Social insecurity: Linking retirement and personal responsibility

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One of the greatest fruits of high productivity and rising incomes in a country like the U.S. is the financial ability people have to retire. This possibility was beyond the imagination of pre–World War II workers and is still far beyond the expectations of most people living in Third World countries. For most of human history, people simply worked until their bodies gave out and then depended on their children to care for them in the last years of life. Now, in advanced economies, retirement figures into almost everyone’s expectations.

However, an expectation does not by itself create an adequate financial base for retirement, especially when the expectation is based—as it is in the U.S.—on substantial Social Security benefits. The fact that Social Security is in trouble has been trumpeted for more than a decade, but still no major reforms have been introduced to put things right. Because all potential reforms involve costs, politicians have deferred the necessary difficult decisions.

Social Security needs to be thought of in the larger context of retirement. Retirement is never a right. It is possible only through the fruit of productive labor, sacrificial saving, effective investment and responsible budgeting. Retirement depends on the willingness of families to routinely make sacrifices, setting aside some portion of their current income. Retirement also depends on firms using these savings to fund investment in new production facilities, better equipment, and research and development. The link between saving (by both governments and families) and retirement income is key to both a healthy economy and its ability to provide for senior citizens.

The connection between saving and retirement earnings is most obvious for those who contribute to Individual Retirement Accounts. It is visible also to those who work in companies that provide pensions for which employee contributions are required.

The danger of delinking retirement income from saving is that families come to count on a *certain* future retirement (as with retirement plans that promise a specific benefit) and therefore tend to save less themselves. This has consequences both for the individual and the economy. For individuals, inadequate saving can make retirement difficult, if not impossible, should expectations about future benefits not be met. For the economy as a whole, less saving by individuals means slower growth in productivity. And slower growth in productivity means that there will be less growth in invested funds and so, in turn, less money available to fund retirement.

Even more dangerous to society is the disconnect that has arisen between the government's promises of Social Security benefits and its own commitment to save to provide these benefits. This weakness was built into the system from its inception in 1935. Originally, benefits paid to current retirees were to be funded exclusively from modest payroll taxes (1 percent of the first $3,000 earned) paid by both current employees and their employers. The initial beneficiaries of Social Security made no financial contributions into the system. During the first ten years of the system, the ratio of workers paying Social Security taxes to beneficiaries was more than 40 to 1. Given Depression rates of unemployment and the poverty conditions that prevailed, a commitment of benefits to the limited number of people who survived past the age of 65 seemed like the least society could do to help older workers and to honor their contributions.

Over the years, Social Security benefits have increased, as have the contributions required of workers. The tax rate for 2007 was 6.2 percent (this does not include the 1.45 percent tax rate paid for Medicare) on the first $97,500 of earnings, with this amount paid by both employees and employers. Benefits are now automatically adjusted yearly to offset the effect of inflation.

But demographic changes have rendered the Social Security system unsustainable in its current form. One important factor is the aging of the generation born between 1946 and 1964. In 2008 the first baby boomers can start retiring—at age 62—and receive partial benefits from Social Security. The baby boomers head into retirement at a time when birth rates have dropped—from 16.7 births per 1,000 people in 1990 to 14.2 births in 2007. In addition, life expectancy has increased over the past 40 years from an average of 70.8 years in 1970 to a projected lifespan of 78.5 years in 2010.

Because of these demographic changes, the number of workers for each beneficiary dropped from 5.1 in 1960 to 3.3 in 2006. This ratio is expected to decrease to 2.1 by 2030 and to 1.8 by 2080. As a result, the Social Security system faces serious funding shortfalls beginning around 2018 and continuing into the indefinite future. Given the huge gap between Medicare's current promises to seniors and its basis of funding, the future of retirement for the next generations is even bleaker.

How did we get into this fix? One reason is that people began to think of retirement funding as a right and primarily a public responsibility, and so—not surprisingly—started saving less. For more than a decade, American firms have been funding more and more of their capital investments—the key to economic growth—with money from foreign investors. Foreigners' willingness to place their savings in the U.S. is good for the U.S. economy in some ways, but it means that an increasing share of the fruits of economic growth goes to the foreign investors and are not available for funding the retirements of American workers.

