LOBBY SEVEN

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SOCIAL SECURITY

Three Trillion Dollars in a Filing Cabinet

"You really should read the OASDI Trustees Report," - Anonymous

Like so many pieces of advice I've given to my friends, I would guess this one has literally never been followed. But why haven't you read the report? If you work for 40 years and earn $100,000 per year, by the time you retire you will have invested $496,000 into Social Security, based on current tax policy. Do you have other large investments that you know nothing about?

Despite being a constant in political discussions, and representing annual payments of $888 billion – 24% of the federal government's budget – most people have no idea what Social Security is, how it works or what its future looks like.

- What is Social Security?
- How does Social Security work? What is the "Trust Fund"?
- What is the prognosis for the system? Is there a "crisis"?
- What about the various changes that have been proposed?

What is Social Security?

"Social Security" is the common name for the Old-Age, Survivors, and Disability Insurance ("OASDI") Program. Created by the 1935 Social Security Act as part of the New Deal, the intention was to combat rampant poverty among seniors, which at the peak of the Great Depression was approaching 50%[1]. The Social Security Administration (SSA) was created to manage the program. An initial check for $22.54, written to Ida May Fuller in 1940[2], has evolved into the largest Federal Government expenditure and a major factor in the US economy. As of 2015, 60 million Americans were receiving benefits from Social Security[3].

In the eighty years of its existence, Social Security has been modified many times by Congress. Some of the major events in the program's history are[4]:

- 1939: Spouses and minor children added as beneficiaries
- 1954: Disability program added
- 1960: Supreme Court clarifies several topics related to Social Security
- 1965: Medicare created
- 1977-1983: Significant changes to funding and benefit calculation to ensure stability
- 1997: Temporary Assistance for Needy Families and State Children's Health Insurance Program added to SSA

[1] I haven't been able to find good statistics on senior poverty from 1930-1935. However, given that senior poverty in 1959 was 35%: (State of Working America), I'm confident in this statement.

[2] Ida May Fuller

[3] SS Benefit Statistics

[4] For general overview of the history of OASDI/SSA, see SS History.

According to the Center on Budget and Policy Priorities, in 2015, Social Security income raised 22 million Americans out of poverty[5].

How does Social Security work? What is the "Trust Fund"?

Social Security is deceptively simple. If you look at your paycheck stub, you will see a field "FICA SS Tax" or something similar. This is equal to 6.2% of your earnings, up to a cap of $118,500 per year. If you have ever managed a payroll, you'll know that companies pay the same amount based on their employees' earnings[6]. This money goes to the SSA, who sends out monthly checks to beneficiaries[7]. The amounts of the withholding taxes and benefits are set by Congress[8]. Any extra cash generated goes to the "Trust Fund"[9].

Social Security is a "pay-as-you-go" system, fundamentally different from how a pension funds operate. In a pension fund, contributions are made by or on behalf of current workers, invested until they retire, and then paid out to the same workers. In Social Security, the contributions made today are used primarily to fund today's retirees. At some point around 1980, some nerds[10] looked at the numbers and saw there was a problem – the system was doing well today, but down the road the demographics didn't look good. So they made a bunch of changes (increase taxes, reduce benefits, increase retirement age) to ensure the system would remain solvent. The Trust Fund started to grow.

Fast forward to today – the Trust Fund is going strong with $2,800,000,000,000[11] or so in the bank. But of course, the way in which this huge sum is managed is not straightforward, because freedom or something. The Trust Fund used to hold regular old US Government securities, but the Social Security Administration couldn't handle the mark-to-market. So they created a new class of securities ("special issues") which can be redeemed by the Trust Fund for face value at any point[12]. The certificates for these securities are – literally – in a 3-ring binder in a filing cabinet in Parkersburg, West Virginia. Here is a fascinating photo of George W. Bush looking at pieces of paper:

[5] CBPP - Poverty

[6] If you are self-employed, you pay the tax in a different way, but it basically works out to the same thing.

