

The Reality of Social Security: If Reform Doesn't Happen, What Must Each of Us Do?

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This article examined what a hypothetical wage-earner in America should do to prepare for probable reductions in Social Security benefits that will result from the political and legislative gridlock that has characterized Washington. Retirement scenarios were constructed, varying (1) the number of years until the current retirement age of 67, (2) current wage level, and (3) yield on retirement savings. In light of the sobering results, scenarios for retirement at age 70 were investigated. The results also speak to the viability of proposals for the privatization of Social Security. Along with other proposals for Social Security reform, privatization is discussed.

INTRODUCTION

To some, the title of this paper strikes a chord of cynicism, to others, realism. We posit that the most likely scenario in Washington is continued political and legislative gridlock characteristic of recent decades. In the context of Social Security reform, one side is adamant in its refusal to consider adding to the “burden” of the present working generation (and businesses that share this “burden”) by either increasing the Social Security tax rate or by increasing the ceiling on wages that are subject to the tax. The other side sees Social Security as an intergenerational covenant that must not be breached. But, without meaningful reform, Social Security as we now know it is unsustainable. The only question is when the page will turn. At some point, Social Security tax receipts will fall short of the system’s benefit obligations. This is not to say that Social Security is doomed to bankruptcy. However, the Social Security Trustees’ Report has consistently stated that, by the year 2033, Social Security tax receipts will support a benefit level that is about 75 percent of the current level.

This paper lays out a call to action that should (must) be heeded by every worker in America. For most, Social Security benefits are anticipated to be a very significant component of overall retirement income. If the Social Security part of one’s retirement plan is likely to fall short, adjustments must be made elsewhere in that plan—i.e., more retirement savings now or less retirement spending later. Both the individual and the Federal government have potentially critical roles in allowing the worker to realize a comfortable retirement. Individuals should weigh carefully their spending and saving needs, currently and into retirement. Washington could facilitate increased retirement savings by raising the annual ceiling on contributions to an individual retirement account (IRA). But, how much must be saved to compensate for the anticipated shortfall in Social Security? This question is addressed by presenting several retirement

planning scenarios at various current income levels and years remaining until planned retirement. The output of each scenario is the percent of annual income that must be saved in order to compensate for the anticipated reduction in Social Security benefits.

The paper will first address the status of the Social Security system. Then, major proposals for Social Security reform will be discussed. Next, the methodology employed to construct the various retirement planning scenarios that are analyzed will be described, followed by the presentation of the results of the analysis and discussion thereof. The concluding comments will include suggestions and the rationale for changes in the IRA contribution rules.

FINANCIAL STATUS OF SOCIAL SECURITY—CRISIS OR HYPE?

Is the Social Security Trust Fund in a state of crisis? The honest answer to this question is, “Probably not.” But, this is not to say that the Social Security system does not face significant and substantial challenges, which, if left unanswered, will lead to a crisis of monumental proportions. Unfortunately, if history is any indication, Social Security is the 900-pound gorilla with which no one in Washington wants to dance. Indeed, an aid to Tip O’Neil, then Democratic Speaker of the House, referred to Social Security as the “third rail of American politics.” (Safire, 2007) So, where does the Social Security system stand today? The annual report of the trustees of the Social Security system provides the answer.

The total increases to the Social Security Trust Fund in 2011 exceeded the benefits paid by the trust that year. The Trust Fund balance at the end of 2010 and 2011 was \$2,609 billion and \$2,677.9 billion, respectively (Trustees, 2012, p. 6). This \$68.9 billion increase represents about a 2.6 percent increase. However, this trend of surplus income is not stable. Or rather, the trend is stable, but in a downward direction. The Trustees express the Fund’s solvency by comparing the Trust Fund balance to anticipated benefit costs for the following year. Between 2010 and 2011, this measure of short-term solvency declined from 354 percent to 340 percent (Trustees, 2012, p. 7). The Trustees project the Trust Fund to increase at a decreasing rate through 2020. Beginning in 2021, the Trust Fund will have to begin drawing down its Trust balance to meet its benefit obligations. And in 2033, the Trust Fund will have a zero balance (Trustees, 2012, p. 10). After the Trust Fund has been used up, annual income will only be able to support benefits at a 75 percent level—falling to 73 percent in 2086 (Trustees, 2012, p. 11).

