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The Entitlement Time Bomb Politicians Refuse To Discuss

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In a presidential campaign full of controversial headlines, one looming policy issue with major consequences has been largely ignored. Our country is simply not prepared to meet the promises made to the baby boom generation for retirement income and medical care.

The sheer size of the baby boom is a major part of the problem, with roughly 76 million people, born between 1946 and 1964. That group dramatically eclipses the numbers born both before and immediately afterward.

Public financing for retirement programs has depended upon a favorable ratio of retirees to workers. Census data show that ratio will fall from 3.5-to-1 in 2015 to 2.3-to-1 by 2035. Workers would need to increase their contributions to Social Security by 50% to keep pace.

Without that increase, today's $2.8 trillion Social Security trust fund will be wholly inadequate. In 2013, the Social Security Trustees estimated the future unfunded liability at $23.1 trillion. If that entire amount was paid out over the 35 years of life expectancy for the youngest boomers, average government spending would need to increase by almost $600 billion per year.

Medicare makes the problem much worse. The Social Security Trustee's estimated a $43 trillion unfunded liability for the Medicare program in 2013. A Cato Institute paper in 2015 "conservatively" estimated Medicare's unfunded liability at $48 trillion, but also noted it could easily swell to $88 trillion if medical inflation reaccelerated. Amortized over the same 35-year horizon, those figures would add between $1.2 trillion and $2.6 trillion in annual federal spending.

Several solutions have been proposed to fill the funding gap, but they fall into four basic categories: reduce benefits, raise taxes, borrow more or print more money. Unfortunately, none of these options readily solve the problem.

Reducing Benefits

A 2015 study by the Insured Retirement Institute reports that 40% of boomers have no savings at all, and only 19% have saved even a minimal amount for retirement. Moreover, simply assuming boomers will work longer to cover the shortfall does not fully reflect the reality of today's workplace, where structural changes in the workforce are eliminating many jobs boomers might occupy.

Proposals to cut the level of benefits or raise the retirement age also seem impractical. In July, average retirement benefits under Social Security were about $1,300 per month. Given normal living costs, cutting that amount by much would be difficult. Moreover, increasing the retirement age by one or two years when life expectancy runs into the mid-80s seems unlikely to significantly reduce the funding shortfalls.

Raising Taxes

Many advocate removing the income cap that exempts wages above $118,000 from Social Security taxes. While taxing all household income above that amount would raise an additional $200 billion, in reality, the revenue raised would be much less. Most households have more than one wage earner, and that amount does not capture the exempt portion of a second household wage. Moreover, wages and salaries constitute only half of personal income for the nation, and higher-income households tend to get more of their income from sources that would not be taxed.

Likewise, proposals to increase the Social Security tax for everyone by 2%, could raise almost $200 billion if the total of all household income were taxed. But again, nonwage income would cut that roughly in half, and there would be significant pressure to exempt lower-income wage earners from any increase.

Increasing Borrowing

Net national savings as a percentage of the economy has fallen from roughly 11% of GDP in the 1960s ($1.8 trillion in today's economy) to only 3% of GDP today (a little less than $500 billion). Thus, most of the additional money would need to come from overseas. China and Japan, our two largest overseas lenders, currently own roughly $1.2 trillion and $1.1 trillion of U.S. debt, respectively. It seems unrealistic to think that we could simply borrow an additional $1.8 trillion to $3.4 trillion each year.

Printing More Money

Printing more money to cover required spending needs is the solution of last resort. That would probably generate less political opposition in the short term, but would almost surely generate higher inflation over time.

According to the St. Louis Fed's website, the broad Money Zero Maturity measure, which measures the liquid money supply within an economy, stood at $14.5 trillion in September. If we printed the $71 trillion needed to cover the Social Security and Medicare shortfall, it should add about 5.2% to the annual inflation rate over a 35-year horizon, absent any offsetting changes in other monetary or fiscal policy. Bear in mind, too, that higher inflation would also presumably increase the funding shortfall.

What Should Investors Do?

There is no easy fix for this problem. The shortfall is large enough that we will undoubtedly need to employ multiple measures. All of these options could, in part, help to address the looming retirement funding shortfall, but ultimately, higher inflation seems inevitable.

Investors should understand that equities provide one of the best long-term protections against inflation. While rising inflation can depress equity prices in the short term, rising corporate asset values and earnings should offset that effect over time. International equities can be particularly helpful at insulating investors from inflationary pressure in the U.S.

Eventually, politicians will be forced to deal with this issue. The longer they wait, the harder the adjustment will be, but the society and the economy will survive. Even if the politicians remain oblivious, investors can prepare. With an appropriate portfolio strategy, investors can help assure a better financial future for themselves and their families.