# CREATIVE Wealth Maximization Strategies

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## Will 75 Become The New 65?

In 1949, Casey Stengel became the manager of the New York Yankees. Over the next 12 seasons, the Yankees, under Stengel's leadership, would go to the World Series 10 times, and win seven World Championships – a record of sustained success that has remained unmatched in professional baseball history.

And yet, at the conclusion of the 1960 season (the Yankees lost the World Series to the Pittsburgh Pirates when Bill Mazeroski hit a ninth-inning home run in the decisive seventh game), Stengel was fired. **Why?**

After the 1960 World Series, Dan Topping and Del Webb, the businessmen who owned the Yankees, decided to institute a mandatory retirement age, a common practice among many businesses at the time. The age they selected was 65. As Stengel had just turned 70, his employment could be terminated, regardless of his job performance. A few days later, Topping called a press conference to announce that Stengel's contract with the Yankees would not be renewed. Stengel, who was known for his eccentric, yet witty quotes about baseball, attended the conference. When asked to comment on his dismissal, Stengel quipped, "I'll never make the mistake of being 70 again."

This incident took place just over 50 years ago. But even today, age 65 holds an almost sacred position in the discussion of retirement. Why? How did 65 become the magic number for retirement?

### The 20th-Century History of Age 65

When the U.S. government established the Social Security program in 1935, participants became eligible to receive retirement benefits at 65. Some commentators have described this decision as a copy of the first modern government insurance program established by Otto von Bismarck in Germany in 1889. But the "real story" is a bit more mundane. The German plan initially set 70 as the retirement age and didn't lower it to 65 until 1916. And according to Social Security's official website : www.socialsecurity.gov...

**"This decision was not based on any philosophical principle or European precedent. It was, in fact, primarily pragmatic, and stemmed from two sources. One was a general observation about prevailing retirement ages in the few private pension systems in existence at the time and, more importantly, the 30 state old-age pension systems then in operation. Roughly half of the state pension systems used age 65 as the retirement age and half used age 70. The new federal Railroad Retirement System passed by Congress earlier in 1934, also used age 65 as its retirement age. Taking all this into account, the CES planners made a rough judgment that age 65 was probably more reasonable than age 70. This judgment was then confirmed by the actuarial studies. The studies showed**

**Perhaps more than any other single issue, increased life expectancy has changed the financial metrics of retirement. While news-papers and media pundits attempt to divine the tea leaves of today's economic activity, they often overlook the trends put in play by demographics, trends that almost certainly will play a larger role in everyone's long-term economic well-being.**

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**that using age 65 produced a manageable system that could easily be made self-sustaining with only modest levels of payroll taxation."**

## A Self-Sustaining System? *Really?*

Note that last phrase: "**using age 65 produced a manageable system that could easily be made self-sustaining with only modest levels of payroll taxation."** Considering that both Social Security and Medicare are under-funded today, what was the logic that believed these programs could be sustained with only "modest levels of payroll taxation?" **It was the belief that most citizens would not live long enough to receive benefits, and those who did would not live long in retirement.**

When Bismarck instituted government-sponsored retirement benefits in 1889, life expectancy in Germany was under 50, and according to J. H. Schulz in his 1988 book, *The Economics of Aging*, "Bismarck knew that the program would cost little because the average German worker never reached 65, and many of those who did lived only a few years beyond that age." Five decades later, when Social Security was implemented in 1935, "the average life expectancy in America was only 61.7 years." If these numbers held true, many workers would pay taxes for benefits they wouldn't live long enough to receive. Projecting a large number of payers and small number of beneficiaries meant the plans could be administered with minimal taxes spread over a large number of people. As age 65 became the benchmark for Social Security, the private sector followed suit, using 65 as the retirement ages for pension plans, often as the end-point for some insurance benefits, and in the establishment of mandatory retirement provisions, like the one that cost Casey Stengel his job.

