it is emotional rather than rational. For example, former U.S. Representative, Barbara Kennelly, President and CEO of National Committee to Preserve Social Security and Medicare said, "There's no crisis. There's a 'shortfall' of 30% of the benefits starting in 2042 when the trust fund gives out. The system could be shored up with changes similar to those undertaken by Congress in 1983, such as increasing the payroll tax." So it is all a matter of how you look at it. To her, there is no "crisis," there is only a "shortfall." It is only a crisis if you have to come up with 43% more money to pay for this.

### Limited Solutions

Options to cure the problem are few, and none of them are palatable to politicians who must tell the voters that they may get less than they were promised while paying more than they had planned. We always come back to the premise that there is no free lunch; eventually somebody has to

pay. The options really boil down to some combination of only two actions: reduce costs (benefits) or increase revenues (withhold taxes).

**Reduce Costs:** Cut the dollar payments or increase the age at which people become eligible for benefits. This is very hard on people who are retired or are near retirement. They planned for decades to have this money for retirement, and it would be disruptive, in some cases disastrous, to deny them at this late date. This issue is also political suicide for any elected official. But the under 40 folks are probably going to realize that they just cannot afford to retire so soon and working an extra few years will be necessary.

**Increase Revenues:** Increase withholding taxes for those who are still working. The amount has risen from its initial level of 2% of the first \$3,000 earned to the current level of 15.3% on the first \$87,900. (The amount of tax is greater if you earn more than the stated amount. There is no cap on the Medicare tax.) At some level, the taxes will become counter productive and people simply will refuse to work.

About all that is politically acceptable is to continue to pay current retirees and near retirees as we are doing now but begin phasing out or ratcheting down the system for some subset of younger citizens. Much is made of the fact that if Social Security is privatized, individuals may lose these savings in the stock market. However, a system can be set up for a portion of these funds that would work much like an IRA does today. It is not feasible to allow young people to keep all their money because some of it must be paid in to

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support current retirees whose money has already been spent to support those who participated in Social Security before them (the Ponzi concept).

One thing is clear: the young, reasonably successful participants today should expect to receive little or nothing from the system. Social Security is becoming a wealth transfer system from the “successful” to the “have-nots.” It is likely that by the time today’s young contributors retire, there will be a “means” test imposed, and those who have had the means to contribute will also be deemed to have the “means” to do without the benefits.

Social Security is described as the “Third Rail” for politicians—the electrified rail that will kill you politically if you touch it. Just because politicians do not discuss it does not mean it is not there. If you are unacquainted with the details of how this system is going to work, you owe it to your children and their children to become better informed. They will pay the price of an older populace who will undoubtedly vote their pocketbooks. The result will be to continue to mortgage the future of the young.

*We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.*

President Franklin Delano Roosevelt, August 14,  
1935 Upon Signing the Social Security Act

In summary, your Social Security “investments” have nothing to do with investments. As baby boomers age, politicians are being forced to address the economic reality. If the system stays as is, the parents (the boomers) and grandparents will realize good Ponzi-scheme returns on their Social Security investments, but their children and grandchildren will be devastated, eventually paying up to 25% of everything they earn to support their older generations. This will be an emotional balancing act with each generation’s arguing their case.

Abolishing Social Security would be politically impossible and socially unacceptable. However, the system must be radically changed, and the changes will be difficult to swallow. The politicians will continue to put some lipstick on the welfare program in order to try and sell it to the American people as an investment program. Stay tuned as this new “war” is waged; a war that is not just within our own country but also within each of our families. (Note that none of this discussion considers Medicare and Medicaid that should have far greater potential costs than Social Security.)