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"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 D. Roosevelt, upon signing the Social Security Act (August 14, 1935).

On that date, President Roosevelt signed what may be the most significant piece of legislation in our nation's history. The Social Security Act created a program to provide retirement income to all of the workers in America, and was sparked by the continuing economic strife of the Great Depression. Efforts to provide an old age pension go much farther back in time, such as the English Poor Law of 1601 and the military pension promised to Civil War veterans. Thomas Paine's final pamphlet, published in 1795 was titled "Agrarian Justice" and called for an annual stipend of 10 pounds sterling to be paid to each citizen upon reaching the age of 50.

Since Social Security benefits began in 1935 (Ida May Fuller was the first recipient), the structure and benefits of the program have changed a number of times. In 1939, a key amendment created the Social Security Trust Fund to hold and invest surplus funds. Another interesting change shifted the original concept of payments from a reserve to a hybrid of a reserve and a pay-as-you-go approach. The pay-as-you-go approach was added to ensure that early beneficiaries would receive their promised benefits.

The postwar era has seen quite a few changes in the program. Workers who were not originally covered (such as domestic help and the self-employed) were added in 1950. The ability to retire at age 62 came along in 1961, and benefits for divorced spouses got coverage in 1965. The divorcees affected were women at the time, and it took a lawsuit for divorced men to be added. Social Security payroll tax rates have risen a number of times, and today the rate is 12.4% - half paid by the employee and the balance paid by the employer. Self-employed workers are required to pay the entire 12.4%.

For many years, the Social Security's annual tax surplus has offset the deficit created by spending on other government programs, and a 1968 change in the way our government does the budget allowed Social Security's annual surplus to hide some of that deficit. Social Security's annual tax surplus has narrowed in recent years, and in 2018 benefit payments are expected to exceed taxes plus interest on the Trust Fund assets for the first time. As a result, the overall annual federal government deficit is expected to balloon to well over $1 trillion per year for the next 10 years, reflecting the impact of the combined Social Security shortfall plus the chronic deficit for other spending.

While Congress increased benefits regularly in the 1950s and 1960s (usually in election years) a permanent adjustment of benefits for inflation was added in 1972. An immediate across-the-board 20% increase and an annual cost of living adjustment (COLA) were added, though the COLA formula contained an error that added an annual COLA based on two times the rate of inflation. The high inflation years of the late 1970s exacerbated the effect of this error, and it was fixed in 1977 with legislation that also increased payroll taxes.

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Despite Jimmy Carter's claim at the time that "Social Security funds will be sound", the 1977 fix didn't last long. In 1982, Alan Greenspan was appointed to head a commission to address reforms, as the Trust Fund was expected to run out in only a year. The reforms enacted in 1983 added previously ineligible categories of employees to the system, increased taxes and the full retirement age (FRA), and also made benefits taxable for the first time for higher-income retirees. The changes were intended in part to address the coming bulge of baby-boomer retirees.

The transition from surplus to deficit in the Social Security program's annual revenue picture does not mean that we cannot pay full Social Security benefits today. The Trust Fund held $2.9 trillion at the end of 2017, a decent sum of money in most eyes. While the shift this year to an annual deficit means that the Trust Fund will be declining, the Fund will still have assets for a number of years to come. The current estimate is that the Trust Fund will be depleted by 2034, and absent further changes the Social Security Administration will only be able to pay about 75% of current benefits once that happens.

The previously mentioned 1983 changes included the creation of a special, non-marketable U.S. Treasury bond to be held only by the Social Security Trust Fund. As the Trust Fund is tapped to pay benefits in coming years, these special bonds will be redeemed by the Treasury. One might be impertinent and ask what happened to the surplus money that Social Security handed over to the Treasury in exchange for the purchase of these special bonds. It might seem logical to most people that Treasury, mindful of the future obligation to repay these bonds would have created a reserve fund for this purpose and put the money in it.

The impertinent thinker is right to ask, as no such fund exists. The money that Social Security handed over each year was simply spent on other government programs as the money came in. Now that the bonds must be redeemed, Congress has to take a portion of its annual budget and use it to redeem them. That money, not surprisingly, is coming in part from current tax revenue. This leads us to an interesting premise based on the notion that at some point all of the bonds will be paid back. If we recognize that the bond repayments today are coming from current year tax (not payroll tax) revenue, what is to stop Congress from appropriating money to be lent to Social Security to keep the benefits flowing at their current levels once the bonds are paid off? This does give us some comfort that our benefits won't be suddenly cut by 25% once the last bond is redeemed, and certainly Congress knows that allowing such a cut to take effect would guarantee a loss at the next election.

The fly in the ointment of this thinking lies in the amount of our overall spending that is being financed by borrowing. Investors have trusted the "full faith and credit" principle that US bonds will always be repaid since Alexander Hamilton put us on that road, and they continue to buy our bonds. Without a clear path forward to finance the bulge of baby boomer retirees collecting Social Security (as well as Medicare, which is in the same boat), we risk the loss of investor confidence in our debt.

A growing economy should help, as that produces greater tax revenues, but no sensible analyst believes that even robust growth will solve the problem. The slow growth of the workforce might limit economic growth, and even lots of new immigrant workers may not bring in enough revenue. Congress is unlikely to make changes for current retirees and those soon to retire who count on their benefits. I believe Social Security will continue to exist, but it is likely that we will see changes for younger workers. If we could only convince Congress to work on this now, while there is time. Wishful thinking, I know...

Thomas E. Dexter, CFP®

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