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ISSUE

The impact of
potential
changes in the
Social
Security
System.

¹ Saving, Jason L. and Alan D. Viard, "Social Security Restructuring: Tough Decisions Ahead," Federal Reserve Bank of Dallas, *Southwest Economy*, Issue 5, September/October 2003. <http://dallasfed.org/research/swe/2003/swe0305c.html>

² Board of Trustees, The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Social Security Administration, March 2004.

³ The Board of Trustees, The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

⁴ The Board of Trustees, The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

MEASURING UP

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Social Security Reform

Social Security has profound implications for individuals and employers. Social Security currently disburses more than \$470 billion in annual benefits to 47 million recipients. Roughly 64% of recipients depend on Social Security for more than 50% of their income, and 20% of recipients depend on Social Security as their only source of income.¹

Individuals and employers pay \$533 billion in annual payroll taxes to finance these disbursements. As of 2003, the Social Security System faced an unfunded liability of \$10.4 trillion.² This represents the difference between: (a) the present value of all future payouts, and (b) the sum of the present value of all future payroll tax receipts and the current Social Security Trust Fund. This financial burden will require significant reforms. Potential solutions suggested are increased payroll taxes and/or reductions in the growth rate of benefits, or the possibility of private savings accounts. Although reforms are not likely to affect benefits for current retirees and older workers, in the absence of significant changes, young workers will receive future benefits that are drastically lower than those under the current System. Organizations that sponsor retirement plans for employees might find it necessary to alter the design and funding for these plans in response to potential changes in the Social Security System.

This edition of *Measuring Up* explains the challenges that confront Social Security. It discusses how

potential solutions might affect employees and entities that sponsor retirement programs.

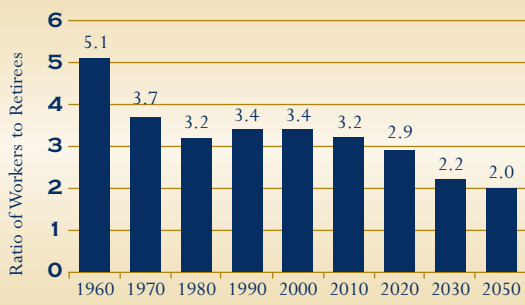
Description of Problem

The System in its current form is unsustainable. By 2018, Social Security will pay more in benefits than it receives in taxes. In 2003, the Social Security Trust Fund held assets of \$1.5 trillion, but by 2042, the Fund will be completely exhausted.³ This financial imbalance stems from the \$10.4 trillion unfunded liability.

Without significant changes, by 2042 benefits will either need to drop by 27%, or payroll taxes must increase by 36% to make up the difference.⁴ Raising taxes will impair job creation, reduce real income growth over time, and hinder economic growth, while reducing benefits will impose financial hardships on retired workers, tarnish the "American Dream," and aggravate intergenerational social tensions. Further, workers might look to their employers to fill this void, thereby placing financial strains on employers.

FIGURE ONE

Decrease in Workers to Retirees Ratio



Source: 2004 Trustees Report (OASDI), Table IV.B2.

Another issue that has prompted calls for reform is the poor “investment” return on Social Security contributions over the average working span of an employee. For example, for a 25-year old employee, the effective investment return amounts to approximately 1.64%

annualized, given current plan provisions.⁵ Based on Yanni Partners’ capital market assumptions, a balanced portfolio of 60% equity and 40% fixed income would produce expected returns of approximately 7% annualized. The opportunity cost imposed by the current System has prompted many policy analysts to suggest market-based solutions to this problem.⁶

History of Social Security and Roots of the Problem

During the late 1800s and early 1900s, state and local governments created the first social insurance programs, while the private sector also established retiree benefit programs. However the Great Depression in the early 1930s decimated these early plans, forcing the Federal Government to act. In 1935, President Roosevelt proposed economic security legislation to Congress, which led to the creation of the Social Security Act. This law established two national social insurance programs to meet the risks of unemployment and old age. Benefits from this newly created program were paid beginning in 1940, with Ida May Fuller of Vermont as the first beneficiary. Over her lifetime, Fuller received benefit payments of \$22,888.92, though she contributed only \$24.75 in payroll taxes.⁷

Fuller’s gain illustrates a major problem now plaguing the System. Early generations received a windfall at the expense of later generations. Early beneficiaries received much more in payments than they paid in taxes. This wealth transfer created a

legacy liability that future generations must bear.⁸ The System cannot support a cash flow imbalance indefinitely because taxes are not invested in productive assets. Current payroll taxes fund the benefit payments to retirees, creating a System that accumulates no real assets, but rather a sequence of transfer payments from young to old. This process is known as a pay-as-you-go system. In concept, pay-as-you-go would be sustainable if the economy generates sufficient labor force growth to maintain a healthy ratio of active workers to retirees. When the System was established, this ratio was more than 40 workers per retiree. The ratio dropped to 3.3 workers per retiree in 2003 and is expected to drop to 2.2 by 2030 (see Figure One).⁹ Compounding this demographic challenge, Americans are living longer, thereby increasing the System’s actuarial liability.

