401(k) Investments

The Retirement System Diaries, Chapter 1: The So-Called Retirement Crisis

This is the first in a series of three articles designed to encourage thoughtful action.

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There is a real retirement crisis in the United States, but there is also a fake one. This article attempts to bring some levity and perspective as to which pieces of the sky are, in fact, falling.

The United States has no coherent national retirement policy. We should, but we don't. The reason is Democracy, that finest of imperfect institutions. As Churchill said, "Democracy is the worst form of government, except for all those other forms that have been tried from time to time." It works like this: the media runs a story of how an elderly widow from Purity, USA, is being evicted from her apartment because she can't afford the Medicare copayment from when she crawled into the hospital after being mugged. Congress leaps into action and the Purity Outliving Retirement Kurtosis Act ("P.O.R.K.") is born. It gets added to a large pile of similar laws in the accretion of legislative oddments that is the closest America comes to having a plan.

We have no plan. But look on the bright side: We also have no dictator. A dictator would probably have a plan—but then we'd have a dictator. *Sic semper tyrannis*.

We also have Capitalism. And capitalists are always looking for ways to make a difference in ways that also pay the bills. Thus, we get a refrain that has grown increasingly popular in the media, in academia, and in the retirement industry itself: "There is a retirement crisis." But by "crisis" we don't mean anything obvious like war, famine, or national penury. Instead, "retirement crisis" has come to mean simply that people aren't saving as much as they should and won't be able to retire with enough money to maintain their late-career standard of living. Admittedly, no one ever says it that way, but that's what they mean.

This is not a crisis.

The real crisis is fiscal and global. Simply put, we've promised ourselves more retirement benefits than we can afford. The problem is worse in Europe than in the United States, but our medical woes are worse than theirs. They can't afford their pensions, and we can't afford our health care. And since retirement policy and retiree health care policy are inextricable, the results are similar: The industrialized world cannot afford its future unfunded liabilities.

Interestingly, however, solving the fake crisis may save us from some of the effects of the real crisis. The solution to unpayable future benefits may well be a reduction in the need for those benefits via the private retirement system. More money in 401(k)s and IRAs means less demand for social welfare payments. This point is not lost on America's politicians, who are focused on the private retirement system as never before.

A Brief History of Retirement

There were no retirement plans before the 1880s, when the first state system was born under Germany's Iron Chancellor, Otto von Bismarck, who instituted a series of social reforms in a bid to mollify the growing socialist and labor movements. It was a time of great inequity for workers, who were fighting for basic rights. They won.

In the first half of the twentieth century, every industrialized country began instituting social safety nets, including various health care, retirement, and disability programs. Prior to that time there were no such programs, so these tentative first steps were aimed at creating support for the most basic needs.

After about 1950, the industrialized countries all had basic social insurance in place, and the emphasis of legislation and labor negotiations shifted to incrementally increasing benefits. Second and third world countries began fledgling programs of their own, typically starting with pensions for government employees. Through the mid-1970s in the United States, the legislative history consists of one new program and benefit increase after another—rising benefits for Medicare, Medicaid, disability, unemployment, Social Security, and more.

Starting in the mid-1970s, however, realization began dawning that, eventually, someone would need to pay for this stuff. [*See*, for example, the 1975 *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, available at *ssa.gov*] No volunteers emerged. The political battle thus began to halt the growth in unfunded liabilities, and the legislative history shifted to a pattern of cost controls and benefit cuts, albeit modest ones. If you doubt this, see the excellent summary on the Social Security Administration's Web site.

Today, the industrialized world is awash in debt. Ironically, much of the debt is held by countries that have way less money than we do. We're borrowing money from people who ride bicycles so we can buy fancy cars, not so figuratively speaking. And on top of this direct debt, we have trillions of dollars in unfunded liabilities for our future social insurance payments.

The crisis is not the debt and it's not the unfunded liabilities *per se*—debt, when properly used, is simply a way to spread the cost of an asset across the usable life of the asset. "Good" debt lets us pay for things like infrastructure as we use it. We build a bridge, and we pay for a year's worth of bridge every year—this is sound economic and fiscal policy, so long as we can actually afford the bridge. So the crisis is not debt *per se*. The crisis is the scale of the payments relative to the size of our economies. We simply can't afford the payments—not without significant economic hardship, at any rate, and perhaps devaluation of the payments.

What Can We Do?

Since we will not fund the unfundable—that which cannot be, will not be—there are only a few ways we can go.

First, we can fix the problem by cutting the benefits. Politicians hate that one. But a "cut" can be as modest sounding as slowing the rate of growth in the payments or extending the retirement age, or as progressive-sounding as means-testing benefits so rich people don't get any. A "cut" includes any change that lowers the future payments—we need not cut *current* benefits. But politicians can never endure howls of execration from voters, and they chicken out on even discussing meaningful entitlement reform.

Only one meaningful cut has ever been made in the United States—the phased-in raising of the Social Security retirement age from 65 to 67 starting in the 1980s. In France, they riot in the streets when anyone proposes raising the early retirement age past 60 (when a large percentage of the population retires, often under a disability pension). In Greece, they riot in the streets to show their annoyance with proposed cuts to pensions that, without cuts, literally would require a 60 percent payroll tax in the not too distant future. Benefits, once promised, prove virtually impossible to take back, so even future benefit cuts are difficult to accomplish politically.