## But Actual Life Statistics Changed.

Since 1935, several factors have changed the rosy projections of low-cost government pensions and the practicality of using age 65 as a benchmark. A great number of people have been living longer – but still collecting benefits at 65 (or earlier in some cases, as most government-sponsored pensions have adopted an early eligibility age – EEA – at which participants can receive slightly lower benefits). This increased longevity results in a two-way stress on government retirement plans: more people receiving retirement benefits for longer periods of time.

After a great surge following World War II (the baby boom), population growth has leveled out in many Western countries, meaning there are proportionately fewer tax-paying workers to support the retirees. Instead of a large number of payers and small number of beneficiaries, the equation has been reversed; there are too many retirees and not enough workers to support them. In order to restore these retirement programs to financial viability, there are only three options: increase taxes, decrease benefits, or raise the retirement age. Considering the possible reactions of their citizens, the most expedient course of action has been to raise the retirement age.

## So the Rules Changed.

In 1983, the Social Security Administration began gradually increasing the age at which participants could be eligible for full retirement benefits, from 65 to 67, based on the year of birth, with those born after 1960 not eligible for full benefits until age 67. In recent months, legislative discussions have proposed raising the age requirement to 70, usually in a similar graduated fashion.

In Europe, where the demographic double-whammy of aging populations and fewer workers is more severe, changing the normal retirement age (NRA) is a volatile social issue. This past summer, France raised its NRA to 62 from 60 **and riots broke out**. Spanish political leaders have proposed raising its NRA to 67 (from 65), and raising the NRA is on the radar of several other European countries. In the modern world, 65 is no longer the magic number for retirement.

## So What?

There is some evidence to suggest that the retirement ages established in government pensions strongly influence individual retirement decisions. A November 2010 report from the Heritage Foundation titled "**Time to Raise Social Security's Retirement Age"** cites data collected from 1997 to 2009 by economists John Rust and Christopher Phelan, saying the "results suggest that Social Security creates significant disincentives to labor force participation, and is largely responsible for the peaks in retirements at ages 62 and 65…." In general, once you can begin receiving a monthly check from the government, you are more

### Life Expectancy and Retirement

| Year | Life Expectancy at Age 65 | | Percent of Life in Retirement, Normal Retirement-Age Retirees | | Percent of Life in Retirement, Early Retirees | | Equivalent Normal Retirement Age | |
|---|---|---|---|---|---|---|---|---|
| | Men | Women | Men | Women | Men | Women | Men | Women |
| 1940 | 77.7 | 79.7 | 16% | 18% | n/a* | n/a* | n/a* | n/a* |
| 2007 | 82.5 | 84.8 | 19% | 21% | 25% | 27% | 69.0 | 69.1 |
| 2035 | 84.2 | 86.4 | 20% | 22% | 26% | 28% | 70.4 | 70.5 |
| 2080 | 86.5 | 88.6 | 23% | 24% | 28% | 30% | 72.3 | 72.2 |

* In 1940, workers were not able to receive benefits before the age of 65.

**Source:** Heritage calculations based on Social Security Administration, *The 2008 Annual Report of the Boards of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, April 10, 2008, Table V.A4, at *http://www.ssa.gov/OACT/TR/TR08/V_demographic.html#203457* (November 17, 2010).

Table 1 • B 2492 heritage.org

likely to retire or decrease earnings from other employment. Conversely, if governments were to raise the age for receiving benefits, it appears many people will find compelling reasons to work longer and retire later.

But modest increases in the normal retirement age for government pensions will not fully address government pension problems. Remember how both Bismarck's retirement age of 70 and Social Security's 1935 NRA of 65 exceeded the average life expectancies of their country's population at that time? According to statistics from the Social Security Administration cited in the same report from the Heritage Foundation**,** the life expectancy of a man who retired at 65 in 2007 was 82.5 (see chart on previous page).

