

## THE LONGEVITY REVOLUTION

### Chapter 13 Financing Longevity: Part I Self-Responsibility and the State<sup>1</sup>

*Today's average 65-year-old man and woman can expect to live to be 81 and 85, respectively. Over 17 percent of 65-year-old men and 31 percent of 65-year-old women are expected to live to 90 or beyond. Will they outlive their resources and be forced to lower their living standard?*

#### Overview

One consequence of longer life expectancy has been added years of retirement, which has resulted in mounting pension and health costs. Governments and employers, in turn, have reacted by reevaluating and reducing their commitments to the health and financial security of their citizens.

Can we afford old age, especially in this new era of expanded longevity? How much can government and business be expected to provide for retirement? Will the growing numbers of retirees bankrupt nations? How much can individuals save and invest? How long should a person work?

At the same time that experts suggest a replacement level of 70 percent to 80 percent of a worker's last earnings<sup>2</sup> in order to maintain a standard of living at retirement, there is growing pressure for people to predict their own needs and to bear some or all of the financial risks. The shift from mutual dependence on the universal pool of an entire society (or a company) to

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<sup>1</sup> The numbers and calculations herein reflect conditions and data in general circa 1997–2005, as available.

<sup>2</sup> The United States lags behind Germany, Canada, and other countries that provide better pension benefits and replacement of income.

individual responsibility in financing and managing retirement marks a significant departure from the ideal of the twentieth-century welfare state.

Some risks, such as anticipated life expectancy (especially living “too long”), risk tolerance, the state of the economy (e.g., the rate of inflation or the occurrence of recession), health status, employable skills, living-cost requirements in retirement, education of children, and other responsibilities can only be encapsulated into an imperfect algorithm of providence and risk. Ultimately, much depends on the questionable integrity of the securities market and on the state, which varies in its loyalty to its citizens and the individual.

Reflecting the complexity of this much-debated issue, this chapter is divided into two sections: “Self-Responsibility and the State” looks at various aspects of Social Security, both a venerated and maligned program. “Providence and Risk: The Role of the Marketplace” addresses the role of the private sector in financing longevity.

### Introduction

A 1997 nationwide poll conducted by the *Washington Post*, Harvard University, and the Kaiser Family Foundation found that 75 percent of Americans believed the federal budget could be balanced without touching Social Security and Medicare.

Having survived 12 presidents, at least as many political agendas, and the myriad fluctuations inherent in a free-market economy, Social Security has earned its place at the table as an enduring, well-designed, and adaptable, albeit poorly understood, social program. Through war, recession, and even governmental shutdown, Social Security has always come through.

Backed by Treasury bonds—the safest asset in anyone’s portfolio<sup>3</sup>—and protected against inflation by having its benefits tied to the Consumer Price Index, Social Security is an extraordinarily efficient government program. Its trust funds are held separately. Administrative costs are less than 1 percent of benefits that are paid out, in contrast to private pension administrative costs, which range between 12 percent and 14 percent.<sup>4</sup> It also fully portable; vesting is not required.

When the baby boomers make up 20 percent of the population and about 30 percent of the vote, and they recognize their own need, that of their children and that of the generations that follow for Social Security, no politician hoping for election will find it prudent to neglect this demographic.

By one estimate Social Security will be solvent until 2042, at which time the youngest surviving baby boomer will be 78 and the oldest 96. The Congressional Budget Office estimates that Social Security is solvent until 2052, when the youngest boomer will be 88 and the oldest 106.

### What Is Social Security?

#### Lifetime Annuity

Social Security is a lifetime annuity that is paid for as long as a person lives, assuring a minimal level of financial security even if all other resources are depleted. For 20 percent of Americans age 65 and older, Social Security is their sole source of income, and for roughly one-

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<sup>3</sup> The government must pay T-bond holders before it pays anyone else, including employees, contractors, and even insured bank depositors.

<sup>4</sup> *Life Insurers Fact Book*, 2003, American Council of Life Insurance.

third of this age group the program makes up 90 percent of their total income.<sup>5</sup> Social Security is not prefunded like a private annuity or pension plan. The retirement benefits are paid mostly by the Social Security contributions of today's workers, an arrangement that has functioned successfully for more than 60 years. It is a universal compulsory savings program that is earnings-related with regard to both contributions and benefits, with 95 percent of American workers paying Social Security taxes. (Some four million municipal and state employees are not in the Social Security system.)

The program requires a regressive tax for low-income workers; however, earned-income tax credits lower taxes for low-paid workers or pays them cash directly if they are too poor to pay taxes. If the combination of a couple's income and Social Security does not exceed \$32,000, they do not pay Social Security taxes after retirement.<sup>6</sup>

#### Life Insurance and Disability Insurance Program

Through its Old-Age, Survivors and Disability Insurance (OASDI), Social Security protects children, survivors, and disabled persons, as well as retirees. It is a life and disability insurance program that does not require a health status report for coverage and provides a total of \$14.5 trillion in life insurance—greater than that of the total private disability and life insurance

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<sup>5</sup> *Wall Street Journal*, June 28, 2004, page R1.

<sup>6</sup> <http://www.irs.gov/pub/irs-pdf/p915.pdf>  
<http://www.bankrate.com/brm/itax/tips/20010115a.asp?print=on>  
[http://www.gofso.com/Premium/LE/20\\_le\\_ir/fg/fg-SS\\_Benefits.html](http://www.gofso.com/Premium/LE/20_le_ir/fg/fg-SS_Benefits.html)

market.<sup>7</sup> For disability, the value of the protection is about \$203,000; and for survivors life insurance, it is \$295,000 for a 27-year-old worker with two children and average earnings. In 2001 it provided survivor benefits to young families who lost breadwinners in the terrorist attacks on September 11.<sup>8-9</sup>

### Sharing in a Rising Standard of Living

The initial Social Security benefits of a new retiree are determined in part by the overall level of wages in the economy, as well as past earnings. This is called “wage-indexing,” and it assures new retirees that their living standard keep up with that of the working population.<sup>10</sup>

### Who Funds Social Security?

Wage earners pay 6.2 percent of their wages into Social Security, and employers are required to match that amount.<sup>11</sup> The self-employed pay the entire 12.4 percent. In 2003, \$534 billion (84 percent) from payroll taxes went to Social Security, and about \$85 billion (13 percent)

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<sup>7</sup> 1997 estimate, from a memorandum by Willard Witherspoon, Jr. entitled Equivalent Life Insurance in Force under OASDI, October 19, 1998. Made available by Robert Myers. The corresponding amount of private life insurance in force for 1999 was \$13.5 trillion.