[7] Interesting aside: the costs to manage the SSA is $6.2 billion per year, or around 0.22% of assets. This compares favorably with private, passive bond funds (NELYX charges 0.37%, to choose an example at random). And of course, the SSA does a few other things, such as send out 60 million checks per month.

[8] Through "mandatory spending", the details of which we won't get into today. But it means that the amounts are based on laws other than annual appropriations bills. This has intended to (and succeeded at) shielding SS from the political winds of the day.

[9] Technically, there are two Trust Funds, one for Old Age + Survivors and one for Disability. But the government basically treats them as fungible, so I will too.

[10] I assume

[11] That's $2.8 trillion. SSA Annual Report

[12] Trust Fund Data Homepage. You can have fun looking at all sorts of data about the Trust Fund here. I find them to be very transparent about what they are doing.

After touring the building where the filing cabinet sits, President Bush made a controversial statement about the nature of the Trust Fund[13]:

> There is no "trust fund," just IOUs that I saw firsthand, that future generations will pay -- will pay for either in higher taxes, or reduced benefits, or cuts to other critical government programs.
>
> The office here in Parkersburg stores those IOUs. They're stacked in a filing cabinet. Imagine -- the retirement security for future generations is sitting in a filing cabinet. It's time to strengthen and modernize Social Security for future generations with growing assets that you can control, that you call your own -- assets that the government cannot take away.

I disagree with this description. While they are not marketable, the "special issues" are backed by the "full faith and credit" of the US Government in the same way "normal" Treasuries. Failure to pay them would be a default on federal obligations. And the $2.8 trillion isn't money that future generations will pay – it's money that past generations have invested in US government debt. It did not change the amount we have borrowed; if the Trust Fund wasn't holding it, somebody else would be. I would mostly agree that the government could take them away – but what type of investment can't the government take away, if it wanted to? I agree completely that we could probably find a better plan than storing $2.8 trillion[14] in a filing cabinet in a small city in West Virginia.

But let's focus on what he said would happen if the Trust Fund were depleted. Fortunately, we know the answer, because it is in the law. Social Security has a dedicated funding source, so a deficit would be bridged by reducing benefits[15]. This would indeed be bad for people who were expecting to receive full benefits.

What is the prognosis for the system? Is there a "crisis"?

The phrase "Social Security Crisis" has been thrown around so much that it's lost all meaning[16].
Let's look at where we are today by the numbers.

In 2015, the full OASDI perimeter had income of $920 billion, of which around $93 billion was investment income. Total expenses were $897 billion, meaning that on a cash basis, Social Security had a profit of around $23 billion[17]. We can agree that no business turning a $23 billion profit is in a crisis – so there is no immediate Social Security Crisis. But what about the future?

The Trustees of the Fund project the future of the system based on 3 economic/demographic scenarios: low-cost, intermediate and high-cost. Between the 3 scenarios, the Trust Fund is expected to be depleted sometime between 2029 and Never[18]. After this, assuming no changes to policy, it will be able to pay out between 73% and 100% of promised benefits through the year 2090, which is as far as they look.

Boiling down to my view on this: "At some point in the 2030s or 2040s, the Trust Fund will probably but not definitely be depleted. At that point – and assuming no action beforehand – there would probably be a significant but not drastic cut to

[13] SSA - History
[14] Yes, I do like repeating this number
[15] SSA - Cash Flows and Reserves
[16] So you don't have to do your own Google search: WSJ: Retirement Policy Under Donald Trump; MarketWatch: Retirement age needs to rise to 70; AFL-CIO: 3rd Presidential Debate
[17] SSA - Annual Report Summary
[18] SSA - Projections; the assumptions for the 3 cases can be found at: SSA - Demographic Assumptions and SSA - Economic Assumptions. My opinion is more optimistic than "Intermediate" Scenario II (but less than Scenario I)

benefits. After this cut, it should run fairly smoothly for as long as we can project." Merriam-Webster defines "crisis" as "a situation that has reached a critical phase[19]." Without getting into the semantics, I wouldn't consider this to be equivalent to my view; hence, I do not think there is a long-term Social Security Crisis either.

What about the various changes that have been proposed?

