A Private Little Retirement, II
by Dan Jacoby

(Note: This is revised and updated from a column published four years ago.)

I figure Miami Beach. Sun, sand, services for the elderly. And I'll pay for it all with my very own private retirement account set up through the tireless efforts of my very own retirement guru, George W. Bush.

That is, I'll pay for it as long as the stock market does what it did in 1998 and not what it did in 2001 … or 2002 … or 2003 … or 2008! I'll pay for it as long as we don't have another recession just before I retire. I'll pay for it as long as my investments aren't in the next version of WorldCom, Global Crossing, Enron, Bear Stearns or Lehman Brothers.

The real problem with private retirement accounts explains why this is a rich man's proposal. Put simply, people who know how to invest for the long term are more likely to do better, while people without investment experience are more likely to lose money. In other words, the rich get richer while the poor get shafted.

But private retirement accounts will pay more interest than the Social Security Trust Fund collects, won't they?

Perhaps. But perhaps not. Chances are the stock market in general will do better than government bonds over the long term. But each individual's retirement account will have a different mix of investments. Then there's the catch-22: The more freedom of choice people get, the greater the chance that more people will lose a significant part of their retirement savings, but limiting investment options just means that people will have less of a chance to do better than the current system.

Well, if private retirement accounts aren't the solution, what is?

What's the Problem?

Before getting to the solution, we must first understand the problem. The problem is not, as is widely reported, the worsening ratio of people paying in to the system versus people collecting. It is true that the number, which used to be 42:1 and is now down to roughly 3:1, is probably going to drop to as little as 2:1. But this number is not the real source of the problem.

Those who claim that this ratio is the problem say that workers are funding the system for retirees (the "ultimate Ponzi scheme"), and that when there aren't enough workers (or too many retirees), the system won't be able to handle the load. The misconception stems from ignoring the reason for the nearly $2.4 trillion (estimated) now in the Social Security Trust Fund.[1] That money is there because today's workers are helping to fund their own future benefits.

And that's the point; we are funding our own retirement.

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[1] The 2008 OASDI Trustees Report (http://www.ssa.gov/OACT/TR/TR08/II_highlights.html) reported $2.2 trillion in the fund as of the end of 2007, a $200 billion increase from the end of 2006. Estimating another $200 billion increase for 2008 results in a $2.4 trillion balance.

The problem is that today's recipients are getting benefits based on life expectancies that are decades old. As a result, today's beneficiaries are getting more benefit checks than was originally planned for, which means they're taking out more money than the system is designed to pay. Right now, this problem is being masked because the largest generation in history is currently paying in as much as they ever will. When the baby boomers stop paying in to the system and start collecting benefits, the mask will be stripped away, and the Trust Fund will eventually be depleted.

When will the Trust Fund run out of money? The truth is that nobody knows. All the projections being bandied about are based on a horde of guesses about future economic growth, inflation, immigration, birth rates, life expectancy, and other variables. The trustees of the Fund, in their most recent report, state that the Fund is "projected to become exhausted and thus unable to pay scheduled benefits in full on a timely basis in 2041".[2] The Congressional Budget Office's current "best guess" is 2049.[3]

We know two things. We know that these problems don't need to be solved today, this week, this month, this year, or even for several more years to come. But we shouldn't take too long. It's as if we were on a sled going down an extraordinarily long hill. Way down the hill, an enormous boulder is directly in our path. The sooner we change course, the easier it is to avoid the boulder. We have time, but the longer we take the more difficult the solution will be.

We also know is that the current benefit rates are unsustainable over the long term. This means that one or more of several actions must be taken. There are four categories of possible solutions: raise taxes, cut the benefit rates, take money from somewhere else, or raise the age at which a person can begin to receive full benefits.

Solution Category #1: Raise Taxes

The first solution, raise taxes, can be done in three different ways. Currently, we are taxed at 12.4% of the first $102,000 of our salary, half of which is paid by the worker with the other half paid by the employer. That $102,000 ceiling changes every year, going up at the same rate as median income. Investment income is not taxed (not for Social Security, anyway). We can, therefore, raise the tax rate from 12.4% to something higher, lift the ceiling from $102,000, or begin to tax investment income.

The first alternative, raising the tax rate, is one of three things that were done in 1983, the last time the Trust Fund ran empty. That tax increase was, and still is, the largest middle-class tax increase in American history. In the current climate, anyone who proposes a middle-class tax increase of any kind, for any reason, would probably face the current political equivalent of being tarred and feathered – and with good reason. So let's rule out raising the tax rate.

The second alternative, raising or eliminating the salary cap, may be able to raise all the money needed to avert a crisis, at least for the foreseeable future. There are, however, three problems with this alternative.