So, if Washington continues to avoid touching the Social Security “third rail,” the worst case scenario is that, in 2033, Social Security benefits will have to be cut by 25 percent. And, the reality of the “third rail” metaphor will be tested. Or, Washington might continue scheduled benefits by paying the shortfall from the general fund. However, the Trustees project that by 2086, the end of their 75-year projection horizon, the cumulative unfunded balance in the Trust Fund (i.e., the cumulative excess of benefit costs over income) will be approaching \$9 trillion (Trustees, 2012, p. 15), which makes the funding of scheduled benefits from the general fund very unlikely.

From this discussion, one might infer that Washington has two more decades, until 2033 when the Trust Fund hits zero, to either address the Social Security funding gap in a meaningful way or prepare seniors for a 25 percent reduction in benefits. However, the clock may be ticking more quickly. While the Social Security Trust Fund had nearly a \$2.7 trillion balance at the end of 2011, workers in America must hope that the Trust Fund does not prove to be a “misplaced trust fund,” given the fact that the “assets” in the Trust Fund are actually IOUs from the Federal government. The government even pays interest on these IOUs—about \$106 billion in 2011 (Kaplan, 2008, p. 25). But, of course, that interest is immediately borrowed back in exchange for more IOUs. In fact, the Social Security Trust Fund holds more US government debt than China—17.9 percent vs. 9.5 percent of the total US debt, respectively (Political Calculations, 2011). So, Washington does not have until 2033, when the Trust Fund is exhausted, to address the Social Security funding problem, but rather until 2021, when Social Security can no longer fully pay its benefit commitments.

While the Social Security system may not be in a state of crisis today, each year of Washington handwringing regarding what to do about Social Security makes any solution that much more painful. If the solution is to increase payroll taxes, an immediate 2.61 percentage-point increase (i.e., 15.01 percent

from the current 12.4 percent) would close the funding gap. If nothing was done until the Trust Fund was exhausted in 2033, a 4.3 percentage-point increase would be needed (i.e., 16.7 percent payroll tax rate). On the other hand, if the solution is to reduce benefits, a 16.2 percent reduction would be needed now, compared to a 25 percent reduction in 2033 (Trustees, 2012, pp. 21-22). In reality, the most likely progression of this situation will not produce a “critical event,” but rather the worker will be forced to realize less and less of the expected benefits as Washington fails to adjust course and is unable to use general fund revenues to maintain the Trust Fund—i.e., pay its IOUs. And, this erosion of benefits could begin as soon as 2021, when the Trust Fund has to begin redeeming its IOUs.

PROPOSALS FOR THE REFORM OF SOCIAL SECURITY

In May of 2012, AARP, an advocate for older Americans, presented twelve reform proposals to its online readership, including commentary by experts holding opposing views of each proposal. The presentation of each proposal included an estimate of the extent to which that proposal would close the Social Security funding gap (AARP, 2012). Several of the proposals included in this online article will be presented.

Most Reform Proposals Require Someone to Sacrifice or Pay

None of the proposals explicitly called for reducing benefits paid to retirees. However, several proposals would indirectly reduce benefits. One proposal would call for changing the manner in which annual cost of living adjustments (COLAs) are determined. The index used certainly would impact the direction and magnitude of change in the Trust Fund funding gap. Currently, the COLA is based on the consumer price index (CPI), which does not necessarily reflect spending patterns of retired persons. For example, retirees spend a larger portion of income on health care. If COLAs were based on an “elderly index,” the funding gap would actually be increased by 16 percent. On the other hand, using a variation on the CPI that reflects spending changes resulting from price changes (chained CPI) would have the effect of reducing benefits by three percent after ten years and by 8.5 percent after 30 years, eliminating 23 percent of the funding gap. This proposal is still dependent on CPI, which arguably is not reflective of retiree spending.