### What's the Answer?

If the goal of government-sponsored pensions is to be self-sustaining with only modest payroll taxes, the normal retirement age has to rise even further, perhaps to 75, or even higher! Otherwise, the only other alternatives are increased taxes or decreased benefits.

Higher taxes and decreased benefits would effectively force many people to work longer and retire later. Higher taxes result in less take-home pay, which means less money available for saving. Decreased benefit levels mean the individual must accumulate more to offset what will not be received from government plans. 50 years ago, Casey Stengel was told to stop working because he was past 65. Today, many signs point in a different direction: **After 65, you must keep working!**

### So… If Age 70 (or 75) Is The New 65, What Else Changes?

If longer life expectancies result in higher normal retirement ages for government pensions, these changes will likely have a ripple effect on regulations related to personal saving and accumulation. If, for example, the NRA for Social Security is raised to age 70, then the age regulations pertaining to required minimum distributions and/or penalties for early withdrawals might also go up. If more people are still working (and saving) past age 70½, does it make sense to *require* retirement account withdrawals while they are still working full time?

David C. John, the author of the Heritage Foundation report referenced above, mentions that if economic conditions compel people to work longer, income insurance benefits must also be changed. For example, disability benefits currently administered by Social Security stop at age 65, when retirement benefits take over. It is also common for many individual disability income policies to stop paying benefits at age 65. For disability benefits to continue beyond age 65, higher taxes (or premiums) will most likely follow.

The structure and use of other income protection products, such as life insurance, will be affected as well. Decisions about the amount of life insurance to purchase are frequently derived from an estimate of one's income-earning potential. In the working-until-age-65 paradigm, a 35-year-old might project another 30 years of earnings. But having to *protect 40 years of earnings* will result in proportionately larger life insurance amounts.

Projecting a longer lifetime may also compel individuals to give greater consideration to the cost-effectiveness of permanent life insurance or blends of permanent and term insurance.

Because government-sponsored retirement benefits are funded by taxes collected during one's working years, it is almost impossible to discontinue existing programs, even if they aren't financially viable. You just can't tax someone for 30-40 years, then renege on the promise to deliver retirement benefits; the social and political fallout would be too great. Given these practical realities, the most logical "adjustment" is raising the normal retirement age – and the early eligibility age as well. As these changes would apply to all Americans, many aspects of individual financial planning could be affected.

**DO YOUR CURRENT FINANCIAL PROGRAMS ACCOUNT FOR THE EFFECTS OF INCREASED LIFE EXPECTANCY?**

**OR ARE YOU STILL STUCK AT "65"?**

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## The Behavioral Nudge to Spend, Built Into the 2011 "Payroll Tax Holiday"

One of the tax changes negotiated in Congress' closing session of 2010 was a one-year reduction in the employee's portion of Social Security and Medicare taxes deducted from workers' paychecks. Previously, each employee paid 6.2% of their first $106,800 in salary into Social Security. Employers matched that amount, and each party also contributed 1.45% of earnings into Medicare. The one-year tax reduction from the payroll tax credit will reduce the employee's contribution by two percentage points, meaning employees will pay only 4.2% of their first $106,800 (employers will still continue to pay 6.2 % as before).

According to an article by Ylan Q. Mui in the January 10, 2011 *Washington Post*, the White House estimates the "payroll tax holiday" will result in increased take-home pay of around $1,000 a year for the average American


family. Any increase in take-home pay will usually be received positively by the public, but **it is interesting to note the structure of this tax break.**

### How to tempt us to spend it?

Many economic advisors believe one of the keys to financial recovery is increased consumer spending. But given other factors in the economy, such as high unemployment and high levels of personal debt, a large percentage of Americans have chosen to forgo discretionary spending in favor of either *increasing their savings* or *reducing their debt*. Mui states that since the beginning of the most recent recession two-and-a-half years ago, the savings rate for Americans has jumped to 5.3%, a sharp rise from the negative rate of saving prior to the bursting of the real estate bubble.

