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According to U.S. government projections, in 2020 the Social Security program will start drawing down its assets to pay for all of the benefits promised. This is the first time this has happened since 1982. If no adjustments are made, the Social Security trust fund is expected to be depleted in about 15 years around 2034.

This doesn't mean that benefits will stop being paid or that the system is "broken" or not working as it should. It means that the surplus of funds built up from the large Baby Boom generation will be used up. Benefits will then need to be supported by current working generations. This is the way a pay-as-you-go system like ours works.

You might be wondering how we got into this situation in the first place. Despite its importance to our society, most of us don't know the history of Social Security and how it works. The story behind it is fairly straightforward, its funding challenges were predicted in advance, and it's not the Baby Boomers fault, like you might think.

The Social Security system as envisioned by Franklin D. Roosevelt resembled a private insurance plan—a fully funded way for workers to gradually build retirement savings that would grow at the rate of return of government bonds. He expected each generation to receive benefits roughly equal to their lifetime contributions plus interest.

However, this is not how the program was actually implemented by lawmakers. Many older people were destitute in the 1930s during the Great Depression, and there was extreme pressure to provide financial assistance. As a result, political pressure was rising to tap into Social Security funds to immediately give money to those that were destitute.

Roosevelt initially resisted this because he did not want future generations to go into debt to finance the system. He felt it would be unfair to have large unfunded obligations that would have to compete with other programs for government resources in the future. He also felt it was unfair for anyone to get less out of the system than they put in, which would be necessary if funds were given to the elderly in the 1930s who hadn't contributed.

However, lots of money was just sitting in the Social Security system with people in need and Roosevelt lost his political and policy fight. In 1939, lawmakers decided to use the funds to start paying full benefits to those who had paid little or nothing into the system. This turned Social Security into a pay-as-you-go system with predictable consequences down the road for future generations.

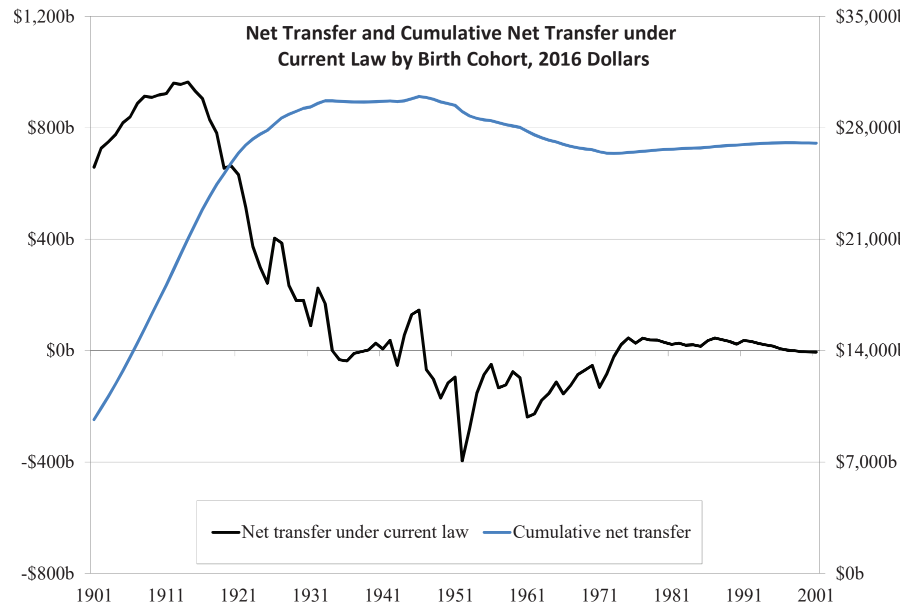
By paying lifetime benefits to these early recipients, the nation effectively gave away the Trust Fund that would have accumulated, as well as the interest that would have been earned on that money. Researchers call this the "Missing Trust Fund," which raises the cost of the program because taxes must be higher in the future to cover the lost interest payments on this money. In fact, the Center for Retirement Research estimates that payroll taxes are 3.7% higher than if Social Security was operated as a fully funded plan.

Another effect of paying large benefits to early cohorts is that later generations will necessarily earn a comparatively low rate of return on their contributions. Early beneficiaries make out very well because they didn't contribute much, yet they received full benefits. This is not indicative of a flaw in the Social Security system. It's simply the mathematical reality of a pay-as-you-go system that has matured. If early generations receive above-market rates of return, all others must receive below-market returns.

BUCKINGHAM
STRATEGIC WEALTH

Average annual rate of return for U.S. Social Security retirement and survivors benefits for those born in selected years	
Year of Birth	**Average annual rate of return**
1876	36.5%
1900	11.9%
1925	4.8%
1950	2.2%

Source: Dean Leimer, "A Guide to Social Security Money's Worth Issues," Social Security Bulletin, Summer 1995, Table 3.



Source: Alicia H. Munnell, Wenliang Hou, and Geoffrey T. Sanzenbacher (2017) *How to Pay for Social Security's Missing Trust Fund*. Center for Retirement Research at Boston College.

The figure to the right shows the net transfer (benefits minus contributions) and cumulative net transfers for each birth cohort since 1901. You can see that early recipients had positive net transfers at the expense of future generations. Not only did Baby Boomers born from 1946 to 1964 not cause Social Security's problem, they have actually paid more into the system than they will receive in benefits. More recent generations are expected to fare better than Boomers.

Now that we understand the history, where do we go from here? At some point in the next 15 years, either benefits will need to be cut, taxes will need to increase, or some combination of the two will need to occur. Changes will probably happen later rather than sooner given our political climate, but the demographics are certain—there are going to be too many people drawing benefits relative to those contributing to the system. Lawmakers are keenly aware of the problem but have been reluctant to deal with it until it's forced upon them.

If *taxes are left unchanged*, benefit cuts are projected to be around 20% and could take the form of smaller monthly checks, reduced inflation adjustments, a delay in the start date of benefits, or some form of means testing for the wealthy. The Center for Retirement Research projects that to *keep benefits the same*, payroll tax deductions would need to permanently increase by 3-4% or income taxes would need to permanently go up a little over 2%. These tax increases are what is needed to replace the interest that is lost every year on the Missing Trust Fund.

It is impossible to know how the future will unfold but it seems likely we will see some combination of future benefit cuts, delayed starting dates and payroll tax increases. This is something we will keep in mind as we help you with your longer term retirement planning.

As always, thank you for you continued trust and confidence.

Warm regards,

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