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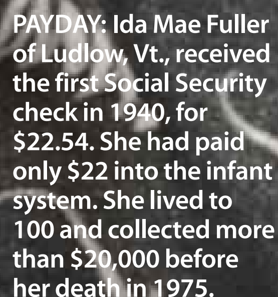

PAYDAY: Ida Mae Fuller of Ludlow, Vt., received the first Social Security check in 1940, for $22.54. She had paid only $22 into the infant system. She lived to 100 and collected more than $20,000 before her death in 1975.

SOCIAL SECURITY ADMINISTRATION

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YOU'D BETTER SAVE LIKE CRAZY IF YOU WANT TO FUND A 30-YEAR RETIREMENT

social security

BY THE EDITORS

For three generations, working Americans have thought that Social Security would allow them to retire at age 65 and enjoy the good life. That dream is now a fantasy. If you want to retire with financial security, you'd better start saving and investing heavily—now. Because although our current Social Security system has done a great job reducing elderly poverty and is currently running a $53-billion surplus, it faces a long-term funding shortfall of *trillions* of dollars.

Unless the system is overhauled, closing that gap means pushing the 12.4 percent payroll tax way up to 20 percent or more. Or cutting benefits by 30 percent. So while you're upping your savings, remember to exercise more and eat right; you may need to work longer than you've planned.

Pay as You Go

Debate over how to reform Social Security rose to fever pitch in the late 1990s and is figuring prominently in the 2000 presidential election campaign. As the number of Americans over age 65 climbs from 37 million in 1998 to 64 million by 2025, the nation will have to grapple with an imbalanced Social Security system, rising medical costs, health care rationing and age discrimination. The very nature of retirement will change.

The debate is highly emotional because Social Security is a pillar of most Americans' retirement planning. It has helped reduce elderly poverty from 35 percent of seniors in 1959 to roughly 10 percent in 1998. In that year (the latest with complete numbers), Social Security paid out $327 billion to 38 million retirees and survivors. More than 60 percent of seniors today receive most of their retirement income from the system.

Virtually no one quarrels with Social Security's achievements—or with the values they reflect. The debate is over how to sustain them as the aging of America places a wrenching strain on the system's finances.

Social Security was initiated by the Social Security Act of 1935 as a "pay as you go" system: current workers lay money on the table, and retirees get benefits from it. When the system is running surpluses, as it is today, funds not paid out are "lent" by the Social Security Administration to the government to cover the cost of other programs—everything from aircraft carriers to park rangers. In exchange, the Social Security trust funds are credited with special, nontradable debt obligations from the Treasury Department. These bookkeeping debts of one government unit to another are the only trust fund "investments" allowable by law. The funds cannot be invested, for example, in stocks or bonds. "Pay as you go" made sense in 1935, because the U.S. economy was in dire straits, and the first priority of the system's designers was to bring immediate relief to many people who had paid in little or nothing. But as more people retired over the years, the payroll taxes (or FICA, established by the Federal Insurance Contributions Act) that support Social Security's payouts had to be raised dozens of times. FICA was originally set at

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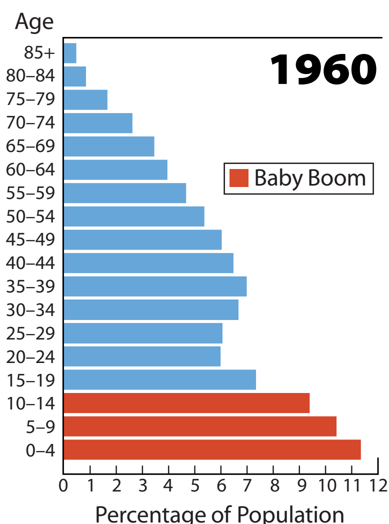
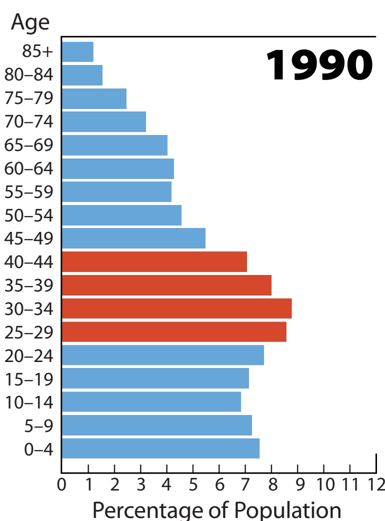
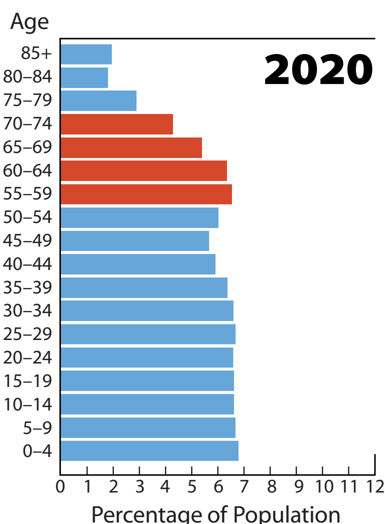
the U.S. gets age-heavy

The advancing baby-boom bulge is dramatically altering the U.S. age profile, placing a burden on the Social Security system.







