

Social Security and Private Savings: Complementary Roles

By Matthew Baumgart, Pamela Perun, and Lisa Mensah

Retirement policy debates often pit Social Security against private savings. Advocates of private savings often suggest that personal accounts are superior to Social Security and should replace the current retirement benefit program. Nearly all retirement policy experts agree, however, that *both* Social Security and private savings are needed for a financially safe and secure retirement.

Summary

This brief explains the complementary roles of Social Security and voluntary personal savings. Social Security is insurance against the vagaries of retirement (including income-eroding inflation in old age), disability, and the death of a family worker. As insurance, it is about community: everyone shares the risks; and benefits go to those who experience insured losses. Savings, in contrast, are liquid assets that can generally be spent for any purpose at any time.

The brief also lays out arguments for two proposals by the Aspen Institute Initiative on Financial Security to encourage retirement savings and help retirees turn their savings into lifetime income. America's IRA would be available to any worker without a pension plan at work. It would look just like any other IRA but include federal matching contributions to encourage participation and help boost retirement savings by low- and moderate-income workers. Security Plus Annuities would make it easier for all Americans to use their savings to buy more Social Security-like income through the federal government.

Ronald Reagan spoke the following words in 1983:

. . . nearly 50 years ago . . . the American people reached a great turning point, setting up the social security system. . . F.D.R. spoke then of an era of startling industrial changes that tended more and more to make life insecure. It was his belief that the system can

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furnish only a base upon which each one of our citizens may build his individual security through his own individual efforts. Today we reaffirm Franklin Roosevelt's commitment that social security must always provide a secure and stable base so that older Americans may live in dignity.

— President Ronald Reagan, 1983

When President Reagan spoke those words Social Security was within *months*, not decades, of insolvency. Today, life is no more secure than it was in the 1980s. The need for Social Security – the need for a secure and stable base of income for older Americans – remains as valid as it was in the 1930s and the 1980s. It is also still equally valid today that Social Security is “only a base” from which Americans can build private savings to ensure themselves a more financially secure retirement.

This brief explains the complementary roles of Social Security and voluntary private savings in generating adequate income in retirement. It also lays out arguments for two proposals by the Aspen Institute Initiative on Financial Security to encourage private retirement savings and help retirees turn those savings into lifetime income like Social Security.

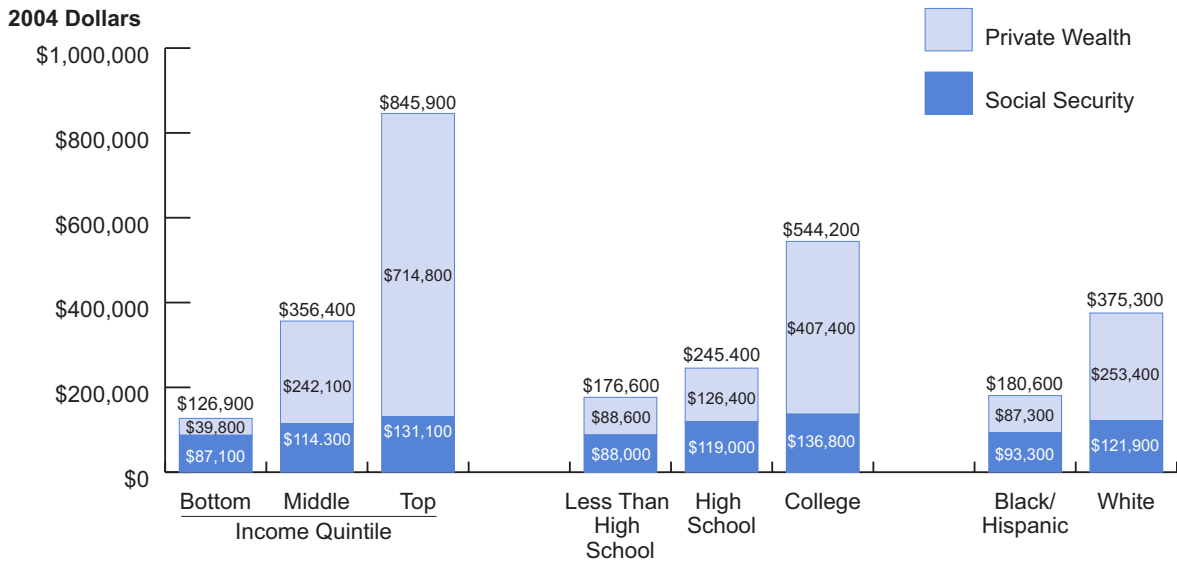
The Social Security Success Story

Social Security has been one of the federal government's most successful programs. As Nancy Altman noted in her book, *The Battle for Social Security*, when Social Security became law in 1935, all but one state had poorhouses, and the vast majority of residents were elderly people who had worked their entire lives. For example, in 1910, over 90 percent of poorhouse residents in Massachusetts entered the poorhouses after turning age 60 (Altman 2005). In short, before Social Security, being elderly in America was too often synonymous with being poor.

