

Economic Review

with Nicholas S. Perna, Ph.D., Webster Bank Economic Advisor



Musings & Amusings: Alfred E. Neuman

"Medical insurance is what allows people to be ill at ease."

"A teacher is someone who talks in our sleep."

"When you're in deep water, it's a good idea to keep your mouth shut."

What, Me Worry? When I was a youngster, my buddies and I loved *Mad* magazine. Alfred E. Neuman, the fictional gap toothed character with the loopy smile, seemed to symbolize our feelings about authority and life in general.

Well, today, there's plenty to worry about. Will Greece bring down the world financial system? Talk about going viral, should we be concerned about bird flu and MERS (Middle East Respiratory Syndrome)? Then there's the Presidential race. Some of the wannabes are funny, but in a really scary sort of way. Did you know that Alfred E. Neuman (hereafter, AEN) was a write-in candidate in 1956? Maybe we should do this in November 2016?

But what about a longer term situation that will affect most of us in a very substantial way: Social Security. By now, practically everybody knows that the system will be "bankrupt" in less than 20 years. And I'm always hearing from young people that Social Security won't be around when they retire. Let's see how much we really should worry.

I just finished a neat little book about Social Security (hereafter SS), *Falling Short*. One of the expert authors is a long-time friend, Alicia Munnell, who heads up the Center for Retirement Research at Boston College, my alma mater.

By 2033, the SS "trust funds" will be empty and incoming payroll taxes will only cover 75 percent of the promised benefits. This is after the effects of legislation that has already raised the age from 65 to 67 at which one can collect "full" benefits. It is also after benefits have been shaved so that they replace a smaller portion of pre-retirement income.

The reasons for this "looming crisis" – as it is usually called – are several. People are living much longer than when the program started in 1935. And they're retiring

earlier. The aging of the Baby Boom generation coming on top of the falling birth rate means that there are fewer workers to support retirees.

We could go on. Let's dismiss one distraction right away. Some people claim that the politicians have "stolen" the SS trust fund to finance other government activities. There never really was a true trust fund because SS has always been a pay-as-you go program.

Early in the 1980s, an attempt was made to prepare for the coming baby boom retirement wave through building up a surplus by introducing changes such as the higher age for full benefits. This surplus was invested in U.S. treasury bonds – hence the claim that it was used for other purposes. But these bonds will all be redeemed by 2033 to pay benefits.

Ok, so what can we do about the deteriorating outlook for retirement? Individuals have only three options: get used to a lower standard of living in retirement, save more, and work longer.

Americans are notoriously lousy savers, but retirement can be much brighter for those who start socking away more money now. Suppose you manage to save an extra \$250 per month starting at age 45 by bringing your coffee to work instead of stopping for that \$3 *grande* served by that cute/handsome young barista, brown bagging your lunch a couple of times a week, and going out to dinner a little less often. Do this for only 20 years and – if you earn 5 percent – you'll have more than \$100,000, which is enough to buy an annuity at age 65 that would pay something like \$550 per month for the rest of your life. Do it for 30 years and you can more than double your monthly annuity payout. Sure, today's meager interest rates make it difficult to accumulate wealth, but earning 5 percent is reasonable over decades with a portfolio of stocks and bonds.

You can also work longer. Many people still retire at 62 with greatly reduced SS benefits. Postponing retirement from 62 to 70 buys better than a 75% increase in your monthly check. Think of it as purchasing an annuity with those extra years of work, except it's probably a better annuity than you can get on the private market. To quote the study, "Working until 70 does the trick... more than 85 percent of working age households would be financially prepared for retirement."

Finally, you want to make sure you get good legal and financial advice on inheritance taxes, using reverse mortgages to "monetize" the equity in your home, and coming up with the financial investments appropriate for you.

You can do all of the above, no matter who controls Congress or inhabits the White House. National reform of the SS and other entitlements is likely and will almost certainly make it harder/more costly for people to retire comfortably.

In one sense, the problem may not be as big as many people fear. The authors calculate that it would take an immediate 2.88 percentage point hike in the SS tax to avoid the 2033 crisis and put the system back on a sound financial footing for another 75 years. That's the *combined* rate, so we're really talking about less than 1.5 points each for workers and employers. The longer we wait, the bigger the tax increase – or benefit cuts – have to be.

Congress can also mitigate the coming crisis by slowing the rise in benefits. There's a lot of talk about fixing the indexing of SS checks which are adjusted annually by the increase in the Consumer Price Index over the previous year. Some folks say this is too generous and we should switch to an alternative cost of living index that rises less rapidly. There's some merit here, but the problem with cutting benefits by changing the indexing or further raising the retirement age is that it comes down harder on those with lower incomes since SS replaces a larger share of their pre-retirement incomes than for wealthier folks.

"Privatize" the whole SS system so that the payroll taxes are paid into individual accounts much like 401(k)s and

IRAs. Individuals would have some discretion over how the funds in their accounts are invested.

Well, there's an almost insoluble "transitional problem." Since there's really no trust fund, there's no way the government has the money to give each beneficiary a lump sum to set up a private account. Employers are able to do this when they switch from defined benefit to defined contribution retirement plans because they have the money in their pension reserve funds.

If the payroll tax were to be raised, then the current system might invest the resulting surplus money in stocks and bonds, perhaps through the use of index funds. This really wouldn't qualify as privatization, but it might help raise the returns without increasing administrative costs the way myriad privately managed accounts would.

No one can predict what Congress will do. Dealing with a crisis nearly 20 years in the future is a non-starter for those whose long-term horizon is the next election. According to AEN, "America is still a land of promise, especially during a political campaign."

State of the States: In looking over a recent regional forecast's comparisons of the next five years with the past five, I found some interesting information. Looking back, Connecticut and Rhode Island had a tough time recovering from the Great Recession which ended nationally around the middle of 2009. My view is that their recessions were worse than average, largely as a result of serious state budget problems. And their recoveries have also been hampered by measures taken to address these shortfalls. Massachusetts and Metro New York City have done better.

Over the next five years, Massachusetts GDP growth will continue to be similar to the national average. Although Connecticut, Rhode Island, and Metro New York City are forecast to lag somewhat, they will perform better than the recent past.

The region is not expected to be a hotbed of job formation, with all areas lagging the nation. However, all are expected to have pretty good productivity performance which I have approximated by subtracting job growth from the GDP increase. My simple calculation shows the rise in GDP per worker over time. This, in turn, should result in fairly decent real income growth.

Recent budget developments in Connecticut, which relied heavily on business tax increases, pose some downside risks for the above outlook. Connecticut needs to develop a more business friendly atmosphere. Eliminating the chronic uncertainty generated by the annual/biannual budget battles in Hartford would help. However, this all takes political will and courage. As AEN pointed out, "Elections are when people find out what politicians stand for and politicians find out what people will fall for."

REGIONAL GROWTH (ANNUAL %)

	2009-2014			2014-2019		
	Jobs	GDP	Prod	Jobs	GDP	Prod
Connecticut	0.5	0.7	0.2	1.2	2.3	1.1
Massachusetts	1.3	2.3	1.0	1.4	2.8	1.4
Rhode Island	0.8	1.3	0.5	1.3	1.9	0.6
Metro New York*	1.6	2.0	0.4	1.2	2.3	1.1
United States	1.2	2.2	1.0	1.7	2.7	1.0

Source: Moody's Analytics, May 2015

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