<sup>8</sup> Average weekly earnings for an individual are \$532.02. (Bureau of Labor Statistics, United States Department of Labor. March 2005. <http://bls.gov/news.release/empst.t16.htm>.)

<sup>9</sup> Real median household income is \$43,318 per year. (DeNavas-Walt, Carmen, Bernadette D. Proctor, Robert J. Mills, and U.S. Census Bureau. *Income, Poverty, and Health Insurance Coverage in the United States: 2003*. Washington, D.C. <http://www.census.gov/prod/2004pubs/p60-226.pdf>.)

<sup>10</sup> The Bush Administration argues for converting to “price-indexing,” which would significantly reduce the standard of living of future retirees.

<sup>11</sup> Essentially all economists agree that the full payroll tax (including the employers’ contributions) come out of wages.

came from interest earned on the system's surplus. Thirteen billion (2 percent) came from taxes that working retirees paid on their benefits. The taxable wage base in 2005 was \$90,000 for OASDI.

The overall program is progressive in that higher wage earners receive higher benefits, although it is a smaller percentage of their average earnings than low-income workers. For example, the average wage earner who retired in 1997 received about 42 percent of his/her average earnings, while low wage earners received about 60 percent, and those with high incomes received about 28 percent.

For the majority of workers employed in low and moderate-income jobs, Social Security provides equal benefits for equal earnings and uniformity of coverage.

Private pension plans have not proven as secure as Social Security, and, historically, many private defined-benefit pension plans have defaulted. Since passage of the Employee Retirement Income Security Act (ERISA) in 1974, private defined-benefit pensions have much improved, but, even so, many programs remain underfunded. ERISA requirements have motivated companies to switch to defined-contribution plans, which are not insured under ERISA, and, consequently, proportionately fewer companies have defined-benefit programs than defined-contribution systems.

### Who Receives Social Security?

In the Social Security Act of 1935, the word "entitlement" simply meant that the people were *legally entitled to benefits if eligible and filed a claim*. Today, it has come to be identified as "welfare" and is considered a pejorative reference. Who are these entitled individuals?

In 2002, payments went to more than 46 million people each month, averaging \$9,744 in yearly benefits. Couples received an average of about \$15,000. Of the 46+ million recipients, more than 32 million were retirees, nearly five million were spouses and children of retirees and disabled workers, nearly seven million survivors (of whom 1.9 million were children), and 5.5 million disabled. *Altogether, 3,915,520 children were covered by Social Security*, most protected from impoverishment when wage-earning parents died or were disabled. Of the retirees, 26 percent relied on Social Security for at least 90 percent of their income. For 20 percent, Social Security was their only source of income, and 50 percent would have fallen below the poverty line were it not for Social Security.<sup>12</sup> This is especially significant for older women, who live longer than men and who receive 52 percent of benefits.

It must be noted that the official poverty line is calculated differently for older than for younger people. In order to be counted poor, an older person has to receive 8 percent to 10 percent less money than a person up to 65 years of age.<sup>13</sup> In 2004 the poverty level for an individual 65 and above was \$9,310 per year,<sup>14</sup> for a couple \$12,490 per year.

Survivor benefits are paid to dependent children of deceased workers, which includes unmarried children under age 18, full-time high school students under age 19, and adult children disabled before age 22; a widowed spouse age 60 or older (if disabled eligibility begins at age 50); a widowed spouse of any age who is caring for eligible children under age 16 or a disabled adult child; and dependent parents of the deceased worker.

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<sup>12</sup> Income of the Population 55 or older: 2000, 2000 Social Security Administration.

<sup>13</sup> International Longevity Center-USA, *Old and Poor in America* (New York: International Longevity Center, 2001).

<sup>14</sup> About \$179/week or about \$25/day. See *Federal Register* 69:7336–38, 2004.

### How Does Social Security Influence the Intergenerational Contract?

The intergenerational contract is a social contract between the generations that has its origins in the earliest recorded models of organized society. Without explicit definition, an intergenerational contract implicitly defines how the generations come together for their mutual benefit and for the overall benefit of society. Social Security represents one such intergenerational contract in that it is a direct income transfer from younger to older workers, their families, and the disabled. In effect, members of the younger generation, in a pay-as-you-go (PAYG) system, pay benefits for their parents. At the same time, more *private* money is transferred from old to young than from young to old; indeed, some beneficiaries return part or all of their Social Security to younger family members.

Some argue Social Security promotes intergenerational conflict. For example, the now-defunct Americans for Generational Equity (AGE) warned inaccurately in 1987 that payroll taxes could reach anywhere between 23 percent and 42 percent to pay for Social Security and Medicare, compared with 15.3 percent at the time. Richard Thau, executive director of Third Millennium in Manhattan, a lobbying group that works on issues affecting people under 35, has expressed similar concerns.<sup>15-16</sup> On the other hand, Harris Interactive, Peter D. Hart Research Associates, and other polls indicate that old and young alike support Social Security and Medicare.

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<sup>15</sup> Young Workers' Unique Stake in Social Security Reform, a panel at a conference on Social Security & Young Americans, sponsored by the Cato Institute, America's Future Foundation, and Third Millennium (2002).

<sup>16</sup> Taylor, Humphrey. The remarkable lack of intergenerational conflict as to how government spending should be divided between services for young and old. *The Harris Poll #24*, May 20, 1998.

Should Social Security Require Means Testing?

Social Security does not require means testing; rather, funds are redistributed to low-income workers upon retirement. Peter G. Peterson, President Nixon's secretary of commerce and author of *Gray Dawn: How the Coming Age Wave Will Transform America—and the World*,<sup>17</sup> advocates a means test for retirees with incomes above \$40,000. In point of fact, only 8.0 percent of Americans over 65 have incomes in excess of \$50,000 a year, and they are often still employed. According to the U.S. Census Bureau, 18 percent of men and 10 percent of women 65 years and older are currently in the civilian labor force.<sup>18</sup> On the other hand, Robert J. Myers, who was chief actuary of the Social Security Administration between 1947 and 1970 and executive director of the National Commission on Social Security Reform in 1982—the Greenspan Commission—has noted that if the redistributive nature of Social Security were eliminated, either the old and poor would be abandoned entirely or an extensive and expensive public assistance program with high administrative costs would be necessary.

