

Social Security: History, Theory, Mechanics and the Future

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The (inaccurate) Metaphor for Financing Retirement



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A Better, More Accurate Metaphor



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Social Security: The Foundation

- The largest source of retirement income for almost 2/3 of all Americans
- Between 25% and 40% of retired Americans rely exclusively on Social Security for retirement income
- 23% of married and 46% of individuals are estimated to receive at least 90% of their income from Social Security

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Social Security: The Foundation

- Social Security provides guaranteed lifetime income
 - Most individuals today do not participate in defined benefit plans other than Social Security
 - Few defined contribution plans offer annuities and few participants choose them

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Social Security: The Foundation

- Social Security benefits are indexed to the increase in wage growth in calculating initial benefits
- Once in payment status, benefits are indexed annually to increases in the cost of living (CPI-W)

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Social Security: The Foundation

- Taxed the way private-sector defined benefits are
 - Employer deducts its cost
 - Employee is taxed on gross income
 - Employees may pay tax on the benefits
 - Tax treatment is unpopular and misunderstood

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Social Security: The Foundation

- Provides joint and survivor retirement annuities
 - Benefits to spouses, ex-spouses are add-on
 - Family benefits – e.g., dependent children, also add on
- Provides disability insurance
- Provides life insurance

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Social Security: Theoretical Underpinnings

- Social insurance rather than an entitlement
- Idea was not novel—see Thomas Paine, *Agrarian Justice*
- Near universal coverage
- Provides basic economic security to the entire family

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How is Social Security Funded?

- Federal Insurance Contributions Act (FICA)
 - Employee Portion
 - OASDI—6.2% of wages, up to taxable wage base
 - Taxable wage base limited to \$176,100 for 2025
 - Taxable wage base indexed to wage increases
 - 94 percent of employees earn under the maximum

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Funding (Cont'd)

- Employer Portion of FICA
 - OASDI—matches employee contribution dollar for dollar

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Funding (Cont'd)

- SECA Tax on self-employed, attempts to replicate treatment of employer-employee payment of FICA taxes
 - TP gets income tax deduction for employer share of tax
 - This deduction reduces the self-employment income to which SECA then applies-
 - Multiply self-employment income by 92.35% of net self-employment income

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Funding (Cont'd)

- Investment Income on Reserve
 - Must invest in government or government-backed securities
- Taxes paid on social security benefits are dedicated to OASDHI

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Eligibility for Old Age Insurance Benefit

- 40 quarters of coverage
 - A quarter of coverage is credited in 2025 for each \$1,810 of earnings
- Different rules for disability and survivor benefit (e.g., fewer covered quarters required and reflects age as of date of disability)

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Old-Age Benefits Calculation

- Step One: Determine Average Indexed Monthly Earnings (AIM)
 - This is the average of the 35 highest years of covered wages, with each year indexed to average wage growth
 - Note: index covered wages only for years through age 60

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Benefits (Cont'd)

- Step Two: Calculate the Primary Insurance Amount
- Calculate PIA
 - Three bend points, \$ amount changes each year
 - PIA for workers first eligible in 2025 equals
 - 90% of first \$1,226 of AIME +
 - 32% of the next \$7,391 of AIM+
 - 15% of remainder of AIM.

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Benefits (Cont'd)

- Note: The PIA is a progressive formula, with larger replacement rates for the first two bend points.
 - Overall progressivity for retirement benefits is somewhat limited by shorter life expectancies of lower income workers, though same formula for disability and survivor benefits
 - But taxation of benefits when received restores some progressivity

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Example

- Jill has AIME of \$10,000 per month and claims on her full retirement age
 - PIA equals
 - 90% of first \$1,226, or \$1,103.40
 - 32% of next \$7,391, or \$2,365.12
 - 15% of remainder or 15% of \$2,609, or \$391.35
 - For a total PIA of \$3,859.87
 - But you round down to nearest dollar, so \$3,859

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Benefits Cont'd

- PIA indexed to inflation beginning at age 62
- If benefits begin at social security retirement age, benefits will equal PIA (with future indexation)
 - Social Security Retirement Age: 67 for people born in 1960 or after.

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Benefits Cont'd

- Benefits decrease if commenced before full retirement age
 - (PIA is reduced by 5/9 for up to 36 months and then by 5/12 for remainder)
 - 30% reduction at age 62 for individuals born in 1960 or thereafter.
 - Example: Jill turns age 62 in 2025, has a PIA of \$3,859. If she commences her benefit in 2025, her benefit will be reduced by 30% to \$2,701. (But her benefit will then increase each year to reflect changes in the cost of living.)

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Benefits Cont'd

- Benefits increased if benefits commence after full retirement age
 - PIA increased 8% for each full year after full retirement age (2/3% increase per month)
 - Example: Jill delays her benefit until age 70. Her monthly benefit will be her \$3859 PIA increased by 24%. Her benefit would be \$4,785.