Increasing the full retirement age would reduce the number of years each Social Security recipient received benefits. When Social Security first went into effect in 1935, a small minority of Americans lived long enough to receive benefits. The significantly increased longevity of Americans has proven to be most inconvenient to Social Security funding. If, beginning in 2023, the full retirement age was increased by two months each year until it reached 68, 18 percent of the funding gap could be eliminated. Increasing the full retirement age to 70 (again, by two months each year) would more than double the positive impact, closing the gap by 44 percent. A variation on this theme would use longevity indexing to either delay the full retirement age or to reduce benefits. Depending on the specifics, this proposal could fill 20 – 26 percent of the funding gap. A valid concern to be addressed with this approach would be whether increased longevity is reflective of a longer period of time one is able to make a positive contribution to the workforce.

Proposals that increase payroll taxes include the outright increase in the tax rate and increasing or eliminating the payroll tax cap. Raising the tax rate by 0.25 percent (0.5 percent with employer matching), eliminates 22 percent of the funding gap, while raising the tax rate by a full percentage point (two percent with employer matching), eliminates 64 percent of the gap. Raising the payroll tax cap has the same effect as a rate increase, but it is borne by upper income taxpayers—and employers. Currently, the payroll tax cap is set so that about 84 percent of U.S. wages are subject to Social Security tax. Without raising the tax rate, raising the cap to \$250,000 from \$110,100 (the 2012 wage cap) would result in 90 percent of wages being subject to Social Security tax and would eliminate 36 percent of the funding gap. Completely eliminating the tax cap would eliminate 86 percent of the gap.

Privatization, an Idea Whose Time Came and Went—Maybe

Privatization refers to proposals that would divert at least a portion of one's Social Security tax away from the Trust Fund and into the individual's private retirement account (PRA). Privatization was the centerpiece of President George W. Bush's Social Security reform agenda. However, even with his party controlling both the House and the Senate, privatization did not gain the needed traction. Under the Bush proposal, wage earners who participated in this option would receive proportionately smaller retirement benefit from Social Security. But, as those opposed to PRAs were quick to point out, there would be less tax revenue flowing into the Trust Fund. At best, privatization offered an actuarial breakeven—in the long-term. In the short-term, when the Trust Fund already was approaching the point at which benefit commitments would exceed Trust income, the diversion of payroll taxes to private accounts exacerbated the short- to intermediate-term insolvency of the system. Estimates of the transition costs approached \$2 trillion (Weiner, 2007). Further, as would be emphasized by the impending "Great Recession," abrogating an intergenerational social commitment did not resonate with the American public. The only sure benefactor from privatization was Wall Street. One commentator estimated that the present value of the increased fees earned by Wall Street would be \$940 billion (Goolsbee, 2004). A Wall Street spokesperson put the "windfall" at a mere \$39 billion (Wolk, 2004). Factcheck.org (2005) likewise estimated a much smaller figure.

With the Senate in Democratic hands in 2006 and Barrack Obama elected president in 2008, one would think that the idea of privatization was, if not dead, in a profound coma. However, in 2010, Paul Ryan (2010), then ranking Republican member of the House Budget Committee and in two years to be Mr. Romney's vice-presidential running mate, included in his budget proposal, titled "Roadmap for America's Future," the partial privatization of Social Security. As with previous proposals, Social Security would remain untouched for those at least 55 years old. For younger Americans, up to 1/3 of their payroll tax could be diverted into private accounts. To sweeten the deal, those opting for private accounts would be given a guarantee that they "will not lose a dollar they contribute to their accounts, even after inflation." (Ryan, 2010, p. v) The proposal requires that \$1.2 trillion be transferred from the general fund to the Trust Fund between 2037 and 2056. If all goes as planned, these transfers would be repaid in 2083 (Van der Water, 2010). One would presume that this \$1.2 trillion "loan" from the general fund to the Trust Fund would come only after the \$2.6 trillion in IOUs owed by the general fund to the Trust Fund had been repaid—i.e., \$3.8 trillion in total to the Trust Fund. A second suggestion that privatization may not have been abandoned can be found in the 2012 GOP Platform. Although not using the word "privatization," the GOP Platform did address the issue of Social Security reform. "Republicans are committed to setting [Social Security] on a sound fiscal basis that will give workers control over, and a sound return on, their investments." (Platform Committee, 2012, p. 23) While few will argue with the first part of this statement, the second part seems to suggest some form of privatization.

SOCIAL SECURITY REFORM: IF NOT FOR THE PEOPLE, BY THE PEOPLE

In this section, the analysis employed will be described, followed by presentation and discussion of the results. Because these results are very relevant to the privatization debate, we will revisit the topic of privatization before closing the section with an acknowledgement of the limitations and assumptions of the analysis.