Means-tested programs have negative repercussions. For example, Australia, which instituted a means test in the 1940s, has reported a “perverse incentive” for people to deliberately choose to earn less, or to “spend down,” as retirement nears to minimize their income and assets in order to be eligible for retirement benefits.<sup>19</sup>

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<sup>17</sup> New York: Times Books, 1999. Also see Peterson, Peter G., *Running on Empty: How the Democratic and Republican Parties Are Bankrupting Our Future and What Americans Can Do About It* (New York: Random House, 1999).

<sup>18</sup> U.S. Census Bureau, April 2003, *The Older Population in the United States: March 2002*, Washington, D.C. <http://www.census.gov/prod/2003pubs/p20-546.pdf>.

<sup>19</sup> Whiteford, Peter, and Angenent, Gregory, *The Australian System of Social Protection—an Overview*, Occasional Paper No. 6, 2nd ed. (Canberra, Australia: Department of Family and Community Services, 2002).

In view of the inevitable incidents that are beyond our control, I believe Social Security needs to remain universal and independent of one's employment, health, income, or assets. The small percentage of older persons who don't need Social Security can choose not to apply. Or they can turn it over to their favorite charity or to the general revenues of the government.<sup>20</sup>

### Should Social Security Be Privatized?

President Franklin D. Roosevelt said of Social Security payroll taxes in 1936: "We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program."<sup>21</sup> And during his term in office Republican President Ronald Reagan emphasized that Social Security was not responsible for the federal deficit. Indeed, it helped conceal it. Today, two contradictory statements are made about Social Security:

1. Older Americans do not get their money's worth and would do better in the private market, and
2. Older Americans receive far more than what they contributed in payroll taxes during their working years plus accumulated interest.

Which is true? Do people get their money's worth? Or do they get too much? Let's look at the numbers. Average workers who retired in 1996 regained their Social Security tax contributions with interest after 6.2 years in retirement. Minimum wage workers regained theirs

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<sup>20</sup> Edward Stolman, a businessman, would encourage the philanthropic impulse by offering a tax deduction to those who will contribute their Social Security to a fund devoted to improving the lives of the poor.

<sup>21</sup> Schlesinger, Arthur M. Jr., *The Age of Roosevelt: The Coming of the New Deal* (Boston: Houghton Mifflin Company, 1959), 308–9.

after 4.4 years and the maximum wage earner after 8.2 years. (Of course, the more well-to-do live longer and therefore collect benefits for more years.)

When we think about privatizing Social Security, we must also seriously consider the stock market's vulnerabilities. All investments carry the prospect of risk as well as profit; on the other hand, *average* active managers do far worse than index funds. Only about 20 percent of managers do better (and not always the same 20 percent). In fact, the Standard and Poor 500 fell somewhat lower in the October 1987 stock market precipitous drop than did actively managed stocks. Index funds are *not* safer than actively managed funds and gain only in a bull market.

In 1996 Alan Greenspan asked: "*How do we know when irrational exuberance has unduly escalated asset values which then become subject to unexpected and prolonged contractions?*" (The italics are mine.) In 1999 it was reasoned that a significant drop beyond a possible 20 percent correction that some expected in the contemporary stock market would dampen enthusiasm for privatization. In fact, two years later the stock market severely contracted as the dot-com speculative bubble burst,<sup>22</sup> and scandals, such as at Enron, emerged.

Nonetheless, ideological, political, and business interests have seized upon any dire projections to promote privatization of Social Security, and some organizations have misunderstood and/or exaggerated issues related to its solvency. Support for privatization has come from a number of sources and follows several lines of thinking. It was promoted in part by those who oppose all public welfare programs. One example is the Cato Institute, a libertarian research organization, which began a \$2 million, three-year campaign to promote replacing Social Security with privately managed individual accounts. Think tanks like the Heritage Foundation and the Concord Coalition also encourage this "crisis" mentality in support of an

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<sup>22</sup> The Standard and Poor stock index lost over 40 percent of its value.

agenda to discredit what some label as “the nanny state.” Wall Street is divided on the issue, with one camp predicting a financial bonanza if part or all of Social Security is privatized.

In 2000, President George W. Bush established a Commission to Strengthen Social Security. The commission presented three options for workers to establish individual investment accounts by using a percentage of their Social Security payroll taxes. It is still unclear how these options will be financed in an era of large projected budget deficits outside Social Security. One alternative is to initiate large reductions in traditional Social Security benefits, but this option fails to restore long-term solvency to Social Security, despite previous pledges that any commission plan would do so.

Although the Social Security system is not in long-term actuarial balance, this is due neither to poor management nor to poor planning. According to the intermediate estimate, Social Security can pay 100 percent of benefits until 2042 (2052 according to the Congressional Budget Office).<sup>23</sup> Then if current trends continue and if no changes are made, Social Security would be required to reduce benefits, add revenue, or effect some combination of the two. At worst there would be a 30 percent cut in benefits, with beneficiaries receiving 70 percent of presently scheduled benefits. *However, the intermediate assumption (which is really pessimistic) that projects a declining economy, must also apply to any plan that involves privatization!*

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<sup>23</sup> By 2018, Social Security would draw upon the \$1.7 trillion trust fund that resulted from the recommendations of the Greenspan Commission 1983 (see later).

One newspaper headline read “U.S. Pension Panel Votes for Wall Street.”<sup>24</sup>

*There is a major contradiction between the consensus of the Advisory Council to invest in equities and the dire economic forecast of the Social Security Trustees, since neither Social Security nor stock market–based pensions easily weather a crash or serious recession.*

I believe that individuals share a responsibility to finance their own longevity. Given the realities of economic downturns, the need to assure adequate incentives to avoid undue dependency and maintain a preretirement standard of living, children of elementary school age need to be taught to begin building their own “endowment”—by developing personal savings and investment plans to supplement government and occupational pensions.