Even though I don't consider it a crisis, I do think we should take some action to strengthen the system. Depending on economic conditions going forward, there is certainly risk to future benefits, so it makes sense to act now in some small ways to lower the probability of needing drastic actions in the future. We have a few choices[20]:

1. Increase the FICA tax rate

Helpfully, the Trustees' report explains that the "Gap" – or "long-range actuarial deficit" using the technical term – for Social Security is 2.66%[21] of taxable wages. In other words, if we increase both the employee and employer portion of FICA tax by 1.33%, they would project the system to stay solvent. Remember that 2.66% number – it is a good way to make an apples-to-apples comparison between the choices.

2. Increase the cap on taxable income

Currently, only income up to $118,500 per year is subject to Social Security FICA tax. Increasing this cap would increase the income subject to the tax, and affect only about 20% of households[22]. There are many plans to change the cap, which of course would have different effects. Eliminating the cap entirely would close around 90% of the Gap. A common proposal is to set the cap dynamically so that it covers 90% of all income; this would close 30-40% of the Gap.

3. Decrease the benefits paid by Social Security

Remembering that benefits would "automatically" decrease if the Trust Fund is exhausted and nothing else is done, we could reduce benefits today so that we will not have to reduce them as drastically in the future. One proposal you've likely heard of is to decrease the annual inflation adjustment using something called "chained CPI[23]"; this would close 15-21% of the Gap. Lowering benefits by 3% for those newly eligible in 2017 and later would close 14%.

4. Increase the retirement age

The retirement age is already steadily increasing towards 67 in 2027, due to the changes made in 1977-1983 mentioned above. If the retirement age were slowly increased to 68, this would close 13-17% of the Gap.

5. "Privatize" Social Security

Going back to 2005, you may remember that there was discussion of allowing private investment accounts in Social Security. They died very quickly when it became clear the general populace was strongly against it. The exact effect of Privatization is dependent on the proposal, and a subject of endless debate. My view is that it is unlikely to improve the solvency of the system[24]. At a basic level - money would be diverted from the Trust Fund to your personal account; you would personally get a better or worse return depending on the market, but the Trust Fund and overall solvency are largely unaffected.

6. Combination of the above

[19] http://www.merriam-webster.com/dictionary/crisis
[20] In case you want far more choices for how to fix Social Security, you can see this: SSA - Summary of Provisions to Change
[21] See #16 above
[22] Tax Policy Center
[23] I don't really know what Chained CPI is. But it is basically a long-term cut by decreasing cost-of-living increases to benefits.
[24] Here is somebody from each side of the Privatization debate: TCF: Privatization is a Bad Idea ; Cato: Privatization is a $10 Trillion Opportunity

To the first order of magnitude, the interrelation between these changes will be limited. Therefore, you can use the above guidelines to mix and match various proposals to reach your "long-range actuarial deficit" bogey of 2.66%[25].

Trillions of dollars, affecting every portion of our economy, and a critical filing cabinet. The big question is: what is going to happen, especially after recent election results? The uncertainty here is almost complete, and it is easy to find an elected official with any opinion you happen to have. From my perspective, no politician or political party wants to be seen to be cutting Social Security; no cuts to future benefits will happen unless one party can pin the cuts on the other. Alternatively, it is a pretty a safe assumption that a GOP congress will prevent tax increases on high earners, where a Clinton administration might have made some changes to the cap on subject wages. The GOP attempted a privatization scheme 10 years ago, and may again. I would expect it to fail again, as the underlying politics haven't changed. So, I think that we will move along, with literally no changes to the program for at least the next two to four years.

But this isn't a bad thing. As I describe above, I think it is hyperbolic to say that we have a "Social Security Crisis[26]". And - the policy we set today will affect our ability to keep our citizens out of poverty for the next fifty years or more. We have time, so let's have a bit of humility and act cautiously. And when the OASDI Trustees put out their report for 2016, you should at least read the summary.

[25] No, this is not a good party game

[26] With Medicare, the situation is less clear; but these two entitlements are almost entirely separate, so Medicare's future will have to wait for another article.