



# Is Social Security a ticking time bomb?

Solutions for avoiding insolvency involve shared sacrifice and political compromise.

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### **BOTTOM LINE**

As we study Social Security's impending insolvency, there's good news and bad news. Its trustees made an optimistic projection in their 2019 annual report released in April. The program was supposed to have run into the red by the end of 2018, but they pushed that forecast to 2020. Among the reasons were the strong labor market, better-than-expected economic growth and higher federal tax revenues.

But we've only managed to delay the inevitable. Social Security remains a slow-motion train wreck in the long term. If the program's costs do exceed its income next year—the first time since 1982—the government will be forced to dip into its \$2.9 trillion trust fund to pay benefits. And the latest projections show that the retirement program, with some 52.7 million people receiving retirement and survivor benefits, will be able to pay full benefits only through 2034.

Yet the disability fund, with another 10.2 million receiving benefits, is now expected to be solvent through 2052, which is 20 years later than last year's report. Why the significantly improved outlook? Because with the strong economy and labor market, more people are

working rather than filing for disability benefits. However, without any structural changes in the Social Security program, its 63 million recipients will eventually receive only three-quarters of their scheduled benefits, which is politically untenable.

**It's all about demographics** When President Roosevelt implemented the Social Security program in 1935, life expectancy for males averaged 62 years. Most didn't live long enough to collect their full retirement benefits at age 65. That established a very rich worker-to-retiree ratio of 42 to 1. But due to advances in health care, medicine, diet, exercise and nutrition, life expectancy has increased dramatically. Men are now living an average of 76 years and women 81, so they are relying on benefits far longer than originally planned.

At the same time, present day fertility rates are at a cyclical trough, with families having an average of only 1.7 children, compared with peak fertility at 3.6 children in the 1950s and replacement at 2.1 children. With nearly 10,000 baby boomers retiring and becoming eligible for benefits each day, the current model is unsustainable. People receive an average of three times more money from Social Security than they contributed throughout their working life, so we need a more robust worker-to-retiree ratio of at least 3 to 1. But today it has fallen to 2.8 to 1 and is expected to hit 2.2 to 1 by 2035.

Social Security accounts for more than 90% of income for one-third of the 62 million beneficiaries, and 26% consider it their sole source of income. Excluding interest payments on the national debt, Social Security and Medicare account for 45% of federal spending.

**Political silly season** With the presidential election coming up in November 2020, Social Security has become a hot topic. Reform has long been considered the "third rail" of American politics, and there appears to be no appetite in Washington at present to rein in Social Security spending. In 2016, President Trump promised "not to touch" it. Leading Democratic presidential candidates Bernie Sanders, Kamala Harris and Elizabeth Warren have all proposed increasing benefits by raising taxes on the wealthy.

**Common ground** In our view, the long-term solution to Social Security solvency is through shared sacrifice and compromise by both parties. In 1983, for example, the

Greenspan Commission proposed that tax rates increase along with the retirement age. The most reasonable reforms could be a combination of the following:

- **Immigration reform** Given the cyclical trough in fertility rates, immigration reform is the best and fastest way to increase the working-age population. Immigrants would pay taxes into the system, instantly improving the worker-to-beneficiary ratio.
- **Raise the cap** A significant 88% of Social Security's income comes from a 12.4% payroll tax on up to \$132,900 in wages. Raising the cap of taxable income and the tax percentage—and indexing both for inflation—would dramatically increase funding. The risk is that the economy could slow in response.
- **Fix the inflation component** Social Security has a cost-of-living adjustment (COLA) that uses the consumer price index. But it is widely held that it overestimates inflation because it does not account for substitution bias (significantly the Federal Reserve does not trust it). Chained CPI is a better option, as substitution is included in its calculation. Since 2000, the two methods have a 6% difference in their measure of inflation. A switch to chained CPI could lower overall Social Security spending while upholding the program's intent of distributing the same purchasing power each year.
- **Index life expectancy** In 1983, Congress raised the age required to receive full benefits from 65 to 67. Had this change been indexed to adjust for life expectancy in the U.S., the threshold today would be 70. Due to the increase in longevity, lawmakers should increase the retirement age to 70 and index it to increases in future life expectancy.
- **Further means testing** Almost 50,000 millionaires collected Social Security in 2010, including billionaire Warren Buffett. By placing wealth restrictions on those who can receive benefits (also think Mark Zuckerberg, Bill Gates and Jeff Bezos), we will reduce unnecessary spending for those who don't need the support.
- **Expand other savings programs** In May, the U.S. House of Representatives passed the bipartisan Setting Every Community Up for Retirement Enhancement (SECURE) Act. The bill makes 28 pension-plan adjustments affecting IRA distribution rules, requirements for employer-provided retirement plans and the accessibility of 401(k) plans for American workers. Congress also could raise the annual caps in programs such as the 401(k), IRA and 529, which have successfully allowed investors to save for

retirement and college expenses. Lawmakers could create additional programs to further encourage private wealth creation. This would allow more retirees to be more self-supporting without government benefits, potentially freeing up some of the trust-fund assets to support individuals who rely more heavily on Social Security.

- **Generate higher investment returns** The Social Security trust fund is currently invested in Treasury bonds, notes and bills. While they are safe, they generate meager investment returns that aren't growing fast enough to meet the program's increased withdrawals. The government could use an asset-allocation mix of 60% dividend-paying blue-chip stocks and 40% Treasury bonds to generate improved investment performance for the Social Security surplus cash on hand.

*Research assistance provided by Federated summer intern Michael Ware.*

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### TAGS

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### DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Consumer Price Index (CPI): A measure of inflation at the retail level.

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