Description of Analysis

The analysis that follows assumes that in 2033, when the Trust Fund can no longer meet its scheduled benefit commitments, there will be a Draconian decision to slash Social Security benefits. As previously discussed, Trust Fund income at that point in time will be able to fund benefits at about 75 percent of promised levels. But, this figure assumes that the cut applies to all retirees, while past reform proposals have generally protected those who are 55 and older from prospective changes. If this philosophy is followed in our scenario, the benefit cut will have to be even greater. Somewhat arbitrarily, we assume a benefit cut of 30 percent to allow some protection for existing and soon-to-be retirees.

The decision facing younger workers is to (1) do nothing now and adjust to the new reality when inevitable cuts come or (2) take steps now to address the future benefit reduction—i.e., increase retirement savings during working years. Whether additional savings during working years will be enough to fund the benefit reduction is a function of how much is saved and the rate of return earned on savings. To investigate the feasibility of workers being able to alter course to make up for their lost Social Security benefits, the following analysis incorporates a number of different wage-earner characteristics:

- Number of years until eligible for full Social Security benefits (full retirement age, FRA)—assumed to be 67 years of age
 - 15 years until FRA—i.e., DOB 2/15/1961
 - 25 years until FRA—i.e., DOB 2/15/1971
 - 35 years until FRA—i.e., DOB 2/15/1981
- Rate of return on retirement savings
 - 4 percent during working years—1 percentage point more than inflation; 3 percent after retirement
 - 6 percent during working years—3 percentage points more than inflation; 4.5 percent after retirement
 - 8 percent during working years—5 percentage points more than inflation; 6 percent after retirement¹
- Level of income
 - Low wage earner, \$34,750 in 2013—median wage in May 2012 (Bureau of Labor Statistics, 2012)
 - High wage earner, \$113,700 in 2013—2013 wage cap for Social Security tax
 - Middle wage earner, \$74,225 in 2013—splits the difference between high and low levels

This analysis seeks to determine the rate of savings (as a percentage of annual pre-tax income) needed to accumulate an amount that is sufficient to fund the anticipated cut in Social Security benefits. For each income level/DOB combination, the full Social Security benefit was determined using the Quick Calculator available on the Social Security website (Social Security Administration, 2013). The Quick Calculator takes the earnings entered for 2013 and adjusts them backward and forward in time according to changes in national average wages (Social Security Administration, 2013b). We assume that the savings program begins in 2013 and continues through the last working year (i.e., 35, 25, or 15 years of increased savings). The rate of return on savings determines the balance that will be accumulated. To see if this balance is sufficient, the present value of full Social Security benefits is calculated, with benefits increasing to reflect an assumed COLA of three percent. The savings program needs to accumulate enough to fund 30 percent of this present value number, reflecting the anticipated cut in benefits.²

Simple logic tells us that the longer one has to set a periodic amount aside, the easier it is to accumulate the account balance needed to fund the anticipated Social Security cut. However, human nature tends to discount events that are quite far in the future.³ Consequently, the wage earners who are best positioned to be ready for the possible benefit cut are the ones least likely to heed the warnings and take action now. Adding to that is the practical observation that as income level decreases, one's ability to reduce spending in order to increase savings likewise decreases. Exacerbating this challenge for lower wage earners is the way that Social Security benefits are computed. Because Social Security is primarily a financial safety net, the benefit received by low wage earners will be a higher percentage of that person's earnings than is the case for high wage earners (Social Security Administration, 2013c). In terms of Social Security benefit to be received, the low wage earner's receiving a greater percentage of earnings is a positive situation for them; however, when the focus is on that same worker having to replace a benefit shortfall, the challenge of increased savings is linked to the same greater percentage of earnings—a potentially daunting endeavor. To illustrate, consider a wage earner with \$2,000 in indexed⁴ monthly

wages (i.e., only \$24,000 annual earnings). This person’s Social Security benefit would be \$1,084 (about 54 percent of indexed earnings). Compare this to someone earning \$8,000 each month (i.e., \$96,000 annual earnings), who would qualify for a \$2,430 monthly benefit (about 30 percent of indexed earnings). Consequently, the lower wage earner, for whom a savings plan already will be difficult, needs to save proportionately more because of the generous manner in which monthly benefits are determined.