Social Security taxes and benefit levels are not based on expected rates of return and risk levels for various savings instruments (as is the case in private savings portfolios). In fact, there is *nothing* in your Social Security portfolio. The federal government's excess revenues from Social Security receipts (since Social Security receipts are currently greater than expenditures) are not saved but instead are reallocated to fund other government programs. Meanwhile, the Social Security system continues to promise future benefits. These benefits are thus essentially IOUs from the federal government that must be paid in the future either by higher taxes or by further government borrowing.

The obvious and growing gap between Social Security's commitments and its expected future revenues means that Social Security should no longer be regarded as a riskless source of retirement income. In a poll taken by the *New York Times* in 2005, more than half of the respondents said they did not believe that the Social Security system will have the money to provide the promised benefits when they retire. It is common knowledge among economists, and politicians who are willing to look at the facts, that reforms are necessary. They must include some combination of smaller increases in benefits, higher payroll taxes and delayed retirement.

Such reforms can strengthen the financial position of the Social Security system, but they will do nothing to address the perverse incentives that the system generates. The powerful channels of individual responsibility are weakened when people are forced to “save” out of current income—through payroll taxes—but leave it to legislators with very short-term horizons to make decisions about retirement fund money.

Senior citizens are understandably tempted to pressure Congress to expand current Social Security benefits and to delay reforms, since the burden will be borne by another generation. Would these seniors have been willing to impose this burden on the next generation if it was obviously a direct burden on each of their own children? Not likely. Instead, they would probably have increased their personal savings to avoid becoming dependent for their retirement on their children’s earnings.

However, whole generations have been led to believe that they are actually paying in Social Security taxes all that is needed to fully fund their future Social Security benefits. As a result, current retirees vote to maintain the right to receive benefits exceeding what they paid in, and beyond what the system can sustain.

It is precisely for these reasons that several proposals have been made to create personal savings accounts (a partial privatization of the system) whereby individual retirement incomes are linked to efforts to save. A middle-of-the-road proposal of this sort would take a portion of what is now collected as Social Security taxes and allocate them to personal retirement accounts, invested in a limited number of stock and bond instruments. The options would offer various risk/return values, and would be subject to government regulation. Individuals could choose the mix of risk to meet their own needs and values. Some, perhaps a majority, of Social Security taxes would continue to be collected to provide baseline retirement incomes to all workers.

Reforms such as higher taxes, lower benefits and delayed retirement are designed to put Social Security on a firm financial footing, so that the sheer passage of time does not force future payees and retirees into a crisis that would severely hurt both groups. Proposals to create personal savings accounts (PSAs), on the other hand, are designed to counter expectations that Social Security can be the primary source of retirement income. Because workers have the ability to choose the PSA portfolios that best fit their own circumstances, nobody will be led to believe that society owes them a retirement income. This design has operated successfully in a number of countries. In Chile, for example, national savings rates increased from 10 percent in 1986 to 29 percent in 1996.

It is true that investing in stocks involves risk, as evidenced by the ups and downs of the major stock market indexes. However, letting politicians with short-term time horizons decide on Social Security benefits is also a risky proposition. Currently, individuals have no ownership over their future Social Security benefits, and the level of benefits can be changed by Congress at any time. For example, benefits were decreased in 1977, and in 1983 some Social Security benefits became taxable income, which effectively reduced their value.

Historically, rates of return on common stocks have been significantly higher than the rate of return on government bonds that are bought by the Trust Fund operated by Social Security (using the current surplus of Social Security payroll tax receipts over benefits paid out). Over the 50-year period from 1955 to 2004, a dollar invested in stocks would have generated more than ten times more purchasing power than a dollar invested in Treasury bills held by the Trust Fund. The transition to private savings accounts would involve substantial financial costs, but so would any of the potential reforms of the Social Security system.