In 1936, most elderly Americans were living in poverty. Largely because of Social Security, the poverty rate for elderly Americans has dropped to just 10 percent by 2005 (SSA 2006). Social Security builds critical wealth to keep Americans out of poverty in old age. For fully one in every five Americans aged 65 and older, Social Security is the sole source of income. And for over 30 percent of seniors, Social Security represents over 90 percent of retirement income (Reno and Lavery 2007). Social Security also represents the largest source of wealth that many lower-income, less-educated and non-White Americans take with them into retirement (Figure 1).

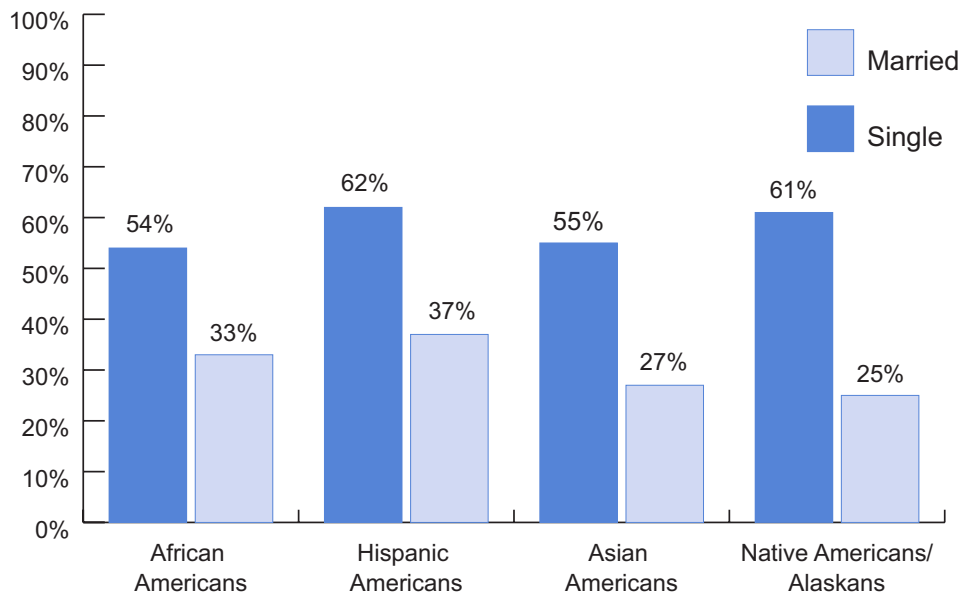
Social Security has been especially crucial for women because, on average, they live longer but earn less than men. In addition, elderly women today are less likely than men to have a private pension, and those who do generally have lower benefits due to lower earnings histories. In 2006, over 40 percent of elderly unmarried women received 90 percent or more of their income from Social Security (SSA 2007). The program also provides critical retirement income to both men and women in other typically low-income groups. For example, Figure 2 shows

Figure 1. Mean Wealth Per Adult for Typical Households Ages 55–64 by Income, Education, and Race in 2001/2004



Private wealth includes pensions, retirement accounts, home equity, other real estate, businesses, and financial assets.
Source: Gordon Mermin, Urban Institute.

Figure 2. Percentage of Beneficiary Population for Whom Social Security Is At Least 90 Percent of Total Retirement Income



Source: Robert Rosenblatt, NASI.

that among beneficiary groups age 65 and older, Social Security is 90 percent or more of total income among 54 percent of single and 33 percent of married African Americans, 62 percent of single and 37 percent of married Hispanics, 55 percent of single and 27 percent of married Asian Americans and 61 percent of single and 25 percent of married American Indians and Alaskan Natives (NASI 2008, Rosenblatt 2008).