LAURIE GRACE; SOURCE: U.S. CENSUS BUREAU

1 percent of all income up to $3,000. The most recent major reform, in 1983, set FICA taxes on course to this year's level of 12.4 percent. The maximum amount of a worker's wages that can be taxed—"the cap"—has also risen, to $76,200 in 2000. Given an estimated payroll of some $3.7 trillion this year, FICA taxes should produce revenues of $479 billion, more than enough to meet the needed payout of $409 billion.

The trouble is that Social Security's surpluses will evaporate. Even the $887 billion in the trust fund will not be enough to meet promised future benefits once the huge baby-boomer generation retires. The basic cause of the shortfall resides in the awesome, glacial pressures of demographics. The pay-as-you-go concept was adopted in an era of large families, rising populations and moderate life spans. When the retirement age was set at 65 in the 1930s, American life expectancy was just over 61, ensuring that there would be many active workers paying in the funds that went out to retirees.

The "support ratio" of workers to retirees has been declining steadily as people live longer, retire earlier and have fewer children. It has fallen from 42 to 1 in 1940 to 3 to 1 in 2000 and will drop to 2.5 to 1 in 2025, when millions of boomers will have retired and the nation's age profile will resemble Florida's today.

By 2014, according to the system's own trustees, Social Security will be taking in less money from FICA taxes than it is obliged to pay out—a shortfall of $21 billion a year by 2015, rising to $252 billion by 2030, in inflation-adjusted dollars.

That doesn't mean Social Security will go bankrupt. A pay-as-you-go system literally can't do that. Even with no reform, the Social Security Administration has a claim on 12.4 percent of future U.S. payroll. But from the time it goes cash-flow negative and begins drawing down its trust-fund holdings, the system's FICA income will cover a dwindling part of its obligations to retirees. By 2037 the last trust-fund assets will be exhausted, according to the latest estimates.

Without reform, this means less money for you. If, for example, you are slated to get $1,000 a month in 2037, plan on getting only about $710. The shortfall is nasty, especially for the poor.

Search for a Solution

Proposals for closing Social Security's long-term funding gap come mainly from two camps. The "tinkerers" want to raise payroll taxes, trim benefits or adopt some combination of the two. A host of policy tweaks have been floated in recent years, including lowering the inflation adjustments now made to benefits; requiring several million state and local workers now exempt from Social Security to join the system and begin paying FICA taxes; and delaying the age at which full benefits can be drawn, from 65 now to 67 or even 70, and then indexing this number up as longevity continues to rise. Another proposal is to "pop the cap"—that is, eliminate the ceiling on wages for which the 12.4 percent FICA tax must be paid. Or just raise the tax 2 percent starting right now.

All these proposals would require some pain. Not surprisingly, each one provokes furious resistance from well-funded interest groups.

The other camp, the "privatizers," wants to raise returns by investing some of Social Security's holdings in stocks and bonds, not just the nonmarketable Treasury Department obligations to which Social Security's trust fund is now limited by law.

Most of the privatizers support the creation of a national system of individual retirement accounts—like 401(k)s—that would receive some, most or all of a person's incoming FICA taxes. Each citizen would be given some degree of choice over how the money is invested. Although stock markets fluctuate, privatizers argue that over the long haul they produce significantly higher returns than government bonds do. A variant put forward by the Clinton administration would allow Social Security's trust fund to be invested in "index funds" like the Wilshire 5000, which hold stocks in thousands of U.S. companies, so that the government, not individuals, bears the risks of market fluctuations.