However, even with the best of intentions, today’s family often requires two incomes simply to survive, to say nothing of helping to support children through college and pay the costs of unexpected illness. It is often very difficult to save for the future, especially in the face of unemployment or stagnant wages. A survey conducted in 1998 by the Employee Benefit Research Institute (EBRI) found that 40 percent of workers said they could not afford to save even \$20 extra each week for retirement. And, unfortunately, there will always be individuals who are shortsighted or imprudent with regard to their future. These realities provide arguments in support of Social Security to insure *a basic, if modest, safety net.*

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<sup>24</sup> *The International Tribune*, December 1996.

## Achieving Solvency

There is considerable *social insecurity* on the part of the public, and it comes at a time of growing inequality of income and wealth.

According to the Social Security Administration, the 75-year funding gap is \$3.7 trillion or about 0.7 percent of gross domestic product (GDP). Estimates made in 1997 calculated that over the next 75 years, *if nothing were done*, payments from the Social Security trust funds would average 1.92 percent<sup>25</sup> of payroll taxes higher than receipts. In the 2001 report,<sup>26</sup> the “pessimistic” low total fertility rate (TFR) over the long range was 1.7 per woman; the “optimistic” high was 2.2, and the intermediate level was 1.95. It is reasonable for society to encourage an intermediate level (which approaches zero population growth) —about 2.1.

*The solution to Social Security least commented upon publicly is increasing productivity, in that with an increase of 1 percent of growth in the GDP the actuarial problem disappears.*

The history of the growth of the GDP in the United States suggests optimism. For example, in 1997, the trustees predicted that the trust funds would run out in 2029. But without any changes to the program, the nation’s improved economic performance added 13 years to the estimate of when the system would face a genuine crisis.<sup>27</sup> But other steps can and should be taken.

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<sup>25</sup> Between 1996 and 1998, United States’ robust economy postponed the drop in Social Security solvency three years from 2029 to 2032 and the 75-year deficit from 2.23 percent of taxable payroll to 2.19 percent. By 2002, the Social Security Trustees projected a 1.87 percent shortfall.

<sup>26</sup> Social Security Advisory Council 2001 OASDI Trustees Report, <http://www.ssa.gov/OACT/TR/TR01/trTOC.html>

<sup>27</sup> *Social Security Reform* (revised 2005 edition). A Century Foundation Guide to the Issues (New York: The Century Foundation Press, 2005).

The Old-Age, Survivors and Disability Insurance (OASDI) trustees routinely report on the system's actuarial status over the next 75 years<sup>28</sup>. By law, they must provide three alternative projections: pessimistic, intermediate,<sup>29</sup> and optimistic. Ironically, longer life and population control become "pessimistic assumptions." Presumably, further medical breakthroughs that would extend life would also be "bad news." *Expanding national productivity, happily, is an optimistic assumption.*<sup>30</sup>

*Payroll Taxes:* The simplest way to achieve solvency today is to raise payroll taxes<sup>31</sup> by approximately 1.92 percent to cover the shortfall over the 75 years, moving up payroll taxes for OASDI to 7.0 percent from 6.2 percent for both the employer and the employee, or from 12.4 percent to 14.0 percent total. In addition, the employer and employee would each pay 1.45 percent of total payroll<sup>32</sup> (2.90 percent combined) for Medicare Hospital Insurance. Thus, the employee and employer would have a tax rate of 8.45 percent of payroll, and if self-employed 16.9 percent.<sup>33</sup>

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<sup>28</sup> Nearly the present life expectation in the United States.

<sup>29</sup> Generally regarded as most likely to occur.

<sup>30</sup> See footnote 25.

<sup>31</sup> FICA, Federal Insurance Contribution Act.

<sup>32</sup> There is no limit for the earnings base on which the 1.45 percent Medicare Hospital Insurance tax is paid.

<sup>33</sup> This should be compared with the Chilean system, promoted by the Cato Institute, that requires 10 percent in payroll taxes by workers for retirement, an additional 3.5 percent for disability and 7 percent for health insurance, a total of 20.5 percent! Moreover, the entire Chilean population is not covered.

The downside to a raise in payroll tax is that it is regressive and hits low-income workers hardest, although it is redistributive at the time of payment of benefits and, to a degree, is offset at present by the earned income tax credit available to those workers.

*Longevity and Work:* Since people are living longer, it makes sense that they should work longer, increasing the amount of money going into the Social Security trust funds while simultaneously reducing the outflow.<sup>34</sup> (However, working longer is neither appropriate nor desirable for everyone, including individuals who have worked long years at dangerous and burdensome labor or those with disabilities.) Studies have shown that people who choose not to retire at 65 enjoy a sense of purpose that can translate into longer and better quality of life.

Increasing age eligibility will mean that one will not get Social Security for as long. Slowly phasing in the change will compensate but may stimulate additional claims for disability insurance and present the need for reforms in assessing disability.

### The Dependency Ratio<sup>35</sup>

Like a stable economy, a stable population is desirable but difficult to achieve. The dependency ratio represents the ratio between the number of persons who are employed to those who are economically dependent. Some demographers and economists have expressed concern over the dependency ratio in the context of the alleged Social Security crisis. While it is true that

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<sup>34</sup> 1978 congressional hearings testimony, conducted by Representatives David Stockman and Richard Gephardt, noted that only modest additions to the work life significantly improved the financial status of Social Security. (U.S. Select Committee on Population, U.S. House of Representatives, *Consequences of Changing U.S. Population: Baby Boom and Bust*, June 1, 2, 1978.)

<sup>35</sup> Webb, Anthony, *The Dependency Ratio: What Is It? Why Is It Increasing? What Are the Implications?* (New York: Alliance for Health & the Future, 2005).

the ratio of retirees to workers between ages 20 and 65 is increasing,<sup>36</sup> if we consider *total* dependency, that is, the ratio of children under 20 and older persons over 65, compared with persons aged 20–64, we discover something quite different. In 1995, there were 71 so-called dependents for every 100 persons at working ages as compared to 95 per 100 in 1965; in 2030 the ratio will be 79 per 100. This is because the decline in the birthrate and the reduction in the number of children help offset the advancing number of people over 65.<sup>37</sup> Moreover, it must be noted that productivity *per capita* has increased, and fewer workers are needed to produce comparable goods and services. Clearly, the dependency ratio is a very uncertain and controversial notion. For instance, many older people have saved and invested, and approximately 15 percent still work; some children earn money before age 20, and some people between 20 and 65 do not. Further, *per capita*, raising a child probably costs more than caring for an older person. For example, the cost of raising a child is about \$300,000, according to economist Richard C. Leone.