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Benefits Cont'd

- Minimum Social Security Benefit
 - There is a minimum Social Security benefit
 - Based on a percentage of the poverty rate for the prior year.
 - In 2025, for people with 30 years of covered service, the monthly benefit is \$1,093.10.
 - The benefit is reduced if there is less than 30 years of coverage. For someone with 11 years of coverage, the monthly benefit is \$52.10.
 - Fewer than 30,000 people receive the special minimum benefit
 - In fact, no new retiree qualifies for it, since the normal benefit always today always exceeds the minimum

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Benefits Cont'd

- Benefits are subject to a retirement test:
- They are reduced if worker is below their full retirement age and worker exceeds retirement earnings test, \$23,400 in 2025.
 - Reduction is \$1 for each \$2 earned over \$23,400.
 - More favorable rule for workers who will reach full retirement age during year.
 - Benefit after full retirement age increased to partly reflect prior reductions

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Auxiliary Benefits

- Spousal (and surviving parent) benefits
 - Spouse receives own benefit and, if less than half spouse's, a spousal benefit up to 50% of the other spouse's benefits at full retirement age, with reductions for commencement before full retirement age.
- Note this situation: spouse contributes to system and receives PSA that is exactly half of what the other spouse receives.
 - But spouse does earn right to disability and survivor protection on the basis of her or his contributions.

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Auxiliary Benefits

- Benefits for divorced spouses, for any marriage of at least 10 years duration
 - Same as spouse, widow(er) benefit
 - Forfeit if spouse remarries

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Auxiliary Benefits

- Disability benefits
 - Must have a condition that will last at least one year or until death
 - Must have required number of quarters of coverage and recency of work
 - Example: if over 30, must have 20 quarters of coverage in 40 quarters ending in year disability began
 - Younger workers may need fewer quarters of coverage
 - Rules somewhat rlower when disability is blindness

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Auxiliary Benefits

- Survivor benefits
 - For spouses
 - Children under 18, or 19 if still in K-12
 - Parent until child is 16
 - Disabled adult children
 - Dependent parents
- Maximum family benefit—varies between 150% to 188% of PIA
- Lump Sum Death Benefit (only \$255)

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Average and Maximum Benefits

- In 2025, the average annual benefit: approximately \$23,700
- Average couple benefit is approximately \$37,000
- Median benefits approximately \$1,000 lower than average
- The maximum benefit for 2025: \$61,296

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Some Controversies

■ Notch Babies

- Error in benefit formula means that people born between 1917 and 1921 get lower social security benefits than people born before or after them
- Problem has essentially disappeared since notch babies are now between 103 and 107 years old

WEP/GPO

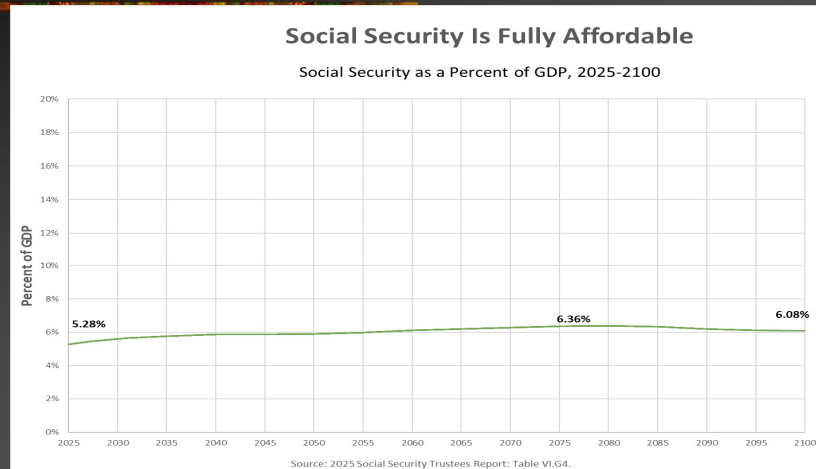
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Some Controversies

- Social Security beneficiaries also receiving state/local pensions once faced two provisions that could reduce their benefits:
 - Windfall Elimination Provision
 - Government Pension Offset
- Congress eliminated these provisions effective in 2024.

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The Future of Social Security



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The Future of Social Security

- Starting in 2023, current income no longer sufficient to cover all benefit obligations, including administrative costs
 - Social Security is now drawing down the trust fund
 - Social Security projections indicate trust fund will be depleted by 2034

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The Future of Social Security

- In the extremely unlikely event that trust funds were depleted without Congressional action,
 - Benefits would be reduced across the board by approximately 22%
- As subsequent slide shows, whether benefits are increased or cut is a question of values, not affordability

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The Future of Social Security

- Reasons for the funding shortfall?
 - When Social Security began, the Social Security taxable wage base covered over 90% of all wages
 - Today it covers approximately 82% of all cash wages, because of income inequality and more compensation going to fringe benefits
 - Demographics
 - Baby boomers retiring
 - Fewer children
 - Legacy costs of system.

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The Future of Social Security

- Ways to restore actuarial balance
 - Increase funding, reduce benefits, or combination
 - Important sometimes overlooked issues:
 - Will changes destroy Social Security's social insurance foundation?
 - Will changes reduce political support for Social Security?
 - Will changes increase poverty and near poverty levels of older Americans?