2 http://www.ssa.gov/OACT/TR/TR08/II_highlights.html

3 http://www.cbo.gov/ftpdocs/96xx/doc9649/MainText.3.1.shtml

The first problem is that in addition to raising taxes on individuals, it also raises taxes on businesses, especially white-collar businesses with upper-middle-class employees. Remember, employers pay half the taxes, and any increase in Social Security taxes affects them as well as individuals. The end result is significantly lower profits, and lower profitability, for small and medium sized businesses as well as large conglomerates. At a time when businesses large and small are struggling for survival, and many white-collar jobs are still being outsourced, this tax increase could have a significant adverse effect on our economy.

The second problem is that it is a tax increase, albeit on only upper-middle-class and wealthy individuals, but still a tax increase. With the growing concern about the alternative minimum tax encroaching on this same group, the last thing they need is to be hit twice. A better solution for those who wish to "tax the rich", or at least repeal the tax cuts wealthier taxpayers have received over the past few years, would be to act directly – that is, repeal the tax cuts. This would go a long way toward lowering the burgeoning deficit, as was demonstrated with the tax increase of 1993.

The third problem has to do with the fact that Social Security benefit formulas already benefit lower-income earners at a higher percentage of their income than higher-income workers. In other words, it's a "progressive" benefit, designed this way so that fewer elderly Americans are forced to live in poverty. As a result, people making the salary cap or higher receive a lower portion of their payments when they start getting benefits. By raising the salary cap, this disparity is exacerbated.

So while lifting the salary cap could alleviate the problem for Social Security, at least temporarily, it would introduce or exacerbate significant problems in other areas. Clearly, it would be far better to find a solution that works, rather than a temporary fix.

The third alternative is to tax investment income. Currently, thanks to the many tax breaks on capital gains, investment income is taxed at a far lower rate than earned income (15% maximum on long-term capital gains vs. 35% maximum on income). Adding a Social Security tax to this income would therefore not place an undue burden on investment, rather it would simply repeal some of the tax cuts investors now enjoy.

Or would it?

Investment income has several forms. Short- and long-term capital gains, dividends, interest payments of various sorts – even interest on ordinary savings accounts – all these things fit under the category of "investment income". Because they come from different sources, and have different benefits and costs for society in general, they are taxed at different rates. Imagine adding a new set of taxes on these different forms of income. Then imagine just how much more your accountant will charge you next year.

If we want to repeal some, or all, of the windfall that rich investors have gotten, going the circuitous route of Social Security taxes is far too complicated. Scratch taxing investment income to pay for Social Security.

Evidently, there isn't a tax increase that will not create larger problems than it would solve. In addition to being a tax increase, which is a problem all by itself, each form of tax increase has its own individual problems. So let's move on to Solution Category #2: Cut Benefits.

Solution Category #2: Cut Benefits

There are two ways in which benefits can be cut. The first is simply to cut benefit rates right now. The second is to change the way benefit increases are figured.

In theory, cutting benefit rates right now is a perfectly legitimate solution. After all, if people are currently collecting more money than they should be getting, based on an honest evaluation of the system, why not cut back on the benefit rates? It may be a nice theory, but it will never happen.

It won't happen for the perfectly understandable reason that current benefit rates are a promise made to people who, to a large extent, are helpless. If we cut back on benefit rates for today's elderly, many of them will have no way to make up the difference. One-third of today's old-age recipients have no other source of income. Most elderly would be unable to make up for the cuts. Put simply, cutting current benefit rates goes against our moral values.

Cutting increases in future benefit rates takes some explaining. Under current law, once a person starts receiving benefits, those benefits rise every year based on the inflation rate. But the initial benefit rate, that is, the rate at which a new retiree begins to receive old-age benefits, changes according to America's median income.

"Median income" is the income at which half the workers earn more than you do and half the workers earn less. Over the past few years, median income has fallen behind inflation, but in general median income rises faster than inflation. Because median income usually rises faster than inflation, the later someone starts collecting benefits, the better off that person usually is.

Some people are calling for a change to this formula, a change that will tie future initial benefit rates to inflation rather than median income. As with the concept of cutting current benefits, it's a nice theory, but there is a significant problem.

The problem is that future retirees will be locked into today's standard of living. Imagine if today's retirees received Social Security checks based on the standard of living in 1940. Many would be living at far below today's poverty level. Millions of elderly Americans would have to move in with their children, as they did back then, putting additional strain on our society. They wouldn't be able to afford medical care, because co-payments are far too high.

Yes, we could change the way future benefits are figured, but that would put us back where we were generations ago. We should be moving forward, not backward. We should be creating more freedom, more independence, and more dignity. We should not be forcing our elderly to choose between poverty and dependence. We should not be forcing our younger generations to choose between taking care of their parents and living their own lives.

Cutting benefits is not the answer. Let's move on to Solution Category #3: Take Money From Somewhere Else.

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Many people talk about “borrowing” or taking the needed funds from the general operating budget. There are two significant problems with this idea.