Second, we can raise taxes to cover the payments. There are a couple of problems with this. It might not work because the payments, as projected, may be unpayable. This is the case in many European countries, such as Greece, Italy, Portugal, and Spain, the four countries with the worst pension crises. There is no credible way that these countries can meet projected benefit payments, and raising taxes will never get them there, mathematically. Raising taxes is also tough because it slows the economy, with various negative consequences, including consequences for seniors. Finally, raising taxes annoys some people, and is therefore difficult to accomplish politically. But if the money is there, it works.

Third, we can grow our way out of the problem. As a former business acquaintance once said, "Growth hides all sins." It's okay to be fiscally irresponsible if you get lucky and get a big pay raise, like a sustained bump in GDP that exceeds expectations. The trick is getting the raise. It is fiscally irresponsible to spend money as if you will get a pay raise that is, by most estimates, unlikely to materialize. Politically, of course, talking about growth as the solution is easy, since the only thing that actually must be delivered is rhetoric.

Finally, we can let inflation take care of the problem for us. Inflation is great for debtors, whose wages are inflated while their debts remain constant. Stated another way, the value of the debts drops as a percentage of income to where debtors can actually afford them. Legislation aimed at slowing the growth of benefits by reducing or eliminating wage indexing is therefore a form of benefit cut—holding obligations constant in real dollars while nominal GDP rises. So, if we could just have some sustained inflation for a decade or two (something not too bad, like 4 or 5 percent) and couple it with price indexing instead of wage indexing, our debts might become manageable. Sounds clever, but ask the Weimar Republic how that turned out for them.

The point is not that we should do any one of these things over another; the point is that we really ought to do something rather than nothing. Change will get harder the longer we wait.

What Happens if We Do Nothing?

This is easier to illustrate by examining an extreme. Countries in the former Soviet bloc defaulted on some pension payments in the wake of the collapse of the USSR, and what payments remained saw their value slashed by rampant inflation. The payments were unpayable, so the problem resolved itself primarily in the form of major devaluations in the payments. Instead of politicians saying, "Your benefit is hereby cut in half," the benefits were cut by more than half through inexorable economic forces.

It is reasonable to expect that a genuinely unpayable amount will be reduced in value through economic forces. One way or another, unpayable benefits will be cut, either outright by brave politicians or through devaluation. "Brave politician" is an oxymoron; therefore, devaluation is the global method of choice for cutting benefits.

Unfunded social insurance payments may not be unpayable in the United States; they might merely be destructive. We are in better shape than many countries, and we have better demographics in the form of immigration—an influx of new workers to help continue pay-as-you-go benefit payments. Our Social Security system, for example, can be solvent for roughly 2 percent of GDP, if we start now. We can afford that, despite the drag on the economy. The problem is that Social Security is not the only unfunded promise we have to fund—there is also health care, trillions of dollars in (severely underreported) government pension obligations, and a rising stack of trillion dollar IOUs (the national debt). At best, these obligations represent a significant future stress on the economy. It will resolve itself, one way or another; the question is how.

Back to the fake retirement crisis. John Doe and his wife, Jane, each earn $40,000 per year, for a household income of $80,000, and they never get a raise other than cost of living based on inflation. They each save 3 percent in their 401(k)s between the ages of 30 and 70, and get a 1.5 percent match on top of their deferrals—what we can all agree is not enough. In real dollars (adjusted for inflation), using modest assumptions, they will have accumulated roughly $300,000 during their working lives, which is enough to generate just $10,000 in retirement. Combined with Social Security benefits—assume about $1,250 per month, each, or $30,000 per year, for the sake of argument (i.e., about 13 percent less than current law projects)—their annual income in retirement in real dollars is around $40,000, or just 50 percent of pre-retirement income. Not enough, say the retirement Chicken Littles—this is a crisis.

But let's examine the nature of the crisis. John and Jane can live warm, secure, food-filled lives, with medical care, in the United States for less than $40,000 per year. Our social insurance safety net will make sure they never go hungry or want for their basic needs, though it may not be their dream retirement. And their "assets" will be substantial—the equivalent of an $800,000 lump sum or more. This is not penury, and it is not a crisis. Grandma may have to move to a depressing little condo instead of to the beach, but Grandma will be okay. Okay is not a crisis.

The point is not that the Does have no worries: Of course they do, and of course they should save more. The point is that their worries are not the real crisis as long as the government can hold up its end of the bargain.

Now look at what it takes to pay for all this. Health care for John and Jane will likely be over $500,000 in retirement, a large portion of which must be paid by the government. The government also has to come up with the money for Social Security, any cost of living increases on Social Security (which are guaranteed under current law), plus the cost of any additional social services of which the Does take advantage in retirement, payments on the national debt, and any future bailouts for state, municipal, and corporate pensions (yes, I predict them). And the government will need to do all of this out of current tax revenues, because there will be no funded assets (such as the Social Security Trust Fund) left after about 2034.

Can we afford this? Probably not. And that's a crisis, but it's far off. We can foist it on our children and grandchildren, like the chickens that we are. ■