#### Social Security “Reform”: Three Scenarios

The Advisory Council on Social Security, appointed by Donna E. Shalala, secretary of Health and Human Services in 1994, could not agree on recommendations to achieve Social Security solvency. So in 1996 it presented three competitive scenarios.

Although more than a decade old, I cite these scenarios because they accurately reflect the possibilities.

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<sup>36</sup> Statement of Alan Greenspan before the Committee on the Budget, U.S. Senate, January 28, 1999.

<sup>37</sup> There has been a steady decline in the *total* dependency ratio since 1900.

I. Maintenance of Benefits Plan

Robert M. Ball, former commissioner of Social Security (1962–1973), led the largest number of committee members in support of a plan that recommended only modest benefit cuts and up to a 40 percent investment in indexed stock funds. (Index funds are indexed to the stock market and rise and fall in response to its fluctuations.) *The Ball plan maintains Social Security in its present form.* The Ball plan proposed “a Federal Reserve-type board with two functions: one, to select the index to be used, probably 3,000 to 5,000 stocks; and two, on a bid basis to select day-to-day fund managers who would buy and sell stocks to maintain the folio in accordance with the index. These managers would be experienced portfolio managers from the private sector, not civil servants.”<sup>38</sup> The total investment of Social Security funds in equities could not exceed 5 percent of the total valued stocks on the open market unless authorized by Congress. Retirees would be insulated from stock market risks.

*Commentary:* Would there be investments in corporations that create environmental problems; in companies possibly subject to anti-trust suits? Would the blue chips gain at the expense of start-up innovative companies, etc.? And what if the stock market is in deep turmoil—wouldn't the government come under strong political pressure to support the market, as Hong Kong's government did during the 1998 Asian financial crisis?

II. Individual Accounts Plan—Partial Privatization

Edward M. Gramlich, economist from the University of Michigan, presented a plan that would scale back Social Security benefits but keep the 12.4 percent payroll tax. This proposal would add an additional tax of 1.6 percent earmarked for government

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<sup>38</sup> Personal communication, Robert M. Ball, March 30, 1998.

investment accounts in an unmanaged passive index fund. The Gramlich plan would keep the same payroll tax, but it would add a mandatory supplemental privatization. This plan was supported by only one committee member, Marc Twinney, former director of pensions for the Ford Motor Company.

*Commentary:* Proponents argue that this is not a tax increase. A state-mandated contribution would go into a private account owned by the individual. However, it has the essential characteristics of a tax, the compulsory confiscation of money. If such confiscation of a private contribution is legitimate, how does it differ from adding to the Social Security payroll tax itself or turning to general revenues?

### III. Personal Security Accounts Plan

Sylvester J. Schieber, director of the Research and Information Center of Watson Wyatt Worldwide, a benefits consulting company, and his group of five committee members, proposed a two-tiered system that would provide a flat benefit set at 70 percent of the poverty line, with about 47 percent of the benefit paid to an average beneficiary. This plan, which is the most radical of the three proposed, would deduct 5 percent of the existing payroll tax and place it in a personal security account.<sup>39</sup> It would take about \$1 trillion in transition costs and require the equivalent of a 1.52 percent payroll tax for 72 years.

*Commentary:* This controversial proposal would mark a major transformation of the system created in 1935 in that *Social Security becomes more of an investment program* conducted on an individual basis and not an insurance system. It would presumably give a lift to

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<sup>39</sup> The Chamber of Commerce and the National Association of Manufacturers lobbies Congress to create individual accounts.

the stock market. There would be massive administrative costs—given the millions of individual plans<sup>40</sup> and the cost of private retirement accounts—and management fees and commissions would be enormous, reducing the presumed additional income for beneficiaries beyond present-day government return. (Trading securities and commodities has amounted to more than \$100 billion in transaction costs taken from investors' returns each year.)

*A Few Thoughts About Privatizing Social Security*

**More than half of Americans do not understand the difference between a stock and a bond.**<sup>41</sup>

**Only 4 percent know the difference between an index and a managed mutual fund.**

**Only 16 percent have a clear understanding of an individual retirement account.**

**Only 8 percent completely understood the expenses that their mutual fund charges.**

Let's face it: Investing in the stock market requires knowledge, judgment, discipline, a strong stomach—plus luck and a thriving economy. And not everyone who invests is successful. Top-flight asset management and investor services are expensive and are not available for most people. In general, since the 1920s, corporate bonds have yielded 7 percent and stocks an average of 10 percent. *But there is volatility and long down periods.*

From the perspective of the world of business and government, the advantage of privatization is clear—it transfers risk to the individual.<sup>42</sup> Moreover, privatization of Social

Security might be a source of economic expansion and general prosperity. Depending on which of the three types of plans—if any—was adopted, Social Security could hold 5 percent to 15 percent of the total market value of stocks. I do not know what it would mean to introduce billions of *new* dollars per year into stocks and bonds. Presumably, it would be a real advantage to Wall Street, but might it have some unexpected and undesirable effects? Would it be inflationary, for example?

In the present system low-income workers benefit, but such a subsidy would not exist or have the same effect under privatization. Typically, low- and middle-income investors do not choose to invest in the stock market but favor lower risk investments, knowing they cannot afford risk. When they can save, they tend to choose government-insured bank deposits, savings and loans, and credit unions.

If the Social Security “surplus” were not available, the government would have to turn to the private market to borrow, at possibly greater costs. If the stock market did fall cataclysmically, especially over a long period of time, who would absorb the losses—would it fall on pensioners? On taxpayers? *This would mark a shift to risk, not a shift to security for the individual.* With the baby boomers constituting 20 percent of the population and 30 percent of the voters between 2020 and 2030, would the government be likely to let older persons, predominantly older women, starve? *This would be the true Social Security crisis and a reason for panic!*

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<sup>40</sup> There are 141 million American workers.

<sup>41</sup> According to Arthur Levitt, former chair of Securities and Exchange Commission.

<sup>42</sup> Phrases such as *privatization* or *personal investment accounts* may be set aside by advocates in favor of the *ownership society*, emphasizing individual choice and personal control, which sound appealing.