The first problem is that the money would not be “borrowed”, but rather “taken”. Borrowing something implies eventually paying it back. In fact, the Social Security did borrow several billion dollars from the general funds in 1983, and paid it back two years later. In this case, however, we’re talking about taking not billions, but trillions of dollars from the general fund, and never, ever paying it back.

Where will this money come from? This is where the second problem comes in. Currently, the general operating budget of the federal government is running record deficits. In a report released on January 9, the Congressional Budget Office “projects that the deficit [for fiscal year 2009] will total $1.2 trillion.”[4] We just can’t afford to keep running up debt.

Taking the money from somewhere else would work if there were some place we could go to get that money. But no such place exists. We’ll have to come up with another solution. Let’s look at Solution Category #4: Raise the Age

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There is nothing magical about the number 65. In fact, people turning 65 this year will have to wait an additional year, until they turn 66, before collecting full old-age benefits. Under current law, passed in 1983, people born in 1954 or later will have to wait until they are 67. Raising the age has been done once before, and it can be done again.

Furthermore, raising the age at which people can collect full benefits makes sense. After all, the solution to any problem should balance its cause. If the root cause of the problem is that people are living longer, then raising the age for full benefits balances that root cause elegantly.

There are two basic problems with raising the age. One is a matter of irrational, though perfectly human, desire. The other is a societal problem. Fortunately, there is a possible side benefit to raising the full-benefit age that could alleviate enough people’s fears to make this solution politically feasible.

Most people don’t want to have to wait any longer to collect the money they feel is “due” them. This desire makes sense; we never want to wait. The problem is that it ignores the basic fact that we are living longer. We have to make hard choices in life, and this is a fairly obvious one. By waiting a short time, we balance the fact that we are living a lot longer. In 1935, when Social Security was created, most people never saw their 65th birthday. For most people today, the 65th birthday is hardly a big deal. Our retirement programs need to adjust to that fact.

The other problem is that the people most likely to need old-age benefits are those who are least likely to be able to work longer. Manual laborers tend to earn less money for their work, and tend to wear out sooner. Minorities, too, have on average lower life spans, and would appear to be disproportionately hurt if the full-benefit age is raised.

We can alleviate this problem three different ways.

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4 http://www.cbo.gov/ftpdocs/99xx/doc9957/01-07-Outlook.pdf

The first method is happening all by itself. The percentage of workers engaged in hard manual labor is constantly decreasing. By keeping the age at which some benefits can be earned, those few manual laborers who remain will still be able to collect. As time goes on, this percentage continues to go down, making this problem smaller and smaller. It will never go away completely, but it will always be getting better.

The second method we need to employ is to continue to make upward mobility possible. In the past few years, upward mobility has been stifled. Without placing blame for this problem here, let's just state that proper measures to increase upward mobility, including redistributing education funding where it's needed most, providing universal healthcare coverage, and restoring job training programs that have been eliminated since 1981, will enable minorities to achieve, as a group, economic, medical and social equality. By achieving this level, minorities' life expectancy will increase faster than the average; in short, they will catch up. The inequality of having to wait longer to receive full benefits will simply disappear.

The third method that will alleviate this problem is to take advantage of the possible side benefit of raising the full-benefit age. By raising the full-benefit age slowly but inexorably, until the age is high enough to ensure the future liquidity of the Trust Fund, we can cut taxes. Since Social Security taxes are only paid out of the first $102,000 of income, a cut in the tax rate, figured as a percentage of total income, would benefit low- and middle-income earners far more than high-income earners. Furthermore, it would reward work, as it only cuts taxes on earned income.

This tax cut has a second benefit: It also cuts taxes for businesses, particularly those businesses with high labor costs. By reducing the cost of labor, businesses can expand more easily, be more productive, grow their profits, and hire new workers –American workers. This tax cut, therefore, is not only a direct economic stimulus, but could also be a significant job-creation measure.

Conclusion

Will it be easy? No. Special interest groups from several areas will gather together to try to derail this (or any) solution. But this is the only solution that directly addresses the root cause of the problem, and not just the symptoms. It is the only solution that can provide a tax cut on the first dollar everyone earns every year, possibly for the first time in American history. And it is the only solution that makes complete sense, fulfills the promises made to previous generations, guarantees benefits to future generations, and accomplishes all this without bankrupting the country.

The answer to the problems putting this solution lies with patience and persistence. Eventually, as the debate continues, people will come to understand the true problem, as well as the flaws in the other types of proposed "solutions". We don't have to solve this problem overnight; we can take several years.

Remember, the sled we're all on isn't slowing down, and that boulder down the hill isn't getting any smaller. We have time, but that doesn't mean we should waste it. If we come to the conclusion now that we must make difficult choices sooner or later, and make those choices sooner rather than later, we will have a far better opportunity to get to Miami Beach.