Social Security's Funding Crisis Has Arrived

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by Gary Shilling

The Social Security Trust Fund has done quite well in recent years, due to the postwar babies' surge into the labor force in the last decades of the 20th century while retirees from the low-birth rate Great Depression years were drawing relatively few benefits. The combination of these two forces pushed the Social Security Trust Fund balance from about zero in 1980 to $2.9 trillion today. But now, the coronavirus pandemic threatens to undo all those gains, and without swift action by the government a new crisis may be at hand.

The fund's Trustees noted in an April report that net inflows into the Trust Fund will turn negative next year, commencing a demise that will see the Trust Fund go broke in 2035. Then, payroll taxes will cover only 79% of promised retiree benefits. Here's the troubling part: "The projections and analyses in this year's report do not reflect the potential effects of the Covid-19 pandemic on the Social Security program," the Trustees stated in the annual report. Clearly, benefits will increase as more workers retire early or claim disability while payroll taxes swoon with the drop in employment.

Social Security is not like a cash-value life insurance policy in which an individual's premiums and interest earned on them are eventually paid out to the insured or in death benefits. Instead, Social Security transfers the payroll taxes of employees and employers to retirees, plus interest.

The huge net inflows of recent years masked the vast expansion of Social Security payouts since World War II that were not actuarially matched by offsetting payroll taxes. That removed any semblance of a savings plan and shifted Social Security to a family welfare scheme. Payments are made to many who aren't paying payroll taxes, including non-working spouses, widows and children. Also, originally, annual retiree benefits were 17.5% of earnings in the last five years of work but have reached 33% of retiree incomes, on average.

Now, 10,000 postwar babies are reaching 65 every day and retiring to draw Social Security benefits. This year, 65 million Americans, or 20% of the population, are receiving over $1 trillion in benefits, including 90% of those over 65. And many currently employed are in the relative sparse baby bust generation that followed the postwar babies, the last of whom were born in 1964.

Social Security's plight has been obvious for decades and the longer Washington procrastinates, the more difficult the solutions. The Trust Fund Trustees state that ensuring solvency over the next 75 years would require a 3.1- percentage point rise in the 12.4% current payroll tax that is split between employees and employers. Even less politically attractive would be an immediate 19% across-the-board cut in benefits. Waiting for the Trust Fund money to run out in 2035 would require a 4.1-percentage-point rise in the combined payroll tax or a 25% cut in benefits, the Trustees calculate.

The increased woes from the pandemic may finally force Washington to act, as costs will probably balloon to the point that the fiction of a self-funding Trust Fund is abandoned and Social Security benefits are paid directly by the Treasury. That would eliminate any protections Social Security has from politics, but concerns about the resulting jump in the federal budget deficit would mount. Payroll taxes on higher incomes and perhaps capital gains as well would be used to redistribute income downward.

If self-funded Social Security benefits are an entitlement that is no longer affordable, so too are state pension fund benefits. Decades of lush retiree benefits, overly-optimistic investment return assumptions, insufficiency pension fund contributions and lengthening retiree life spans have resulted in the liabilities of public pension funds exceeding assets by $1.2 trillion in 2018, according to the latest data and Pew Charitable Trusts. The pandemic will surely worsen the mismatch.

As with Social Security, options to restore to health these pension plans, which are only 79% funded on average, are unattractive. State governments are already strained by falling revenue from declining sales and income taxes, and are unlikely to help. Cutting benefits is politically difficult. To boost investment returns, pension funds can continue to shift to hedge funds, private equity, commodities and other volatile investments, but risk-adjusted returns may not improve, as was seen in the first quarter.

Some states have introduced cost-sharing policies that distribute unexpected gains and losses among employers, employees and retirees. Others are shifting from more expensive and burdensome defined-benefit to defined-contribution plans for new employees or introducing hybrid plans that contain elements of both.

As with Social Security, the coronavirus crisis may force action on these entitlements.

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