Social Security is not only important to today's elderly, it provides essential insurance protection to today's working Americans that is generally not available through an employer-sponsored plan (Rosenblatt 2008). For example, Social Security provides income to disabled workers that, in 2006, was equivalent to a disability policy with a present value of \$414,000, if purchased from a private insurance company. The \$414,000 figure represents the total benefits available to a 30-year-old disabled worker earning between \$25,000 and \$30,000 with a 28-year-old nonworking spouse and 2 children aged two and less than one year. That family also has life insurance protection, in an amount equivalent to a private policy with a present value of \$433,000 (NASI, 2008).

Finally, Social Security enables most working Americans to accumulate their most significant source of wealth for retirement. It would cost the typical retiree about \$225,000 to purchase a retirement annuity similar to the one Social Security provides that includes protection against inflation and continued income for surviving spouses, if such a policy were available in today's market.

The Financial Health of Social Security Today

It is clear that without the foundation of Social Security, millions more Americans would be living in poverty and millions more would be confronting a terrifying, uncertain, and shaky economic future. But, even some economists and policy experts who do not dispute this still suggest cutting benefits significantly – or replacing benefits with a system of private savings – on the grounds that we as a nation can no longer afford the benefits Social Security is scheduled to pay in the future. A closer look at the data suggests otherwise.

It is helpful to begin by describing some basic financial facts about Social Security, as recently reported by the Social Security Board of Trustees in its 2008 report.

At the end of 2007, almost 50 million people were receiving benefits: 34 million retired workers and their dependents, 6 million survivors of deceased workers, and 9 million disabled workers and their dependents. During the year an estimated 163 million people had earnings covered by Social Security and paid payroll taxes. Total benefits paid in 2007 were \$585 billion. Income was \$785 billion, and assets held in special issue U.S. Treasury securities grew to \$2.2 trillion (SSA 2008).

Using its middle set of assumptions, the report projected that Social Security's annual surplus – where annual tax revenues exceed benefits – will continue until 2017. To pay full benefits after that point, Social Security will have to tap the accumulated interest on its excess assets and then, starting in 2026, the assets of the Trust Fund itself (SSA 2008).

This is not a crisis. In fact, this is precisely what the 1983 Social Security reforms intended to happen. Not until 2041 – 33 years from now – will the assets of the Trust Fund be completely depleted. But even then, it is a misnomer to suggest that Social Security will be “bankrupt.” According to the Trustees, there will still be enough tax revenues – even without making any changes in the Social Security program – to pay 78 percent of benefits (SSA 2008).

It is also important to keep in mind that these are forecasts of economic and demographic factors that will occur more than a generation from now. Predictions on what the economy will do over the next five or 10 years – let alone 33 or 50 or 75 years – can be notoriously off the mark. This is evident even in the Trustees’ own projections. In 1997, the Social Security Trustees projected that the Trust Fund reserves would be depleted in 2029 (SSA 1997). This means that the Trustees are currently projecting 12 more years of solvency than they projected just 11 years ago. Put another way, in 11 years, the Trust Fund has gained 12 years of solvency solely based on changing assumptions about the future economy and workforce.

To the extent there is a potential for Social Security “insolvency,” private savings accounts in lieu of traditional Social Security do nothing to rectify that. Individual private accounts do not add one additional day of solvency to the Social Security system. All privatization and partial privatization proposals also contain provisions to increase taxes, cut benefits, increase borrowing, subsidize the Trust Fund with general revenues, or some combination thereof in order to extend Social Security’s solvency.* These steps – and not the replacement of Social Security with private accounts – are what make Social Security more solvent. As Peter Diamond and Peter Orszag pointed out with regard to the proposals of the 2001 President’s Commission to Strengthen Social Security, the option that involves only individual accounts “would not restore long-term balance to Social Security” and the other two options “achieve actuarial balance *in the absence* of their individual account proposals” (Diamond and Orszag 2002, emphasis added). In fact, by shifting current workers from the existing Social Security system to a system of private accounts, the “accounts worsen Social Security’s long-term actuarial balance” (Diamond and Orszag 2002).

This is not to dismiss entirely the idea that Social Security could use some tinkering – although the question about when is a good one. Few people would like to wait until the last minute, resulting in a recurrence of the crisis from the early 1980s when Social Security was literally within months of insolvency. At the same time, a “problem” that will not manifest itself for 33 years does not scream out as a dire emergency. It also suggests that what Social Security needs is just that: tinkering, not an overhaul or a dismantlement – especially given Social Security’s history and role as such a crucial foundation for retirement security.

