The Journal of Portfolio Management

# The Real Issue in the Social Security Debate

Peter L. Bernstein

As the debate over Social Security develops, the focus of attention, as is so often the case, has been consistently in the wrong direction. Changing the financial arrangements is an issue of secondary importance. The real issue is the real issues.

The confusion arises because many people perceive Social Security as somehow distinct from other kinds of transfer payments. But the confusion runs deeper than that. We would do well to recognize that *all* retirement funds face problems that are identical to the problems faced by the Social Security system.

Payments out of any retirement fund—a defined-benefit pension fund, a defined-contribution retirement fund like a 401(k), an IRA, and all the variations on these themes—are transfer payments just as much as Social Security or Medicare or veterans' pensions are transfer payments. Retired people need cash to pay for their groceries and other needs, but putting retirement funds in the mattress or the piggy bank makes no sense. The alternative is to accumulate retirement funds in non-cash earning assets of one kind or another or, like Social Security, as a claim on the government's largesse. Either way, when the day comes for these funds to serve their ultimate purpose of paying for the groceries of retirees, the assets and the claims will have to be converted into cash.

Remember, these individuals are by definition retirees, which means they are no longer earning an income that would pay for the groceries. The money they need must be a *transfer* from some other source. Even drawing on their own capital represents nothing more than a transfer from some other source.

What does this mean? It means the economy will have to be a healthy and vibrant one out there in the future, or nothing works. Pension funds and other retirement funds cannot support retirees unless the cash income these funds earn from dividends and interest meets expectations or unless capital markets are willing and able to absorb asset liquidations without depressing prices in those markets. In the same way, the government must have an adequate flow of revenue or borrowing power to provide the necessary cash to pay the beneficiaries of entitlements.

Hints of this fundamental problem have appeared in the debate over private accounts in Social Security, when opponents of this route worry about what would happen to retirees if the markets are depressed when the day arrives to start liquidating those accounts to pay for current living expenses. There is also a widespread recognition that future cash flows into the Social Security system will be insufficient to fulfill today's promises for future payments.

But the same kinds of worries should apply to *any* retirement fund, including fully funded defined-benefit pension funds. Vibrant stock markets—and bond markets that reflect confidence about future inflation rates—provide the only kind of environment where the conversion of transfer payments will meet expectations without creating turmoil elsewhere. This is where we must focus our attention.

The financial arrangements we choose will influence how we divide the pie in the future, but in the end the size of the pie and the quality of its ingredients are the critical variables. As the future is the result or the creation of the present, the way the nation manages its affairs now may be more important to the solution of the Social Security dilemmas than whether we establish private accounts or continue with the current system.