401(k) INVESTMENTS

The Retirement System Diaries, Chapter 2: Paying for Socialism

This is the second in a series of three articles designed to encourage clear thinking and a bit of apoplexy. The ongoing theme is that the United States has a strong social insurance portfolio, and we like it that way, but we need to figure out how to pay for it.

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The word "socialist" is so freighted with partisan political overtones in the United States that it is difficult to use it without having its meaning lost. Just as many people avoid the word "liberal" because it evokes "Liberal," or "conservative" because it sounds like "Conservative," "socialist" has become a word we avoid unless describing a small portion of the political spectrum. This is too bad because there is no handy synonym for socialism, and we need one, because the United States—by any reasonable historical measure—is a socialist republic. And, more to the point, we appear to like it that way.

Here's how you can tell: What would you call a person who supports a social welfare system that consumes roughly 50 percent of tax revenues via entitlement programs such as retirement income, disability, welfare for the poor, unemployment payments, retiree medical coverage, medical coverage for the poor, subsidized housing, and emergency medical care for anyone, regardless of citizenship or ability to pay (such as the system the United States has today)? Historically, you would call such a person a socialist. Sixty years ago, such a person would have been denounced as a communist and whisked away by J. Edgar Hoover. And since the United States, on the whole, strongly supports these social benefits, we are, *ipso facto*, socialists.

But "socialist" seems to make everyone fidgety, so I will try to tread lightly.

I had lunch with an accountant in San Francisco some years ago. She is politically Left, and in talking about her city she confided, "I love this city. I love the sense of social justice and of commitment to a better world. But these people just do not understand that *there isn't enough money*." (The emphasis was hers.) There is an infinite supply of perceived wrongs in need of righting, and proposals for the righting inevitably call for spending money. And because it's injustice we're fighting, there is a sense of "cost be damned" that leads politicians to agree to spend the money whether it exists or not. And once the money is spent in advance, we're stuck with figuring out how to pay for it. Because the wrong simply *must* be righted. Considering cost is the sort of thing only an enemy of justice would do.

The problem is that most of the really juicy injustices are already taken. Now that problems like workplace deathtraps and seven-day workweeks for child factory workers are taken care of, modern labor heroes are forced to fight for the common man in areas such as ATM fees and the percentage of handicapped spots in the grocery store parking lot. *Vive la liberté*! But the flip side of this fight over marginal benefits points to an important truth—the basic social insurance portfolio is now firmly in place.

Americans overwhelmingly support the ongoing existence of Social Security, Medicare, Medicaid, unemployment benefits, disability benefits (part of Social Security), food stamps, and the rest of the social insurance portfolio. Disagreement over the details of these programs is, of course, significant. But Americans, by and large, no longer dispute the need for the existence of the programs. This is big. Sixty-five years ago, support for social insurance was tantamount to being a communist, at the height of the "red scare."

Fabius Maximus, the "*cunctator*" (delayer) was the author of the "Fabian strategy" of delaying and harassing the enemy, little by little. Fabius used this strategy to help defeat the seemingly invincible Hannibal, despite being a target of ridicule in Rome (thus the nickname) over his refusal to enter into a decisive battle. Fabius eschewed the big, showy move in favor of the small, slow, incremental buildup that led to ultimate victory.

And so a society of British socialists named itself The Fabian Society, based on their worldview: instead of achieving social and economic justice through violent upheaval and the overthrow of nobles and the petty bourgeoisie, the Fabians advocated an incremental approach. Take peaceful baby steps forward over time, and eventually—Utopia, Shangri-La, New Atlantis, Star Trek: Next Generation. (Just watch the show—they're big ol' socialists in the 24th century.)

As a former Marine whose training was based on fighting communist guerrillas and Soviet weapons, and at the risk of sounding maudlin, the concept of a peaceful battle for freedom and social justice is an emotional one for me. Images of the Berlin Wall coming down and listening to Bernstein's "Freedom Concert" make me cry. Fabius had the right idea.

The incremental series of changes in the United States over the past hundred years mirrors the pattern in Europe, though we started later and are therefore not as far along. But consider: in 1900, there was no social insurance safety net, child labor was legal, there were no overtime laws, there was no worker's compensation insurance for on-the-job injuries, no disability, no pensions, no health care.

Today, we have all of this. And more importantly, we like it that way. The vast majority of Americans would not consider outright elimination of these programs, and even the most ardent political conservatives speak mainly of fiscal sanity, not rolling back the social insurance clock completely.

So … we're socialists. The Fabians have won. Incremental changes have created a world in which a level of social programs unthinkable just 60 years ago is now accepted as a minimum requirement of modern society. And most of us agree that this is a good thing. So the focal point has shifted. The debate is no longer about creating social programs—though plenty of voices continue to call stridently for ever more resources to be spent on social programs—but on how to pay for them.