Results and Discussion

For each of three earnings levels, three different savings returns and three different savings time horizons were analyzed. The results of the analysis of 27 different scenarios are presented in Table 1. As expected, the fewer years that remained until planned retirement, the more difficult it was to accumulate sufficient savings to replace 30 percent of one’s Social Security benefits. Low wage earners with just 15 years until retirement faced the most substantial challenge. The difficulty faced by low wage earners was exacerbated if the low earnings were accompanied by a risk-averse investment attitude. If fear of losing one’s investment led to “safe,” low-yielding investments, a likely unrealistic savings program would be necessary in order to replace the assumed 30 percent Social Security cut. With an assumed annual yield of four percent, it is difficult to imagine that a low wage earner could possibly divert an additional 15.2 percent of earnings to savings. Even with a somewhat more aggressive investment strategy that produced an eight percent annual yield, nearly nine percent of each year’s income would need to go to savings. The percentages expressed here are linked to pre-tax income for this analysis; whereas, the worker will likely be trying to set aside after-tax income. Percentages of after-tax income needed to be diverted to savings would be even larger. And, let us not forget that the definition of “low earnings” here is the median wage in 2012. This is a substantial portion of the working population. With an additional ten years until retirement, the portion of income that needs to be saved was reduced by about six percentage points for each level of savings yield. Only with 35 years until retirement did the required savings come down to a level that was likely to be sustainable by low wage earners.

TABLE 1
RATE OF SAVINGS NECESSARY TO REPLACE UNFUNDED
SOCIAL SECURITY BENEFITS UNDER VARIOUS ASSUMPTIONS AS TO HOW LONG
UNTIL RETIREMENT AND SAVINGS RETURNS

Number of Years until FRA	Assumed Return on Savings	Percent of Annual Wage Needed to be Saved		
		Low Wage	Middle Wage	Upper Wage
15 years	4%	15.197%	11.361%	9.190%
	6%	11.662%	8.719%	7.061%
	8%	8.974%	6.711%	5.440%
25 years	4%	8.969%	6.704%	5.003%
	6%	6.219%	4.648%	3.355%
	8%	4.284%	3.202%	2.245%
35 years	4%	6.358%	4.754%	3.867%
	6%	3.971%	2.969%	2.420%
	8%	2.428%	1.815%	1.481%

On the shortest savings horizon, even high wage earners had to divert from 5.4 percent to over 9 percent of income to savings, depending on yield. With longer planning horizons, accumulating enough savings to replace the lost Social Security benefits seemed more feasible. For high wage earners with 35 years until retirement, less than 1.5 percent of earnings needed to be redirected to savings, if an eight

percent yield was attained. Even for low wage earners, the percentage of income going to savings was under 2.5 percent—again, assuming an eight percent yield. But, as suggested earlier, with 35 years before one really has to worry about Social Security cuts, the urgency of the issue will likely be discounted.

Given the challenges associated with actually dealing with the coming insolvency of Social Security, both legislatively in Washington and behaviorally by wage earners, delaying retirement until one is 70 years old may need to be considered. Longer life expectancies make it feasible to continue to work past full retirement age, as does the shift from hard manual labor to professional service occupations.⁵ There would be three additional working years to save for retirement and three fewer retirement years that would have to be funded.⁶ And, retiring at age 70 brings a larger Social Security benefit, which funds over half of the benefits lost to the assumed cut in Social Security. Rather than present the entire analysis with the revised retirement age of 70, we will only present the scenarios for workers born in 1961, i.e., with the shortest time until retirement. It is these workers who will find it most challenging to replace the reduced Social Security benefit, because so little time remains until retirement. These results are presented in Table 2.