* For example, Plan 2 of the President’s Commission to Strengthen Social Security (President’s Commission 2001) – the proposal about which President Bush spoke favorably during his 2005 effort to privatize Social Security – would have based initial Social Security benefits (including disability benefits) on price indexing rather than wage indexing, resulting in a cut in initial retirement benefits of 10 percent for those retiring in 2022 and reaching a 46 percent cut in initial retirement benefits for those retiring in 2075 (Greenstein 2005).

The Real Problem: An Inefficient and Ineffective Private Savings System

While Social Security's current fiscal situation is relatively minor and solvable, its benefits, even today, are not sufficient to assure most Americans an adequate income in retirement. Most experts believe that income equivalent to 75-80 percent of pre-retirement income is necessary in retirement. Yet, Social Security replaces only about 40 per cent of average lifetime earnings for an average earner today and that percentage is slated to fall in the future (Reno and Lavery 2007).

Our national system for voluntary savings exists to help Americans make up that shortfall. For decades, however, it has failed to deliver significant assistance to the millions of American workers who need it the most. Consider these facts:

- Between 2007 and 2011, tax subsidies for saving will cost over \$750 billion, but little will flow to low- and moderate-income Americans because they are less likely to have a plan at work and, even if they do, their savings receive fewer tax benefits (JCT 2007).
- Participation rates in employment-based retirement savings plans have not budged for decades, and many workers — including the majority of those earning less than \$50,000 per year — have no pension plan at work (Perun and Steuerle 2008).
- The Government Accountability Office (GAO) projects that more than one third of workers will reach retirement without any private savings at all. The problem is most acute for lower-income workers. The GAO estimates that the lowest-earning 20 percent will, on average, have savings sufficient for only about 10 percent in replacement income — with 63 percent having no plan savings at retirement at all (GAO 2007).

Clearly, if our current system is to serve as the strong, voluntary supplement to Social Security, present trends must be reversed. Existing private market capabilities must be leveraged to help all Americans, especially low- and moderate-income Americans, obtain the basic assets that make financial security possible. At a minimum, that will require expanded access to savings plans, better plans, and stronger incentives to save (Perun 2006).

Building a Better Retirement Saving System

The Initiative on Financial Security (IFS) at the Aspen Institute has proposed two ways to increase all Americans' financial security in retirement. These proposals are described in more detail in IFS's report, *Savings for Life* (IFS 2007).

Savings for Life envisions a lifelong system of coordinated savings plans that would enable all Americans to achieve major life goals such as owning a home and a secure retirement. All proposals have been thoroughly reviewed by the financial services sector to insure they make sense in the market. They are easy to understand and designed with consumer protections. Their cost is just a modest fraction of the tax subsidies currently being spent on those who do not need such tax breaks to save. And, most important, the retirement proposals supplement – and complement — both Social Security and the current employer-based saving system.

America's IRA

America's IRA would be available to any worker without an employer-provided pension plan. It would work just like any other IRA – a private sector account opened at a private financial institution, with a cap placed on the amount of permitted annual contributions.

For individuals earning less than \$12,500, the government would provide a full \$1,000 “starter” contribution (phased out completely at incomes over \$17,500) to encourage the opening of the accounts. Then, to replicate the employer contributions that successfully encourage 401(k) savings, a government matching contribution – placed directly into an individual's IRA – would be available. Individual savers with incomes under \$40,000 (\$80,000 for a married couple) would receive a 100 percent matching contribution capped at \$2,000. Matching contributions would be phased out for incomes between \$40,000 and \$50,000.

Key Elements of America's IRA

- Available to workers without access to employer-sponsored pension plan
- Uses existing IRA structure
- \$1000 starter contribution for low-income workers who open an account
- Dollar-for-dollar government match available for low- and moderate-income taxpayers who save their own money in the account

What impact would this have on a 37-year old worker who makes \$20,000 a year? According to the financial models created by IFS, if this worker contributed to an America's IRA only 4 out of every 5 years and contributed just 3 percent of his or her income – about \$50 a month at the start – the modest individual contribution and the modest government match would result in that worker having over \$133,000 when he or she retired 30 years from now — about \$63,000 in today's dollars (IFS 2007). That is a significant supplement to Social Security. If converted to an annuity, it is over \$450 more per month in today's dollars.*

Security Plus Annuities

While it is important to find ways to increase the number of Americans with retirement savings, it is also necessary to start thinking about what happens with those savings once people reach

retirement age – particularly to ensure that they do not outlive their savings. What is needed is Social Security-like income that will last throughout their retirement.