This is where the behavioral element comes in. Unlike previous one-time tax breaks that were typically single payments distributed after filing one's annual income tax return, the 2011 payroll tax reduction will be dribbled out, paycheck by paycheck, over the course of the year. For the average family receiving $1,000 in additional income, the difference amounts to less than $20 a week. And since the amount is small, behavioral studies show the "extra" will most likely be spent, not saved.

Think of it this way: If you receive a $1,000 windfall in the form a single check, what is the likelihood that you will immediately spend all of it? It's probably quite slim, because the size of the number causes you to consider larger financial questions. You find yourself thinking, "Should I pay off that debt, set it aside for a large purchase, or add to my retirement account?" With an extra $20 in your pocket, the questions are more likely to involve dinner and a movie.

Richard Thaler, a prominent financial behaviorist and author of the best-seller *Nudge*, determined that most Americans have three categories for their finances: income, assets and future income. Money that falls into the first bucket (income) is most likely to be spent. The second bucket is a mixture of spending and saving, while money allocated to the last bucket (often through automatic withdrawal or payroll deduction) is almost always saved. Thaler found that small increases to Americans' paychecks were usually considered *income* (and often not even recognized as increases), while larger disbursements become assets. Considering these findings, Mui notes that "some economists think the smaller payments will increase the likelihood that the money will be spent because it seems negligible or perhaps even goes unnoticed."

### Unless…

You decide to override your natural tendency to spend small amounts of "extra" money by automatically diverting it through payroll deduction or automatic withdrawals. Now that you've had a few paychecks to see the difference in take-home pay, the simple way to capture those savings is to make an adjustment to any automatic "third-bucket" saving programs you already have in place.

A surprising aside: Mui cites a recent analysis by the National Bureau of Economic Research that examined how consumers responded to the 2008 stimulus checks and the 2009 Making Work Pay credits that appeared in each paycheck. Some data suggested that consumers actually preferred lump-sum payments instead of a stream of payments over the course of the year – even people whose cash flow was tighter. Mui reports: "For years, the government offered low-income workers the ability to receive their tax refund throughout the year instead of all at once. But that program was discontinued this year because only 3% of eligible workers signed up." Perhaps receiving a lump-sum encourages more circumspect and deliberate financial decisions, or maybe having jmore money in hand allows for the consideration of more alternatives. If the financial behaviorists are correct about this issue, i.e., that small regular payments will be consumed while larger lump-sum amounts will result in greater saving, and if consumers apparently prefer receiving lump-sum payments instead of extra dribs and drabs, it appears the government is inclined toward having people spend their extra money instead of saving it.

**NOW MIGHT BE THE PERFECT TIME TO ADJUST YOUR SAVINGS ALLOCATIONS!**

**DON'T LET $1,000 (OR MORE) SLIP THROUGH YOUR FINGERS JUST BECAUSE IT COMES IN SMALL PAYMENTS OVER THE COURSE OF THE YEAR!**

> ***"One realizes the full importance of time only when there is little left of it. Every man's greatest capital asset is his unexpired years of productive life."***
>
> ***- P.W. Litchfield, Chairman, Goodyear Tire & Rubber, 1930-1958***

## By the way…

**Casey Stengel** returned to professional baseball in 1962 as the first manager of the New York Mets. Stengel managed the Mets until 1965, and died in 1975 at the age of 85.

**Paul W. Litchfield,** (1875-1959) joined the Goodyear Tire & Rubber Company in 1900, when he was 25, as a plant supervisor in Akron, Ohio. In 1903, Litchfield was granted a patent for the first tubeless tire. By 1926, he was the president of the company, and served as the chairman of the board from 1930-1958. The community of Litchfield Park, Arizona, west of Phoenix, was named after Litchfield, who had established the town in 1917, as a cotton farm enterprise providing fiber for Goodyear tires during World War I.

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