TABLE 2
RATE OF SAVINGS NECESSARY TO REPLACE UNFUNDED
SOCIAL SECURITY BENEFITS
(15 YEARS TO FULL RETIREMENT AGE, WITH VARIOUS SAVINGS RETURNS)

Retirement Delayed Until 70

Assumed Return on Savings	Percent of Annual Wage Needed to be Saved		
	Low Wage	Middle Wage	Upper Wage
4%	4.273%	3.305%	2.577%
6%	3.245%	2.510%	1.960%
8%	2.461%	1.903%	1.489%

Compared to Retiring at 67

Assumed Return on Savings	Percent of Annual Wage Needed to be Saved		
	Low Wage	Middle Wage	Upper Wage
4%	15.197%	11.361%	9.190%
6%	11.662%	8.719%	7.061%
8%	8.974%	6.711%	5.440%

For all wage levels, the additional savings needed to replace a 30% cut in Social Security benefits is substantially reduced by delaying retirement until age 70. For example, the savings needed for a low wage earner with a 6 percent return falls from 11.662 percent to 3.245 percent with delayed retirement. For high wage earners with a 6-percent yield, the level of savings needed fell from 7.061 percent to 1.960%. In dollar terms, this represents \$2,925 less annual savings in 2013 for low earners and \$5,800 less annual savings for high earners.

Privatization Redux

Proponents represent privatization as the salvation of Social Security. Most privatization proposals call for private retirement accounts in conjunction with a down-sized Social Security. What this analysis

demonstrates is that, while partial privatization might mitigate the impact of Social Security insolvency by diversifying the sources of one's retirement income, privatization hardly offers a comparable replacement for Social Security benefits. Further, every dollar of Social Security tax that is diverted to private retirement accounts makes the insolvency problem for current and soon-to-be retirees that much greater.

For wage earners with a substantial number of years left in their careers, private retirement accounts might be able to replace an individual's Social Security benefits. What privatization does offer is the security of knowing that a significant component of one's retirement plan is not at the mercy of political posturing in Washington. However, this "protection" comes at a cost. A stable investment return must be generated. If the return is too low, the savings plan cannot replace the equivalent Social Security benefits; thus, a benefit reduction caused by insolvency would be exchanged for a benefit reduction driven by risk-averse investing. If the savings are invested in higher yielding, but higher risk, investments, the vagaries of the market may also result in loss of retirement benefits.

Another factor that is too often overlooked by proponents of privatization is that Social Security offers benefits that extend well beyond the individual. A non-working or underemployed spouse is eligible for benefits based on the working spouse's earnings record (50 percent of working spouse's benefits at FRA). Surviving spouses are allowed to step into a deceased spouse's shoes and receive the full benefits that the deceased spouse qualified for. Perhaps, what privatization proponents really believe is that Social Security has expanded well beyond its original role as a social safety net—i.e., is too generous, and therefore too expensive. This point of view has its merits. However, the political blowback from advocating benefit reductions makes expressing such objectives hazardous, at best. Perhaps, privatization is an exercise in political sleight of hand that is hoped to result in unpopular benefit reductions while maintaining plausible deniability for such. Before discarding the current system in favor of privatization or any other proposal, it is important to compare the complete packages offered by each.

Limitations and Assumptions

The analysis and results presented above are subject to a number of limitations and assumptions. Significant among them are the use of pre-tax income, the period used for compounding and discounting, wage level categories analyzed, mortality tables used to determine life expectancy, and other Social Security benefits that were not analyzed. Each is addressed briefly below.

Use of Pre-Tax Income

The level of savings needed is expressed as a percentage of pre-tax income throughout this analysis. Of course, unless Washington allows such savings to be sheltered from income tax, it is after-tax dollars that must be saved. Thus, expressing a given level of savings as a percentage of pre-tax income understates the savings goal. However, the decisions that result in one's after-tax income are many and varied, making any meaningful estimate of after-tax income impossible.

Annual Rates of Return Used

For all computations, the compounding and discounting period is assumed to be a year. Of course, the reality is that most investments generate returns more frequently than annually. Thus, to the extent that monthly, or even daily, compounding is more appropriate, the savings balance that is accumulated in a given scenario is slightly understated. On the other hand, using a shorter period for discounting the Social Security benefits would similarly reduce the savings target as well. Thus, any bias is impacting both the compounding of savings and discounting of benefits to be covered through them.

Wage Levels are Somewhat Arbitrary

The choice of the three wage levels that were analyzed in this paper was somewhat arbitrary. The low wage earner was set at the median wage in 2012. To use the 25th percentile wage would have resulted in a wage so near the poverty level that any ability to increase savings seemed unrealistic.