And so we get to the point of this screed. We need more people to have a gut-level understanding of the simple arithmetic of the social insurance fiscal crisis and grasp the big picture, which is this: We cannot afford the social insurance benefits we are promising to ourselves. We must cut projected (*i.e.*, future) benefits now or watch them evaporate through the economic laws of nature. We must, at a minimum, slow the growth in spending so we inflict less harm on our children and grandchildren. And, yes, we can raise taxes, but that will only go so far. Taxes alone cannot solve this problem. And because it's so politically easy to give benefits and so hard to take them away, kicking the can down the road is the *status quo*.

And it's a big can. For example, here in my home state of Kentucky, our pension crisis is so bad that even other states' seriously underfunded pension systems look like rainy day funds by comparison. The largest component of our three component state pension system is roughly 20 percent funded using the state's assumptions. But it gets worse: the state's assumptions are inflated. Like most states and municipalities, Kentucky uses an interest assumption that is significantly higher than what private companies are permitted to use by law. Higher than what virtually any Wall Street investment guru would use as a capital markets forecast when the talk of the day is of negative interest rates.

Specifically, Kentucky uses 7.5 percent, whereas the typical small business must use roughly 4 to 6 percent, and at a time when bonds (a primary pension investment) are only paying 2 to 3 percent. The mathematical consequences are enormous. By Kentucky's own math, the pension system is underfunded by roughly $20 billion, or $30 billion, depending on which accounting report you consult. But if we use the same assumptions that private companies are required to use, the real level of underfunding as much as doubles. This in a state in which the total annual income (tax revenue) is $10 billion, and pensions are hardly the only demand for resources.

Using Kentucky's low cost of capital (municipal bond yields are roughly 4 percent, which is a good proxy) to come up with a payment schedule, a financial planner armed with a cell phone calculator app would probably say that Kentucky needs to spend 10 to 20 percent of its current budget on pension underfunding alone for the next 30 years to pay for this liability. In point of fact, Kentucky is doing no such thing.

Kentucky provides a microcosm of the global reality: most entitlement programs are seriously underfunded, and the minimum cost of liquidating the underfunding is not currently being paid. To put this in perspective, imagine if you had $50,000 of income and a credit card with $150,000 of debt (the same ratio as Kentucky's $30 billion of pension underfunding compared to its $10 billion income). Because of your stellar credit rating, you get a great interest rate—only 4 percent—and the card company will let you pay a minimum fee that is just $9,000 (1/4th or less of what most credit cards actually require)—enough to amortize (pay off) the debt over 30 years. But you don't make the minimum payments. In fact, you pay less than half, even while you continue to add new debt to the credit card.

This is exactly the situation for governments across the developed world; new debts continue to pile up due to budget deficits, adding to the total debt that must be amortized. The minimum payments for the debt are not made, further adding to the underfunding.

The true situation is, of course, more complicated. Interest rates, inflation, monetary policy, minor reforms, economic cycles, real wage growth (or stagnation), and a host of other factors all affect the true math. But the basic facts are not disputable: The developed world has huge unfunded liabilities from social programs and huge national debts, and is running on deficit spending; deficits add to debts; the minimum amortization cost of the debt is not being paid, which compounds the debt. This is not sustainable.

The political environment surrounding the math can be summarized as follows: Politicians generally understand the situation and know something must be done, but the pattern of public discourse is that those politicians who propose fixes are attacked by other politicians for taking food from the mouths of seniors. More importantly, democracies and republics run on elections, and elections tend to be won by promising people goodies, not taking goodies away. Progress is, needless to say, slow in this environment.

Almost all of the blame for this situation could be laid at the feet of demographics (though doubtless we can find others to blame if we work at it). If the 250-year population explosion that began in about 1800 were not ending, population growth would mean that the "pay as you go" or PAYG system would work just fine, more or less. But with birth rates in the developed world now below the "replacement rate" of 2.1 live births per female, and birth rates in the developing world plummeting, the UN predicts a leveling off of global population at around 9.2 billion, give or take a billion, by around 2050. So PAYG is doomed as currently structured.

What's the alternative to PAYG? Funding. Saving money to pay for future benefits. The problem is that the transition from PAYG to funding is painful, for multiple reasons, but especially because it involves a double payment: at the same time that we are attempting to fund promised PAYG benefits, we are trying to save for future benefits. At the expense of the young. Even this might be OK if we had strong real wage growth (*i.e.*, after inflation), but we don't. Wage growth is stagnant. If you're a Millennial, you should be super annoyed.

I'm an optimist, so I think the United States will figure this stuff out before inexorable economic forces eliminate the problem for us at twice the pain, and at the expense of those who can afford it least. Mostly, I think that. But I wish we would pick up the pace. ■