Key Elements of Security Plus Annuities

- Available to all new retirees
- Can purchase an annuity of up to \$100,000 through the Social Security Administration
- Payments are added to monthly Social Security checks for life
- Private provider underwrites the annuities

Security Plus Annuities would make it easier for all Americans to turn their savings into such income. During their first year of receiving Social Security retirement benefits, new retirees would be able to convert up to \$100,000 in savings from any source – from a 401(k), an IRA, a bank savings account – into a lifetime, inflation-adjusted annuity. The

* This figure reflects annuity purchase rates available through the federal government's Thrift Savings Plan for federal workers as of July 29, 2008.

annuities would be underwritten by the private sector, but the federal government would select annuity providers through a competitive-bid process. The Social Security Administration would administer the program and distribute the annuity payments each month as part of retirees' Social Security checks.

A worker who earned an average of \$40,000 a year and used his or her savings to purchase a \$50,000 Security Plus Annuity would replace about 12 percent of pre-retirement income (IFS 2007).

The Complementary Roles: Social Security and Private Savings

As noted above, Social Security is the sole or almost only source of income for over 30 percent of retirees. For them, it is necessary for survival. For millions more, Social Security provides the bedrock foundation on which, as Franklin Roosevelt and Ronald Reagan noted, they are able to build individual financial security through pensions and private savings.

But, Social Security and private savings are not just complementary because both are needed to ensure financial security. They are complementary because they are entirely different creatures. Social Security is not a savings system – and thus cannot be replaced by private savings. Rather, Social Security is a system of insurance: insurance against the financial vagaries of retirement; insurance against income-eroding inflation in old age; insurance against disability; insurance against the death of a family worker.

At its root, an insurance system is about a community – in this case, the whole of American society – sharing risk and collectively covering that risk. Insurance targets protection to specific insured losses and spreads the cost and risk across all of society (Reno 2007, NASI 2008). Insurance is a form of a “safety net.” It is no accident that Social Security has also been called a “safety net,” because it is there when everything else fails, when economic security is needed most.

It is simply not possible for private savings to play this role. Savings is not insurance. And savings are exposed to the risk of a market downturn, a poor investment strategy, and living longer than expected. In addition, while some vehicles for savings place restrictions on when and how the money can be used, savings are liquid assets that can generally be spent for any purpose at any time. When the savings are gone, they are gone. And the hard truth is, they may never have been enough in the first place.

Americans need both insurance and savings. Unfortunately, too many discussions about Social Security become bogged down in an ideological debate over privatization, when the real discussion should be about how to make retirement more financially secure for more Americans. The solution to our retirement income dilemma is to preserve a strong Social Security program and supplement it through a voluntary system that encourages private retirement savings and lifelong income through annuities.

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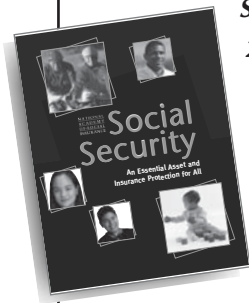
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New from the National Academy of Social Insurance...



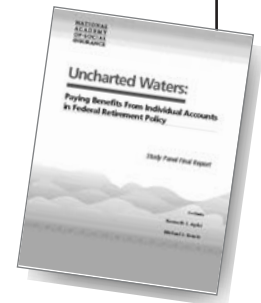
Social Security: An Essential Asset and Insurance Protection for All 2008

The report synthesizes work supported by the Ford Foundation to help low-income people understand their stake in Social Security and add their voices to discussions about its future. Over a dozen grantees met at Ford Foundation headquarters in New York City in 2007 to share the results of their research and outreach activities. The report describes Social Security and its role in providing economic security for African Americans, Latino communities, and women and children. The report features partnerships between researchers and community organizations and includes quotations from participants.

Also from the National Academy of Social Insurance...

Uncharted Waters: Paying Benefits From Individual Accounts in Federal Retirement Policy, Study Panel Final Report, January 2005.

Michael J. Graetz, Kenneth S. Apfel, co-chairs. National Academy of Social Insurance, Washington, DC, January 2005. 225 pages, \$29.99. To order call 202-452-8097 or email nasi@nasi.org.



This report considers some of the payout issues that might arise from implementing a system of individual accounts, if such accounts were to become a part of federal retirement policy. Why is it important to examine "payout" issues? Because a central goal of retirement security policy is to assure some level of adequate income, it is essential that any debate about creating individual accounts include a complete understanding of how the benefits will be received.

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