In a report published in 1997, Dean Baker<sup>43</sup> of the Economic Policy Institute warns that the present trend in stocks cannot be sustained. He argues that the suggested 7 percent real return to investors over the last 70 years is incompatible with a long-term mainstream prediction of less than 2 percent growth in gross national product. This sharply contradicts enthusiasm for privatization of Social Security and for individual investor savings. Put bluntly, the stock market's price-earnings ratio would have to rise to 34:1 by 2015 and 485:1 by 2070 to sustain a 7 percent average return!

A number of other solutions have been proposed. For example, Lawrence Kotlikoff, Boston University economist and inventor of "generational accounting," suggests the use of a federal retail sales tax to cover large amounts of unfunded liabilities of the Social Security system. And Peter Peterson proposes a means-tested system.

Least destabilizing is *the proposal by the 1939 Social Security Advisory Council that the income tax be the third party, if necessary, along with the employer and the employee.*

#### A Fourth Scenario

Let's envision a fourth scenario, which is comprehensive (involving health as well as economic considerations) and goes beyond the traditional conceptual approach to Social Security solvency. It includes no benefit cuts but instead raises the taxable wage base and, as necessary,

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<sup>43</sup> Baker, Dean, *Saving Social Security with Stocks: The Promises Don't Add Up*, A Twentieth Century Fund Economic Policy Institute Report (New York, 1997).

payroll taxes, in measured steps and only to the degree required. This scenario is based upon actuarial advice and evaluation of annual productivity,<sup>44</sup> taking the least painful steps first.

Following is a brief outline that charts a fourth course of action:

- 1) Increase the wage earnings limit on annual taxation for Social Security from \$90,000 to \$140,000.<sup>45</sup> This would solve about 60 percent of the shortfall and affect only 6 percent of the population. It is compatible with Adam Smith's vision of progressivity of taxation and would add security as well as progressivity. Expanding the earnings base is consistent with other taxes—there is no ceiling on sales, income, property, inheritance, and capital gains taxes.
- 2) Study the effects of the raise in age of eligibility to 67 to determine if employers make adjustments and retain workers longer. If justified, slowly raise the eligibility age to 68. Eventually, retirement age should be indexed to changing life expectancy under ideal labor-market conditions, that is, freedom from age discrimination and available jobs. This requires that government increase employer incentives to employ older persons by reducing their costs<sup>46</sup> in a program that is phased in over an extended period of time and that takes into account racial and gender disparities in life expectancy.

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<sup>44</sup> Once again, special consideration should be given to the payroll tax burden on low-income workers. The lowest decile, for example, might be spared a raise in the payroll tax.

<sup>45</sup> Only about 6 percent of U.S. households have incomes above that income. The total removal of the cap would cover two-thirds of the shortfall. Robert M. Ball recommends restoring the maximum taxable earnings base to 90 percent, the level set by Congress in 1983. This figure is adjusted each year in line with inflation (personal communication, December 2004).

<sup>46</sup> See Gruber, Jonathan, and Wise, David A. Social security programs and retirement around the world: micro estimation. NBER Working Paper No. 9407, December 2002.

I believe some changes to Social Security should be introduced immediately, in a system of “partial advanced funding,”<sup>47</sup> saving today for the needs of tomorrow. This is preferable to an exclusive pay-as-you-go system that requires increased future taxes to maintain benefit levels.

Individuals who retire at 62 have a 20 percent reduced benefit under Social Security,<sup>48</sup> but there is an incentive to work longer under Social Security since benefits grow by 7.5 percent per year as long as one chooses not to draw from the fund. In 1982, while I was director of the National Institute on Aging, Alan Greenspan asked me<sup>49-50</sup> to testify to the following question: Because there has been an increase in life expectancy since 1935 when Social Security was created, shouldn't there be an increase in “work ability” or work expectancy? For example, in 1935 average life expectancy of men was 59.9 and women 63.9. In 2005, 70 years later, it is about 74 and 80, respectively. And from base age 65, men live 3.5 years longer and women 5.0 years longer than they did in 1935.<sup>51</sup> A one-year increase in the retirement age is equal to a 7 percent cut in Social Security, says Ron Gebhardtsbauer, senior pension fellow at the American Academy of Actuaries. Such an increase would eliminate about one-third of Social Security's

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<sup>47</sup> As introduced in 1983, to a degree, by Congressional action based upon the Greenspan Commission of 1982.

<sup>48</sup> In 2027, when the age for full eligibility for Social Security is 67, those who retire at 62 will receive only 70 percent of their full benefits.

<sup>49</sup> Butler, Robert N., An overview of research on aging and the status of gerontology today, *Milbank Memorial Fund Quarterly Health and Society* 61 (1983):351–61.

<sup>50</sup> Butler, Robert N., The relation of extended life to extended employment since the passage of Social Security in 1935, *Milbank Memorial Fund Quarterly Health and Society* 61 (1983):420–9.

<sup>51</sup> The two most significant and relevant demographic changes since 1935 are longer life and increasing numbers of women in the workforce.

projected \$3.7 trillion shortfall over the next 75 years, not counting the extra tax revenue it would generate from people working longer.

I favor full eligibility at 68 or even later, but only in association with the development of real possibilities for people to work longer. Otherwise, older people could be subjected to Dickensian poverty. I call this approach *productive aging or engagement*.

#### *Supporting Productive Engagement*

3) The majority of workers in this country retire involuntarily, for example, for health reasons or job loss. Steps should be taken to encourage continuing work:

- Increase the incentive already available and give people greater Social Security benefits by remaining at work longer. Worked out on an actuarial basis, this should be budget neutral.
- Enforce the Age Discrimination in Employment Act.
- Encourage corporate America and all employers to retain and hire older workers who have demonstrated productivity, dependability, and minimal absenteeism. **Decisions by employers regarding whether to promote continued employment of employees past age 65 should be based on function, not on chronological age.**
- Delay age of early Social Security eligibility from 62 to 63, and gradually to 65 (with the assurance that disability insurance is available).<sup>52</sup>
- *Make older employees more attractive and less expensive to business by lowering Medicare eligibility to age 55, while simultaneously making Medicare the primary*

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<sup>52</sup> Raising the age of full eligibility for Social Security does cut benefits from Social Security, but if work is available other benefits linked to productivity accrue to the individual and the nation. In 2003, the National Academy of Social Insurance estimated that 25 percent of early retirees, those 62 to 64, were too frail to do ordinary work.

payer. (Today for the “working aged,” Medicare is the secondary payer after the employer health plan has paid.) This plan would put more money into Social Security as people work longer, and less money would be paid out of the Social Security trust funds. Parenthetically, and compatible with data that suggest that productivity and health are related, there would be increased national productivity and lower health costs.

