

## Sizing Up Social Security

Size does matter you know. There are basketball players, NFL linemen, and the more popular but unmentionable allusion to the bedroom that makes my point, although the older one gets, the more irrelevant playing basketball and football become, if you get my drift. More interesting to me than any of the above, however, is the application of size and its relevance to the animal kingdom. Randy Newman raised eyebrows and a goodly number of hackles three decades ago with his "Short People" ditty – "Short people got no reason, short people got no reason to live" he crooned and the vertically disadvantaged got mad and the tall people laughed and the world went about its business of favouring size – in this case when measured from head to toe. Mr. Newman's parody was so radical that I suspect he was asking us to think as opposed to expressing an opinion, and if so, he was and may still be more of a Buddhist than a Redneck. But I speak not about the size of people here – but to animals of the more ordinary kind.

I am not what you might think of as an animal lover. I've had some great dogs, I now put up with three of Sue's cats, but on the whole I've become more of a life respecter than an inveterate petter of felines or canines. That is, I don't go gaga over them, but I'm glad to have them around because I'm trying to respect all kinds of life and am more

and more pleased by personally being above as opposed to below the grass.

But there's something about the size of a living thing that increases or diminishes my sense of caring and I'm not sure why that should be. Let's start at the top of the height chart and see if you too share this size bias: Elephants, giraffes, whales. Good vibes? Of course. Who couldn't love them? They're either smart, elegant with those long necks, or symbolic of benign power and strength. Would you ever want to kill one? Almost unanimously you'd answer in the negative assuming your name isn't Captain Ahab or you don't run a safari company under the name of "The Great White Hunter." But now let's go small: ants, snails, worms. Feelin' good now? Not so much I suppose since almost all of us have eliminated a bunch of these guys with nary an afterthought. Yeah, I know they get into our kitchens and slime across our lawns and driveways, which is something whales don't do. But a living thing is a living thing no matter what its size. See what I mean? Isn't this somewhat of an intellectual twister of sorts? And just to take one step further into the Howard Hughes deep end, who ever gives a second thought to eliminating billions upon billions of bacteria when they wash their hands? Certainly not me (whew! I'm no Aviator), but the absurdity of the example sort of proves my point. Size does matter, but maybe

it shouldn't so much when it comes to living organisms. Small things, as Newman might have agreed, really have as much a reason to live as big things. Don't get me wrong; I'm not on a stump here calling for the abolition of the Orkin man. I just find it interesting how the bigger they are, the more we seem to love them, but when they get small we give hardly a damn.

Size matters in economics and finance too. Wall Street, K Street, and increasingly Main Street are all "abuzz" about Social Security and the size of our future liability to senior citizens. Can we afford it and what year does the system go bankrupt? (2052 according to the CBO – the day after tomorrow if you listen to Bush's urgent tones). But this argument about insolvency and how much money is or will be in the Social Security Trust fund is really all so silly. It is an argument to promote an agenda that has little to do with seniors and more to do with Bush, his ownership society, and ultimately his domestic legacy alongside the likes of Ronald Reagan and FDR. Without a blockbuster of a program in his second term it is unlikely that Bush can go very far in the history books on the back of a paltry 3 or 4 percentage point tax cut for the rich. Presto! We now have partial privatisation of Social Security heading the agenda upon which the President intends to spend his well-advertised political capital. Privatisation, however, is advanced as a simple way to salvage a sinking system when in fact the problem has more to do with demographics than the lack of ownership.

Rob Arnott of Research Affiliates LLC, sub-advisor of PIMCO's all asset strategy and a co-collaborator with Peter Bernstein on several articles about risk and future asset returns, has advanced what I consider to be the most realistic take on Social Security and Medicare trust funds. Pre-funding these systems, he argues, "is basically irrelevant." And (in my own words) it matters little whether the system is pre-refunded with Treasury bonds or privately held stocks. The fact is that both of these financial assets represent a call on future production. If that production could possibly be saved, like squirrels ferreting away nuts for a long winter, then Treasury IOUs or corporate stocks might make some sense. But they can't. Future healthcare for boomer seniors can only be provided by today's teenagers, twenty-somethings, and even the yet to be born. We cannot store their energy today for some future rainy day. Nor can we save food, transportation, or entertainment for anything more than a few years forward. Each must be provided by the existing generation of workers for those who have retired and are presumably incapable of working. And, as Chart I points out, the ratio of retirees to workers – the dependency ratio – soars from 0.2 retirees for every worker to 0.35 over the next 20 years or so. There's your problem, and neither privatisation nor any goodly number of government bonds deposited in the Social Security trust fund can solve it. While these paper assets may "pay" for goods and services, their value will be market adjusted in future years to exactly match the quantity of things we buy, and that quantity will be