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The Future of Social Security

- Proposals to Increase Revenue
 - Increase taxable wage base so it again covers 90% of taxable wages
 - Increase payroll tax across the board
 - Increase payroll tax for higher earners
 - Dedicate other tax sources, such as estate and gift tax, to Social Security

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The Future of Social Security

■ Proposals to Increase Revenue

- Create new tax streams, such as a tax on investment income
- Reduce tax expenditure for qualified plans and earmark the savings for Social Security
- Invest trust fund in equities

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The Future of Social Security

■ Proposals to Reduce Benefits

- Reduce benefits for those earning over \$60,000
 - Risks changing Social Security so unrelated to prior earnings
- Change index for indexing benefits to less favorable index
 - Would cause benefits to erode over time
- Raise the full retirement age
 - Indistinguishable from across the board cut of 6-7 percent
 - Primarily hurts lower income workers

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Proposals to Improve Social Security

- Increase benefits and across the board and in targeted ways
- Change the indexation formula to the CPI for the Elderly
- Increase the minimum benefit
- Increase the lump sum death benefit
- Add caregiver credit

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Proposals to Improve Social Security

- Add short-term disability benefits, including parental leave
- Add paid sick leave benefits

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Social Security Offsets

- Allows employer to offset contributions to defined contribution plan by a portion of the employer's payroll tax (on the theory that the employer's share of the payroll tax is purchasing retirement benefits) or to offset a portion of the employee's benefit to a defined benefit plan by a portion of employee's Social Security benefit.

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Social Security Offsets

- History:
 - Congress adopts the Social Security Act in 1935, with payroll tax being assessed beginning in 1937
 - Congress adopts nondiscrimination rules five years later
 - Social Security integration approved

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Social Security Offsets

- Description of *Complete* Integration (outlawed by the Tax Reform Act of 1986)
 - Employer pays 6.2% payroll tax to Social Security for each employee, up to the Wage Base
 - 5.7% is the portion that funds the retirement benefit under Social Security
 - The 5.7% employer contribution should be considered the equivalent of a contribution to the employer's retirement plan

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Social Security Offsets

- Example:
 - Assume HCE earns \$200,000,
 - NHCE earns \$100,000, and
 - Social Security Wage Base is \$100,000.
 - Employer contributes 5.7 percent of the entire compensation of the NHCE to Social Security
 - But only 2.85% of total salary of HCE
 - Employer should thus be able to contribute 5.7% to an employer retirement plan of the HCE's employee's salary in excess of \$100,000.

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Social Security Offsets

■ Example:

- The employer plan thus states the employer will contribute nothing on compensation up to the Social Security Wage Base
- And 5.7% for wages in excess of the Wage Base
- The employer thus contributes 0 for the NHCE and \$5,700 for the HCE
- Integrating defined benefit plans more complex

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Social Security Offsets

■ After TRA of 1986

- Plans could no longer use complete integration

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Social Security Offsets

- After TRA of 1986
 - Defined contribution plan
 - The maximum disparity (the difference between contributions above and below the Wage Base) must be no more than
 - The contribution below the wage base ("the base contribution"), or
 - 5.7% of compensation

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Social Security Offsets

- After TRA of 1986
 - Some examples of compliant defined contribution plans:
 - Plan provides 2.85% contribution on compensation up to the wage base, and 5.7% above the wage base
 - Plan provides a contribution of 10% below the wage and 15.7% above the wage base

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Social Security Offsets

- After TRA of 1986
 - Very few defined contribution plans today are integrated with Social Security
 - Partly because 401(k) plans would find it exceedingly difficult to integrate
 - Small profit-sharing plans are the most likely dc plans to be integrated
 - Top-hat plans today fill the role of permitting larger contributions for key employees that was once occupied by integrated defined contribution plans

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Social Security Offsets

- After TRA of 1986
 - Defined benefit plans are also subject to limits
 - Two ways to integrate a defined benefit plan
 - Excess Plans
 - Benefits earned for compensation over the wage base must not exceed
 - Twice the benefit percentage below the wage base, or
 - .75 of compensation (.75 percent of compensation is the Department of Treasury's estimate of what a 5.7% contribution to Social Security purchases)

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Social Security Offsets

■ After TRA of 1986

■ Offset plans

- Calculate the plan benefit and then reduce it by the Social Security benefits considered provided by the employer's 5.7% contribution
 - To use this method, the defined benefit must be based on a percentage of annual compensation
 - The reduction is .75% of compensation multiplied by years of service in the plan
 - But total reduction can be no more than 50% of the benefit before the offset

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Social Security Offsets

■ After TRA of 1986

- It is estimated that 60% of defined benefit plans are integrated (although many of these are now frozen)
- Defined benefit plan integration is often complex, particularly in the case of plans that have benefit accruals before and after the TRA of 1986 and plans that have merged with other plans
- Always consult an actuary on DB integration

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