Currently, payroll taxes exceed benefit payments. The System credits these current operating surpluses to the Social Security Trust Fund which holds special issue bonds from the U.S. Treasury. These securities represent IOUs from the Treasury to Social Security. The Treasury must ultimately fund these bonds with general tax revenue.¹⁰ From the Government’s standpoint, the Trust Fund is a “wash.” The System’s Trust Fund “asset” offsets the Treasury’s bond “liability.”¹¹

Under current assumptions, tax revenues will exceed benefit payments until 2018. Beginning in 2018, the Social Security Trust Fund will bridge the gap between payroll taxes and benefit payments until 2042, when the Trust Fund will be depleted (see Figure Two). Unless changes are made to the current System, by 2042 taxes must rise to 16.9% from the current 12.4%, or benefits must drop by 27% in order to compensate for this shortfall.¹²

Potential Solutions

There are two broad approaches for reforming the Social Security System:

1. Modifying the current System through a series of tax increases and/or benefit cuts, and
2. Restructuring the System to achieve market returns on invested capital.

⁵ Liu, Liqun, Andrew J. Rettenmaier and Zijun Wang, “Social Security and Market Risk,” National Center for Policy Analysis, NCPA Policy Report No. 244. July 2001.

⁶ Brown, Jeffery, “Don’t Just Save Security, Improve It,” TIAA CREF, *Advance*. Winter 2004; Feldstein, Martin, “Fact vs. Fancy: The Skinny on Social Security,” *The Wall Street Journal*. August 17, 2004; Gokhale, Jagadeesh, “Why America Needs Social Security Reform,” *CATO Institute*. November 30, 2004; John, David C., “How to Fix Social Security,” *The Heritage Foundation, Backgrounder*, No. 1811. November 2004.

⁷ DeWitt, Larry, “Brief History of Social Security,” Social Security Administration Historian’s Office. March 2003. <http://www.ssa.gov/history/briefhistory3.html>

⁸ Saving and Viard, “Social Security Restructuring: Tough Decisions Ahead”

⁹ The Board of Trustees, The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

¹⁰ John, David C., “The Top 10 Myths About Social Security Reform,” *The Heritage Foundation, Backgrounder*, No. 1802. September 2004.

¹¹ Koitz, Dave, “Social Security Reform: The Use of Private Securities and the Need for Economic Growth,” *The Congressional Budget Office, Long Range Fiscal Policy Brief*, No. 7. January 2003.

If Congress modifies the current model, the pay-as-you-go system will remain intact. Tax increases can be achieved through rate increases paid by employers and employees, or hikes in the taxable wage base. Benefit cuts can be accomplished by raising the retirement age or reducing benefits to higher wage earners or younger employees.

However, by overhauling the Social Security System (by investing contributions), the returns from the contributions will help pay down the unfunded liability. Contributions can either be invested centrally through the Government, or individually through personal retirement accounts, similar to 401(k) plans.

There is intense debate between the two groups advocating each broad approach. Many analysts believe that a resolution is likely to encompass elements of both models, in recognition of political realities, where compromise is necessary.

Discussion of Potential Solutions

The general consensus is that a simple modification to the current System (tax increases and/or benefit cuts) would fix the problem now, but not permanently for future generations. For example, if the combined 12.4% tax rate were raised immediately to 14.29%, or current benefits were reduced by 13%, the system would be funded until 2078. If no action is taken before 2042, taxes would have to rise to 16.9%, or benefits would have to fall by 27% to keep the System funded until 2078.¹³ Proponents of modifying the current System regard Social Security as a “safety net” and not a catalyst for economic growth. Advocates argue that these changes would preserve this safety net and fix the financial imbalance for many decades.¹⁴ On the contrary, critics contend that raising taxes will inhibit job and wage growth, slowing overall economic growth. Furthermore, cutting benefits will give workers negative returns on their payroll contributions and will break the social contract between the Government and its citizens.