- Offer other tax incentives to employers who retain older workers, and tax incentives for retraining throughout the working years.
- Increase health through improved lifestyles and medical research.

4) *Increase the time period for computation of benefits under Social Security from 35 to 38 years.* Since this would have untoward effects on women who are in and out of the workforce because of maternity leave, child care, and other unpaid family work, establish Social Security family-care credits.<sup>53</sup> France’s system of providing family-care credits could be a model for study.<sup>54</sup>

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<sup>53</sup> In the United States, the average woman works 27 years and spends 12 years in caregiving.

<sup>54</sup> See International Reform Monitor, *Social Policy, Labour Market Policy and Industrial Relations* (Gutersloh, Germany: Bertelsmann Stiftung, March 2005). Also see: Hennick, Rachel, *Family Policy in the U.S., Japan, Germany, Italy and France: Parental Leave, Child Benefits/Family Allowances, Child Care, Marriage/Cohabitation, and Divorce. A Briefing Paper Prepared for the Council on Contemporary Families* (New York: Council on Contemporary Families, May 2003).

5) *Authorize the Bureau of Labor Statistics of the Department of Labor to revise the Consumer Price Index (CPI).*<sup>55</sup> The CPI measures inflation and consumer prices by noting monthly price changes in a “market basket” of 95,000 goods and services that match typical consumer purchases. To recompute the CPI, it is necessary to study substitution by consumers when prices rise. Throughout its history, the CPI has been constructed as if no substitution occurred. Both Alan Greenspan and the late Senator Daniel Patrick Moynihan recommended revision downward. In any case, it should *not* be greater than a 1.1 percent decrease in the cost-of-living adjustment (COLA), which on average would cost \$96 per year of Social Security benefit. By just reducing the CPI by 1.1 percentage points, the Social Security system would move further toward actuarial balance. As Senator Moynihan pointed out, such revision would reduce the payout of the trust funds by \$1 trillion in 12 years. Reduction of the CPI alone would lower the long-term deficit by two-thirds. If the CPI were reduced, it would slow the rise of the federal tax bracket and deduction amounts, effectively raising taxes and cutting the deficit. Part of the tax code and a third of the federal budget outlays have been indexed by the CPI. The CPI is also used to determine wage increases in many union contracts. Because of

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<sup>55</sup> In Japan, pension benefits are indexed to net real wage increases rather than prices. This is calculated minus public pension contributions.

the CPI, Social Security is the only source of income protected against inflation, in keeping with increasing longevity.<sup>56</sup>

- 6) *Tax the benefits of retirees after they have received Social Security income beyond their initial contributions.* (People in the upper income brackets already pay back one-third of their Social Security benefits in taxes.) This includes taxing employers' contributions, so that about 85 percent or more of the Social Security benefit would be subject to tax.
- 7) Since the payroll tax is regressive and affects low-income people the most, *increase the payroll tax only if absolutely necessary and only for as long as necessary* to make up for any residual shortfall after other suggested steps have been taken. *The alternative and socially wiser choice might be to use general tax revenues<sup>57</sup>. If necessary, I advocate a "fail-safe" tax increase for the future.*
- 8) *Introduce reforms in Social Security that eliminate inequities in payment between men and women.* In 1935 when Social Security was inaugurated, the conventional American family was comprised of the breadwinning husband and the homemaking wife. But today, in the majority of cases the "economic unit" is the two-paycheck family, and it should be treated as such in any Social Security reform. Left undone in Social Security is development of a modified earning-sharing system, which combines the earnings in a marriage by "economic unit" and helps reflect the "new family" in which both partners work. This reform should be carried out *without cutting the benefits of widows who have*

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<sup>56</sup> Caution in any downward revision of the CPI is mandated because of the high expenses of older persons due to prescription drugs and health care. *Thus any adjustment must focus on the actual living costs of retirees and the disabled, not on the population as a whole.*

<sup>57</sup> It has been recommended that up to half of the system's cost eventually be financed by general revenues.

*not had a work history.* Divorcees who were married fewer than ten years do not receive the benefit of their husband's Social Security but should receive a prorated cutoff.

Currently, these individuals receive no Social Security benefits accruing from their years in the marriage.

- 9) Undertake a major reconstruction of the Social Security disability evaluation and awards to speed up the process and avoid errors in either direction. Eligibility for disability benefits does not begin until five months after the disabling illness or event, while eligibility for Medicare begins only after 24 months if cash benefits have been received! The Disability Insurance ("DI") Trust Fund is projected, under the intermediate estimates, to pay full benefits until 2015 and requires a similar fiscal solution.
- 10) *Encourage employers to provide both defined-benefit pensions and/or defined-contribution pensions, 401(k)s.* Social Security became necessary in the first place because the free-enterprise system—including small employers as well as large corporations—did not, and perhaps could not, always provide pensions.
- 11) *Mandate a supplementary private pension plan.* I favor an *additional* mandatory payroll charge of approximately 1 percent or 2 percent of covered earnings to be dedicated to individual retirement accounts. They would be best managed by competitive Wall Street companies under broad general governmental supervision. This might enhance both national savings and investments<sup>58</sup> and augment pension adequacy, as well as send an important psychological and symbolic message to people to further provide for themselves. It must be acknowledged as possible, however, that any mandated savings

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<sup>58</sup> Investment as an economic term is distinguished from savings and means the purchase of capital goods and structures.

could simply result in a shift in savings. Would this give a lift to the stock market? No one really knows.

Those with low incomes (under \$20,000 per year) should be given the choice of being excluded from this requirement or subsidized. A sliding scale should be put in place on incomes between \$20,000 and \$100,000. I envision a flexible plan so that the mandated savings could be used in genuine emergencies without penalty.

12) *Encourage private savings and investments spurred by tax-favored IRAs.* For example, in 1997 a new federal law allowed nonworking spouses to set aside \$2,000 each year in tax-sheltered individual retirement accounts (IRAs). The Roth IRA tax-free retirement distributions are especially useful for younger people with lower incomes who anticipate having higher incomes later in life. However, the program would need to be carefully monitored to see if this leads to additional savings or simply shifts them.

