LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> "In general, the art of government consists of taking as much money as possible from one party of the citizens to give to the other." –Voltaire (1764)

The world's first Old Age Pension program was introduced in 1889 by Otto von Bismarck, a Prussian German Statesman. The pension started at age 70 when the life expectancy of a Prussian was 45. When Social Security was introduced in 1935 in the U.S., the retirement age was 65 and life expectancy at birth was 62. Life expectancy at birth now averages about 78.

As is well known, Social Security is not actuarially sound. One of the reasons is that life expectancy has been rising by two or three years for every ten that pass. We should have figured that out early on as the first person to receive Social Security benefits, Ida May Fuller, lived to be 100. She collected lifetime benefits of more than $22,000 after paying in only $20.33.

A fundamental problem with Social Security is that it operates on a pay-as-you-go basis with benefits financed by current taxes. Payroll taxes are collected and close to 90% of the money that comes in is paid out within 30 days in current benefits. Any surplus is loaned to the federal government and spent. According to projections by the Congressional Budget office this past March, Social Security benefits paid out will exceed payroll taxes collected within the next year or two.

There is no *lock box* as some politicians claim. The system works as follows. The Treasury gives the Social Security Administration a non-negotiable, special-issue IOU for the amount of the spent *surplus*. This is a Treasury bond only in the wildest stretch of the imagination. The bonds accumulate interest by the Treasury issuing additional IOUs in lieu of interest. There is never any cash payment involved. When the time comes for Social Security to cash in its IOUs to pay benefits, the federal government—which holds no assets for this contingency—will pay the bill by issuing additional public debt.

Another reason Social Security is in trouble involves the *dependency ratio*—how many workers it takes to pay off each beneficiary. When Social Security was founded there were ten workers for every retiree. That ratio had dropped to 5.1 to 1 by 1960 and is now around 3.4 to 1. It is projected that by 2030 there will be just 2.1 workers paying in for every one retiree. By then, either the individual workers will have to contribute substantially more to the system or retirees will have to settle for smaller checks.

From early on, it was assumed that since the contributions were not deductible for income tax purposes, benefits would not be taxed. That changed in 1983. Initially, 50% of the benefits were taxable to those who were above a certain income level. Currently, 85% of benefits are subject to the income tax. The tax collected is added to the trust fund surplus. (In the form of IOUs, of course.)

The taxation was legislated in a discriminatory way that, in effect, introduces a means test into the Social Security system for the first time. Retirees with above-average income are now required to report 85% of their Social Security benefits as taxable income. It is easy to see where this step might lead. The progression could be to tax 100% of the benefits of those with above-average income, then to tax everyone's benefit, and then to suspend benefits for those who have been sufficiently prudent (or imprudent) to provide themselves with a meaningful amount of retirement income. The long-run future of Social Security would then be an add-on tax for those Americans who make a success of themselves, for which they would receive nothing in return.

Those who are already retired can probably count on receiving most of their Social Security benefits. The younger citizenry, however, may not be so fortunate.

October 2009