According to the Congressional Budget Office, Social Security, Medicare and Medicaid could represent 75 percent of the federal government's budget by 2030, up from around 40 percent in 2005. The projected ballooning of the federal deficit, largely due to underfunded Medicare and Social Security benefits, should focus the minds of citizens. A government operating such a deficit at a time when an increasing share of the nation's debt is held by foreigners is effectively concealing from the public the real nature of future burdens.

If foreigners become reluctant to buy U.S. government bonds and to invest in the U.S. (perhaps because other regions of the world show more economic promise), then the burden of the deficit will become obvious in terms of rising interest rates that affect all Americans. This will lead to a lower standard of living for average households, which are now net borrowers (with near zero overall savings rates). Higher interest rates will also reduce home ownership rates among low-income American families. Furthermore, if investment rates in the U.S. fall (as a result of decreases in investment by foreigners and rising budget deficits), the result will be slower growth in American productivity, which jeopardizes both near-term and long-distant future earnings. Again, those most disadvantaged by slow economic growth are poor families.

Alternatively, a drop in the willingness of foreigners to invest in the U.S. economy could cause the value of the U.S. dollar to fall (economists believe this partially explains the falling dollar—relative to the Euro and yen—during 2007). A falling dollar brings about higher import costs for businesses that import foreign resources and parts, and higher prices for consumers of imports and items made with imports.

Whether inflation rises or the Federal Reserve Bank uses its power over interest rates to limit the potential inflationary impact of the falling dollar, the ultimate outcome of our recent overdependence on foreign saving will be a lower standard of living (or slower increases in living standards), such that decent levels of retirement income (private and public) cannot be maintained. In addition to slower growth, the downturn in foreign savings coming into Treasury bonds and the U.S. economy also means that the current U.S. budget deficit is unsustainable. This increases the urgency of reducing the imbalance between Social Security revenues and outlays.

As stated previously, retirement is not a right. Its funding cannot be assured apart from rising U.S. productivity and greater fiscal responsibility. Neither Social Security reform nor partial privatization will come without cost. Both current and future generations must share these costs in a way that does not overburden particular cohorts. A fair approach to reform would include these features:

1) Maintaining benefit levels paid to soon-to-be and current retirees, because they have little or no earning lifetime left to save and invest for their retirement needs.

2) Lowering over time the net benefit increases promised to current and future retirees. This move usually includes reducing the inflation index by which the benefits are adjusted upward and making a greater share of benefits taxable.

3) Introducing progressive indexing to provide greater cost of living adjustments for the poorest retirees and less for others.

4) Raising the age of eligibility for Social Security benefits to reflect increased years of health and productivity.

5) Raising the income cap on Social Security tax payments (above the 2007 level of $97,500).

These proposals have the virtue of introducing changes slowly and diffusely enough so that families can adjust their earning, spending and saving patterns. Their expectations will be better founded than they could ever be if government were to continue promising the impossible.

Several of the above proposed reforms also preserve one of the key objectives of Social Security: to ensure that even people with low earnings are able to retire with adequate benefits. To achieve this goal, higher-income workers already receive a lower return on the taxes that they pay than do lower income families. Raising the income cap would increase the existing progressivity of the system, as would applying greater cost-of-living benefit adjustments for families with lower earnings than to those with high earnings. Providing adequate retirement benefits to retirees whose lifetime earnings are low is clearly a matter of intergenerational justice.

By themselves, the sorts of reforms described above are not likely to fully solve the funding crisis that faces Social Security. In addition, they will do little to increase incentives for personal saving, which is ultimately needed to fund long-term economic growth and decent retirement incomes for future generations.

As noted earlier, the advantage of introducing individual retirement accounts into the picture is to partially repair the present disconnect between individuals' savings and the political decisions about their eventual Social Security benefits. By itself, such a change would have the effect of calling Americans' attention to the fact that a retirement livelihood can never be just a promise. It requires saving. It demands that everyone become active in providing for his or her retirement through productive work, sacrificial saving—and limited expectations of what can be demanded of government.

Citizens who care about justice for future generations should demand answers on Social Security reform from the presidential candidates. The concerted effort needed for reform requires transcending party politics. We should be skeptical about candidates promising palatable short-term fixes that are aimed at attracting our votes. The long-term costs of that sort of politics will be enormous.

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