13) *Undertake to educate the public about Social Security.* “Social Security is the most successful program that the government has run,” *The New York Times*<sup>59</sup> quoted Marc E. Lackritz, president of the Securities Association, a Wall Street trade group.

14) *Conduct a federally supported health initiative to reduce early retirement.* This would encompass public health efforts to improve lifestyles and support new investments in medical research and expand the power of the Occupational Safety and Health Administration (OSHA) to reduce frailty, dementia, and other diseases. Those who enjoy general physical and cognitive health can work longer. Declining disability rates reduce disability insurance costs and facilitate working longer. Special attention should focus on

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<sup>59</sup> *The New York Times*, December 30, 1996.

racial disparities in life expectancy that adversely affect African and Hispanic Americans.<sup>60</sup>

The fourth scenario adds up to a revision of the very limited U.S. welfare state, based upon an understanding and evaluation of the twentieth-century European, Japanese, Oceanic, and North American experience. We need to understand the thresholds of occurrence of what the insurance industry calls “moral hazard,” the likelihood of tax and work evasion, and the “culture of dependency.”

Social Security only provides minimal benefits, which have already been reduced by the increase in the age of eligibility for full benefits and by increases in the Medicare premium.

### Conclusion

There is good reason to be optimistic about Social Security, which has proven adaptable. Historically, Social Security has changed and evolved since 1935. Four years after its inception the revolutionary family protection was instituted, which expanded coverage to dependents (spouses and children). Since then, any problems of solvency have been dealt with. For example, following the deliberations of President Reagan’s National Commission on Social Security Reform, chaired by Alan Greenspan in 1982 and followed by Congressional action in 1983, Congress imposed income taxes on the benefits of higher income retirees, revised the tax rate

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<sup>60</sup> There is criticism that minorities also who do not live as long are disadvantaged by Social Security. However, that is misleading because of survival and disability benefits that offset the reduced life expectancy. The real challenge is to continue to narrow the life expectancy gaps.

schedule and phased in an elevation in the eligibility age for full benefits to 67 by the year 2027 (for those born after 1959<sup>61-62</sup>).

An important point to remember is that in a system as large as Social Security, small adjustments result in big changes. As a pension and insurance policy, Social Security should draw upon what little we know about the human psychology of risk and providence, taking into account the entire context of income maintenance in late life. Policy should not be entirely driven by political possibilities, *but by ideals that could invent a different future.*

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<sup>61</sup> The value of reduced benefits taken at 62 and of higher benefits later is designed to be equivalent, assuming one lives to one's average life expectancy. Suppose one was due \$1,000 per month at 65, one would receive \$750 per month at 62, and \$1,320 per month at 70.

<sup>62</sup> Only 20 percent of adult Americans were aware of this change as of 2001.

Most people find it difficult to be prudent; at the same time, government must protect itself from unexpected costs. This is the psychological and realistic advantage of a compulsory system that provides only a basic “safety net.” However, it is obvious that neither the government nor business provides ideal worker protection. Certainly, the individual can’t do it alone. *We each must do our part.* Both defined-benefit pension plans and Social Security may incentivize earlier retirement.<sup>63</sup> We need a balanced partnership of responsibilities involving the individual, business, the civil society, and government. We need a commitment to the intergenerational contract between young and old fundamentally embedded within the framework of the Judeo-Christian tradition in America and within the thinking of those who dramatically influenced the development of our country—the theorists of democracy and of the social contract, especially Thomas Hobbes, John Locke, and Jean Jacques Rousseau.

Society as a whole would benefit from an explicit move toward a multibased social protection system, provided by the individual, the family, the community at large, business and labor, and the government at all levels, to build a new balanced partnership of social protections. This would constitute a kind of neo-welfare state—a new covenant—that promotes individual responsibility in alliance with the voluntary sector, the market, *and* government. But a secure tax-based safety net must still back up such a reform.

From these perspectives, Social Security must remain an earnings-related benefit. Further, we must encourage productive aging or engagement that delays Social Security payouts while continuing the collection of the payroll tax. It is obvious that increasing our productive capacity and encouraging older people to work longer will help solve any shortfall. This, in turn, requires new investments in health promotion and medical research.

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<sup>63</sup> See Gruber and Wise, footnote 47.

Finally, it is important for everyone to recognize the greater financial need in old age not met by Social Security by developing other means of saving and investing for old age. However, the steps I have outlined in this chapter will keep the Social Security system itself solvent through 2075 and far beyond.

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**TABLE 1**

Sources of Income<sup>64</sup>

Income of people age 65 and older in the U.S. in 2000:

40 percent from Social Security

18 percent from pensions

23 percent from continuing employment

18 percent from assets

1 percent from other sources

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<sup>64</sup> Sources: *Income of the Population 55 or Older, 2000*, Social Security Administration, Office of Research, Evaluation and Statistics, February 2002.

[http://www.ssa.gov/policy/docs/statcomps/income\\_pop55/2000/sect1.html#t1\\_1](http://www.ssa.gov/policy/docs/statcomps/income_pop55/2000/sect1.html#t1_1)

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<http://www.ssa.gov/policy/docs/ssb/v64n3/v64n3p12.html#mn1>

Social Security for All

- One-third of Social Security beneficiaries are children, survivors, and the disabled.
- 58 percent of Social Security beneficiaries are women.

Social Security as Economic Stimulus

Social Security helps the U.S. economy, which is two-thirds consumer-driven and stimulates local economies. Examples include:

- Florida enjoys \$55 billion annually in income from Social Security beneficiaries—more than tourism or agriculture.
- Other sunbelt states such as Arizona and California enjoy similar benefits.
- Morganton, N.C., calculates that each retired couple living in their community generates as much economic benefit as 3.7 manufacturing jobs.

“North Carolina Community Seeks Active Retirees,” press release, John Cantrell, councilman of Morganton, N.C., 2004.

Will Life Expectancy Increase?

Impact on Social Security Solvency?

- Medical Research Funding Is Flat (National Institutes of Health)
- Opposition to Stem Cell Research
- Growing Obesity—Epidemic of Sedentary Life
- Possible Flu Pandemic

### **Why the Survivors and Disability Programs?**

- The Social Security Administration estimates that of today's 20-year-olds, three out of ten will become disabled and one out of seven will die before reaching retirement age.
- For a young married worker with two children, Social Security provides the equivalent of a \$403,000 life insurance policy and a \$353,000 disability policy.