IRS Table 2000 CM Used to Determine Life Expectancy

In order to determine how many years an individual should be expected to live after retirement, one must refer to a mortality or actuarial table. For this analysis, the mortality table provided by the IRS, Table 2000 CM, was used. As the name implies, the data on which this table is based comes from the 2000 census. This table is gender-neutral. Consequently, since females live somewhat longer lives than males, the 17-year life expectancy that was used for someone retiring at 67 would be a little longer than a gender-specific male life expectancy and little shorter than a gender-specific female life expectancy. While the Social Security website includes gender-specific life expectancies, the differences were relatively small.

Other Social Security Benefits Ignored

This analysis only looked at an individual's savings behavior and an individual's Social Security benefits. As mentioned above, Social Security provides many other forms of benefits, such as spousal and survivor benefits. And, disability benefits were not considered, because these benefits are funded out of a separate trust fund. A married couple's planning for retirement might include consideration of these other benefits in order to maximize the couple's overall benefits. If this is so, the impact of our assumed 30 percent benefit cut would be greater for these couples. This topic merits further attention as the discussion continues.

CONCLUSIONS AND RECOMMENDATIONS

There are no simple or painless answers to the approaching insolvency "crisis" of Social Security. If compromise is possible, some combination of tax increases and benefit reductions would offer a viable path to long-term solvency. However, without compromise, each wage earner in America needs to step up as the responsible party. This paper lays out what each wage earner needs to do, starting right now, to be ready for a possible (or probable) Social Security benefit cut. Unfortunately, whether for satisfaction of immediate gratification or due to meeting basic costs of living, Americans do not have a strong record of saving.⁷ What Washington might do to facilitate this transition towards a higher level of retirement self-reliance is to create a new kind of individual retirement account (IRA), which would offer the wealth-building power of tax deferral—and, perhaps, additional tax incentives for lower earning persons. A person is not permitted to draw on one's Social Security benefits in times of financial hardship. To assure that this IRA will be around when needed for retirement, there ought not to be any financial hardship withdrawals allowed prior to retirement (or age 59-1/2, as present IRA rules provide). What the conclusions of this analysis have in common with the proponents of privatization is that each worker in America needs to take personal responsibility for his or her future.

ENDNOTES

1. For example, the total return (i.e., including dividend reinvestment) of the S&P 500 index discloses a 15-year annualized return of 5.449%, a 25-year return of 9.28%, and a 35-year return of 10.567%, computed through the end of 2011 (CentralTendencies.com, 2011). The reduction in rate of return after retirement reflects the common practice of shifting to a more risk-averse investment style to better protect investment principal in retirement.
2. Note that we are addressing the alternatives for replacing currently promised benefit levels, not analyzing the sufficiency or appropriateness of the existing system.
3. This behavior is referred to in the psychology literature as "psychological distance." See, for example, Spence, et al. (2012), who examined psychological distance as a factor in how people perceive the risks of climate change.
4. Before computing monthly benefits, the 35 highest earning years' wages are adjusted to the present by applying an index factor that reflects the change in wages over time. This figure is referred to as indexed earnings.

5. Older workers make up an increasing portion of the workforce. However, the principal reason articulated for this trend is the aging of the workforce. With the baby boom bubble aging into the 55 and older group, the under 55 category, of course, proportionally has declined. Thus, while 55 and older workers make up a larger portion of the workforce (with this trend expected to continue at least through 2020), the data do not disclose whether a larger percentage of older workers are staying in the workforce (Toossi, 2012). See "Aging in the United States" for more insight on the percent of total population changes in various age categories, which illustrates the baby boom group as a significant portion of total population through 2020 (National Institute on Aging, 1999).
6. Based on IRS Table 2000 CM (Internal Revenue Service, 2012), the older the age that one attains, the older one lives. For example, a new born has a life expectancy just over 80, while a 67 year old has a life expectancy just under 84. So, to be precise, delaying retirement by three years would not reduce the retirement years by three years, but rather by a little less than three years. However, the difference is not material. For our analyses, for a 67 year old we rounded up to get a life expectancy of 17 years. For a 70 year old, we rounded down to a life expectancy of 14 years.
7. Savings rates in the U.S. have been declining since the early 1980's (Martin, 2010).

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