Whichever way the U.S. heads, it will be playing catch-up. Britain, Canada,

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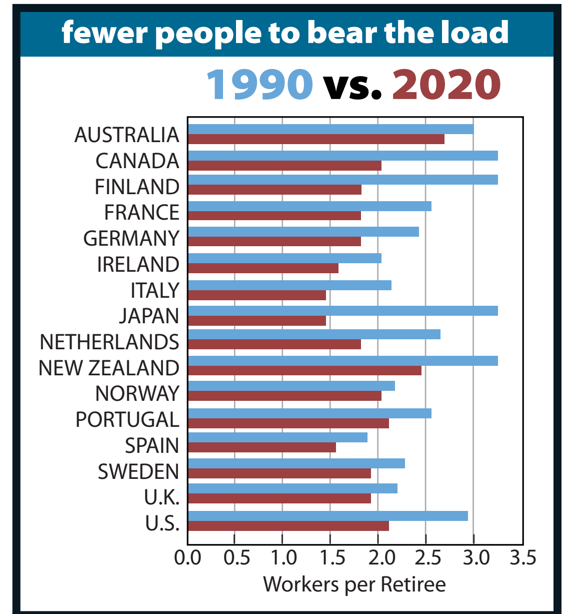
Sweden, Chile, Mexico, China and dozens of other countries have either adopted or are debating national pension plans that rely heavily on investments in private capital markets. No nation—anywhere—is establishing from scratch a public pension system based on the pay-as-you-go principle, and every nation that has such a structure is facing great fiscal pressure to raise taxes, cut benefits or invest in capital markets to raise returns.

Although the financial considerations in reforming Social Security are complex, the political challenge is even more daunting. Social Security is ground zero for bitter ideological and political clashes over values. Bridging these deep emotional divides won't be easy but will be necessary to secure retirement for boomers, Gen-Xers and future generations.

Indeed, the debate over how to "fix" Social Security is a harbinger of a changing attitude toward retirement. With America's over-65 population projected to rise to more than 20 percent of the total by 2025 and with birth rates declining, an early, lengthy retirement—itself a relatively recent social construct—will soon become lore.

The percentage of 62-year-old men still working in America fell from 81 percent in 1950 to just 51 percent by 1985, but it has since begun to tick back up, past 54 percent in 1998. Similarly, half of American men aged 70 held jobs in 1950; this fell to just 16 percent by 1985 but is back up to 21 percent. With Social Security declining in power, seniors may have to work longer. And given the improvements in elderly health, they just may be more able—and more willing—to work than those a generation ago were.

What's more, with younger workers in short supply, sustaining the American economy's extended "boom" will depend on more seniors in the workforce. Conveniently, the shift to a service economy means that there are more highly skilled and less physically demanding jobs for seniors to compete for—or just hang on to. Longer-term, it's not hard to envision millions of seniors planning to use their mid-60s—following their "first retirement"—to go back to school and retool before pursuing a second or third career, whether full- or part-time. Society may well come to see the elderly as an underutilized resource, and many boomers will want to keep a hand in the work of society, maybe well into their 80s.



LAURIE GRACE; SOURCE: WORLD BANK

SHORT SUPPORT: The ratio of workers to retirees will drop sharply in many countries, forcing reform in public pension systems worldwide.

Perhaps legislation to remove the "earnings penalty" on benefits, which President Bill Clinton signed in early April, will help encourage more people to stay in the workforce longer. Under the Senior Citizen's Freedom to Work Act, people between 65 and 70 will no longer lose $1 of their Social Security benefits for every $3 they earn above $17,000 a year.

The rising percentage of seniors and their high voting rate virtually assure that politicians will be offering both the elderly and their employers new incentives to work longer. That's something of a rosy scenario for well-heeled, well-educated seniors. But further down the financial food chain, millions of seniors who lack private pension coverage or personal savings—roughly half the elderly population—may have to bid for less lucrative "second careers" as checkout clerks or night guards.

What You Can Do

The best thing you can do to shield yourself against possible future shortfalls in Social Security is to step up all forms of savings to cover a "worst case" gap in what the system will be able to pay you.

A first step is to visit the Social Security Web site. There you can request a form for getting a statement of all of your past Social Security payments and your projected monthly benefits, adjusted for inflation (see www.ssa.gov/top10.html). Once you have returned the completed form, the administration will send you a free report that details every penny you've paid in FICA taxes and the projected monthly benefit you can look forward to (adjusted for inflation).

These data will give you a sense of your worst-case shortfall. As in the earlier example, if your inflation-adjusted monthly payout will be $1,000 a month, you live past the year 2037, and nothing is done to improve Social Security's return, you can expect to receive only 71 percent of your benefits. So at a minimum, you should plan now to invest enough to provide you with an additional, inflation-adjusted $290 per month—indefinitely.

Note, however, that this amount of savings and investment will just cover your Social Security shortfall. Your monthly check will not be enough to live on comfortably. You'll need to create further income streams with every form of personal and pension savings you can muster. Social Security benefits were never intended to cover all the financial needs of all retirees. The money was, and is, meant to be only a base.

Further Information

Opposing views of how to manage Social Security can be found at **The Heritage Foundation** (pro-privatization) at www. heritage.org; and at **The Economic Policy Institute** (anti-privatization) at http://epinet.org on the World Wide Web.

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