The 2% Solution, Creating a 2% Problem; What YOU Need to Do.

If you are employed, by now you have noticed in your pay statement(s) for January 2011 that you got a "raise" of 2%. This came not from your employer but rather from Washington. As a bonus part of the deal (passed on December 17) to extend the Bush-era tax cuts into 2011 and 2012, the withholding rate for Social Security (also known as "the payroll tax" or as "FICA") was cut from 6.2% to 4.2%. This should be stimulative to the economy, as it is raising take-home pay for over 100 million households. The mere extension of prior-existing tax cuts was not literally stimulative but *rather avoided creating a depressant* that would have existed if the rates were allowed to rise back to old levels.

One might question the logic of lowering the FICA tax *for all income brackets*, but that's what Washington passed. Clearly, more take-home pay for people in the lower to moderate income strata is likely to prompt them to spend more, whether it be on groceries, clothing, toys, or postponed dental work. For people in upper income strata, however, economists of all stripes agree that added income does not result in added consumption as much as it merely goes mainly to savings. And savings, while good for those involved and ultimately a good thing for the economy, do not create any current stimulus to GDP. Of course, when the 2% reduction comes up for expiration, there will predictably be a debate about the deficit effects of continuing it (Democrats) vs. the demand-depressing effects of letting it expire (Republicans). Time will tell how that battle gets resolved.

For smart individuals, a look further down the road is the proper view. Here, there is both good and bad news. First, the bad news, and its implications: a reduction of more than 32% (2 out of 6.2) in the contributions to the Social Security "fund" means that program will become strapped for cash immediately and could go broke sooner than otherwise projected. This cut in money going in comes at exactly the time lots more baby boomers (read, prime candidates to start taking SS benefits) are hitting 65ish, and when some workers 62 and older are being forced to "choose" to take SS benefits because they've been laid off and can't find work. The implication of increased stress on Social Security is clear: individuals must anticipate needing to rely more on their own sources of wealth for income than before, since Social Security is being drained faster that earlier projected. That simply means SAVE AND INVEST! Take that added 2% and put it directly into retirement-designated money pools. First choice, if you are not already achieving the maximum "match" provided by your employer, would be to increase your contribution to your 401(k) or similar plan by not 2% but better 3%. Why the greater amount? Contributions come out of taxable income, so if your combined federal and state marginal income bracket is about 33% (roughly 28% and 5%, perhaps?), then putting in 3% of income costs you only 2% out of take-home pay.

The good news? Washington *has supplied you* with that added 2% by cutting the FICA tax. So you can go back to your pre-December 17 *status quo* in cash-flow terms by adding 3% to your retirement-plan contributions! And by doing so, you will create greater retirement-years' wealth on which to create needed income – whereas Social

Security is now more questionable than earlier. OK, what if you have already maxed out your workplace contributions? Or, what if your employer offers no such plan?

Probably two different answers. If you're maxed in the employer plan, any contributions you make to an IRA will be non-deductible. So be sure to put that money into a *Roth* IRA, where investment returns will not be taxed and where you will not face required minimum distributions at age 70.5 years. If you are not eligible for an employer plan, or there IS none, contributing to a regular IRA will get you an income-tax deduction which will let you put in 3% but have your after-tax income decline by only 2% (offset by the 2% FICA drop that started in January).

Some may argue, "but what if Congress later returns the 4.2% FICA withholding rate to 6.2% -- I'll be stuck with less take-home income if I'm putting more into retirement assets." Mathematically true, and also a terrific excuse for procrastinating. Washington is infamous for 'kicking the can down the road' by not dealing with future problems. Do you want to equally irresponsible regarding your own future retirement-income outlook? If you make $75,000 a year, you've being handed $1,500 and can choose how best to use it. Best advice: add to savings/investment *now*, and deal with that possible shortfall in spending power later. Clip more discount coupons, cut your phone or cable bill, or whatever. One less $4-daily latte including tax and tip, for 250 workdays a year, is $1,000 in *after-tax* money in your pocket. You *can* deal with this possible problem. Increase your saving and investing now, not maybe later!

A few years back, before the two recent stock market crashes, there was spirited debate about the virtues of "privatizing Social Security." It didn't happen. We will not go into the pros or cons here. HOWEVER, the recent reduction in SS taxes by over 32% has reduced the resources of the SS system, i.e., what you were counting on for your future! So you really ought to take the 2% of salary money that was "privatized" (put into your pocket) and not divert it to spending but instead invest it for your personal future financial security. If Washington ever actually deals with the budget deficits, it will need to do so by reducing entitlements. If it caps SS benefit (or Medicare), it WILL be privatizing the problem, that is, making it your budget issue rather than one for the federal treasury. Think about it. And take self-interested action.

It's your own "2% solution!"