Proponents of overhauling the System argue that simply modifying the current model is only a

temporary solution, whereas investing taxes in the capital markets would ultimately defuse the financial liability created by the current System. Investing in the capital markets would provide more overall economic growth to the economy and help to temper the constraining effects of Government influence on the overall economy.¹⁵

There are two primary approaches for investing payroll contributions:

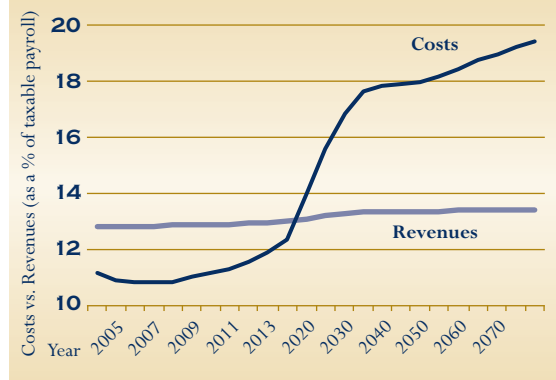
1. A central pension fund managed and administered by the Government, and
2. Private accounts akin to a 401(k) plan.

In a centralized plan administered by the Government, taxes are paid into a large pool in which the Government directs the investments. Advocates of this approach point to the efficiency of the model. Opponents warn against potential Government control of the economy.¹⁶ The second approach to investing contributions is a system of personal retirement accounts where the individual has control of the direction of the investments. The benefits of this approach are that it might help stimulate economic growth, enable individuals to earn market returns on their contributions and grow a retirement nest egg, and restore confidence in the retirement system. Opponents believe this approach might encourage participants to incur excessive risk, divert savings from existing savings accounts, and expose retirement income to the vagaries of the markets.¹⁷

Implications of Reform for Organizations

Providing for retirement income is a major financial and administrative challenge for most organizations. Therefore, any potential change in the structure and

FIGURE TWO
Projected Social Security Costs and Revenues From Taxable Income



Source: 2004 Trustees Report (OASDI), Table IV.B1.

¹² The Board of Trustees, The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

¹³ The Board of Trustees, The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

¹⁴ Diamond, Peter A. and Peter R. Orszag, “Reforming Social Security: A Balanced Plan,” The Brookings Institution, *Policy Brief # 126*. December 2003.

¹⁵ Koitz, Dave, “Social Security Reform: The Use of Private Securities and the Need for Economic Growth.”

¹⁶ American Academy of Actuaries, “Social Security Individual Accounts: Design Questions,” American Academy of Actuaries. *Issue Brief*. October 2003.

¹⁷ Diamond, Peter A. and Peter R. Orszag, “Reforming Social Security: A Balanced Plan.”

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economics of Social Security has implications for an organization that sponsors a retirement program. The scope and complexity of government regulation is likely to increase regardless of the ultimate nature of the reforms. Organizations will therefore need to add additional resources to comply with these regulations.

Social Security reform is likely to impose additional financial pressures on both employers and employees. Reform will require steps to reduce the unfunded liability. Employers and employees will likely bear these costs.

If payroll taxes rise, organizations will likely incur higher tax burdens because Congress will likely allocate these tax increases to employees and employers. A higher payroll tax burden might require some organizations to curtail the scope of current retirement programs. These financial pressures might hasten the demise of traditional defined benefit plans.

If Congress approves private savings accounts, employers will need to evaluate how to modify current retirement programs, because current programs are designed in recognition of other retirement savings opportunities available to employees.

If benefits are reduced, workers might look to employers to make up the difference. Workers

might decide to work longer. One consequence of an aging workforce might be higher medical bills.

If the current unfunded liability of Social Security is not properly resolved, significant dislocations in the economy and capital markets might ensue. The persistence of the Social Security legacy cost might provoke higher inflation as a mechanism for the Government to diminish the real burden of this liability.

Management Responses

Social Security reform is likely to shift higher costs to employers due to the need to help finance the unfunded legacy liability. These financial pressures will increase the importance of managing investment risk properly and improving investment returns.

Summary

Social Security has enabled generations of Americans to enjoy dignity and stability following long working careers. But the System has accumulated a large and growing unfunded liability. This financial burden threatens to impair economic growth if Congress does not fix the System's structural imbalances. Reform appears inevitable. The specific reform measures will have significant implications for employees and employers. Social Security reform will likely affect the structure and management of employers' retirement programs, and the importance of managing investment risk and enhancing investment returns is likely to increase.

Calendar of Events

April 12,
2005

Yanni
Partners
Client
Symposium

Pittsburgh Airport
Wyndham Hotel

Attendance by
invitation only.

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