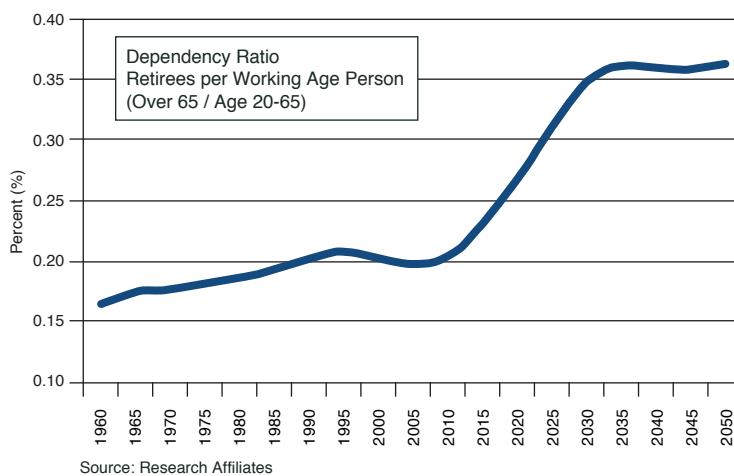
substantially a function of the available workforce and the price they command for their services. This is a concise way of saying that the value of Treasury bonds and even stocks will be valued down in price as they are sold to pay for future goods and services, and that the price of these goods and services will be marked up (inflation) to justify their reduced supply.

Where Social Security and privatisation supporters err is with their assumption that retirees' goods and services can somehow magically be generated or even multiplied by the existence of a certain amount of government or private IOUs. They cannot, at least within the U.S. borders. Production can only come from employed workers and so the basic solution is to produce more workers, either through immigration or postponed retirement for the existing workforce. Productivity gains are often advanced as a solution but employed workers cannot be expected to hand over future advances to retirees without a fight. Having more babies would also turn the trick, but at the moment,

making fewer seems to be the going trend. Let's see Bush try and reverse that juggernaut!

Does this mean that we should all eat, drink, and be merry and leave tomorrow to future generations? Not at all. I mentioned that future IOUs would be of little help in providing senior boomer goods and services but there's little doubt that the minimizing of those IOUs will make the job a lot easier. By reducing budget deficits now, and especially that portion of the deficit owed to foreign governments, we would be able to keep more of our domestic production within our borders and therefore available to senior citizens, a thought that presumably Pete Peterson of the Blackstone Group and a serious thinker on Social Security would agree with. Similarly, lower deficits ultimately should result in lower future inflation, reducing the burden on seniors with fixed incomes and making it possible to channel more real goods and services in their direction. President Bush's theoretical prioritisation of fiscal conservatism is therefore a promising ray

### Respect Your Elders!



of hope in this Social Security razzle-dazzle, but I remain to be convinced of his sincerity and/or discipline on this particular issue.

It seems to me that the existing set of politicians, both Republican and Democrat, are either shortsighted or legally blind. Common sense would inform even the most inexperienced Washington bureaucrat that Social Security (and Medicare) imbalances are curses of demographics and not financial funding. Keeping the “size” of our future IOUs low and out of foreign hands would minimize inflationary pressures and the transfer of goods and services overseas in future decades. It would also make it possible in future decades to borrow

more overseas production than we could have with an excessive debt load. But it cannot avoid the baked-in-the-cake increase in the dependency ratio shown in Chart I. It’s the diminishing “size” then of our working population, or if you will, the increasing “size” of our future retirees that makes the critical difference and raises the spectre of crisis. No amount of privatisation or Social Security reform with the exception of higher Social Security taxes (and therefore lower effective deficits) will change that. Size, as they say – in this case demographic size – does make a difference.

William H. Gross  
Managing Director

---

*The services and products provided by PIMCO Australia Pty Ltd are only available in Australia to persons who come within the category of wholesale clients as defined in the Corporations Act 2001. They are not available to persons who are retail clients, who should not rely on this communication. Investors should obtain relevant and specific professional advice before making any investment decision. The information contained herein does not take into account the investment objectives, financial situation or needs of any particular investor. Before making an investment decision investors should consider, with or without the assistance of a securities advisor, whether the information contained herein is appropriate in light of their particular investment needs, objectives and financial circumstances.*

*Investment management products and services offered by PIMCO Australia Pty Ltd are offered only to persons within its respective jurisdiction, and are not available to persons where provision of such products or services is unauthorized.*

*Each sector of the bond market entails some risk. Any guarantee on government bonds is to the timely repayment of principal and interest, shares of a portfolio are not guaranteed.*

**Past performance is no guarantee of future results.** *This article contains the current opinions of the author but not necessarily those of the PIMCO Group and does not represent a recommendation of any particular security strategy, or investment product. The author’s opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. This article is distributed for educational purposes and should not be considered as investment advice or an offer of any security for sale. No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission.*

Copyright 2005, PIMCO

P I M C O

PIMCO Australia Pty Ltd

ABN 54 084 280 508

AFS Licence 246862

Level 19, 363 George Street

Sydney, NSW 2000

Australia

612-9279-1771