

Part II Social Security and Retirement Planning

Social Security currently provides less than half of total annual income for the majority of Americans over age 65. Since the Social Security program is run by the U.S. government, it once seemed more ironclad than any individual investments or company-sponsored pension plans ever could.

But among many of today's retirement savers that perception is changing. Social Security is widely viewed today as the most uncertain ingredient of a retirement plan. Many of today's younger retirement savers don't believe that the program will provide them with much or anything in the way of benefits when their turn to retire comes around.

According to one recent survey, only a small percent of Generation X believes that Social Security will be their most important source of retirement income. Unless significant changes are made, there is no way that the Social Security Administration will be able to continue paying benefits at their current schedule.

History of Social Security

Enacted in 1935, Social Security was meant to alleviate the cruel poverty and despair in which so many elderly found themselves when no longer able to work. Heavy unemployment among the elderly and growing distaste for the county poor house led to state legislation for old age pensions. State action was spotty, however, and the law generally required personal penury and a showing of inability of children to support their aged parents. Many states had no such laws and those that did paid meager benefits. With most states unable to pay even small amounts, state resources were no match for the financial needs of the elderly.

Even before the program first made monthly benefit payments in 1940, Congress made some basic changes. In its original version, Old-Age Insurance Benefits were to provide only retirement benefits. But a 1937 advisory council endorsed the recommendations of the Social Security Board, and counseled that Social Security should provide social insurance protection for other family members – wives and children who also bear the brunt of income loss caused by retirement and death. Congress quickly agreed, thereby creating Old Age and Survivors Insurance (OASI).

The council also agreed with those economists who urged that Social Security operate on a pay-as-you-go basis rather than building up large reserves. Such a change met the fear that substantial reserves would dampen the economy and avoided the problem of how the federal government should invest huge sums. It also enabled the system to start paying adequate benefits soon after its inception. Pay-as-you-go was adopted in practice but the law continued provisions to build reserves at later dates; Congress repeatedly postponed those increases.

Under pay-as-you-go, current employee contributions and employer payroll taxes roughly equal benefits paid and administrative expenses. A relatively small reserve tides the program over brief periods when collections temporarily fall short of payout. That small amount goes into a trust fund managed by the secretary of the Treasury, the secretary of Health and Human Services, and the secretary of Labor; the 1983 amendments provided for two public members in addition. The managing trustee pays out benefits at the beginning of each month and issues special obligation bonds to the trust fund equal to any amounts unused for benefit or administrative purposes. Those bonds can be cashed in without penalty, whenever needed; hence the “special obligation.” The reserve, though small, does not remain idle; the trust lends funds to the U.S. government for its operations and collects interest on the money lent.

For most of its first three decades, Social Security financing caused much discussion but few operational problems. Many had difficulty accepting the pay-as-you-go concept and felt uneasy about the lack of a large fund to secure promised payments. Through 1949 the payroll tax remained low – 1 percent of taxable income. Benefits were also modest and, because of the small number of persons eligible for benefits, total payout was small. Tax collections annually exceeded outgo and the trust fund grew modestly.

Following World War II, the economy experienced the beginning of an economic revolution. Employment remained high, incomes rose, production boomed, millions bought homes and appliances and cars, many children from formerly poor families finished high school, went on to college, and some entered the professions. Despite anxiety and recurrent recessions, the bulk of the population experienced their first taste of economic comfort. Although affluence still lay ahead, new economic aspirations and even expectations stirred. Organized labor gained political and collective bargaining power. Employers, revived by war production and the postwar Niagara of consumer purchasing, concentrated on making products and money, granted high wages, and established and expanded paid vacations, sick pay, and health insurance not only to executives and managers but also to rank-and-file working people. America’s foreign trade flourished. Ours was the only major economy

intact – we generously aided the reestablishment of Europe’s economy, at least up to the Iron Curtain, and we quickly became the world’s largest producer and merchant.

In the late 1940s, some of these developments led to union demands for private employer-financed group pension plans for workers to augment modest Social Security benefits. Then, acting on the blueprint provided by a Social Security advisory council in the late 1940s, Congress in the early 1950s revised Social Security, seeking to make up for a decade in the doldrums. Coverage expanded during the 1950s to include all of industry, the armed forces, the self-employed on a mandatory basis, and--on an optional basis--state and local government and nonprofit institution employees. The taxable earnings base moved from \$3,000 to \$3,600 in 1951 and \$4,200 by 1955. The employee contribution rate and the employer payroll tax went to 1.5 percent in 1950 and 2 percent by 1955. Minimum and average benefits increased rapidly. The trust funds continued to run annual surpluses and to build reserves.

The 1950s, despite the Korean War and recessions, saw the beginnings of general affluence. Not all participated equally and some were left behind, but wages, earnings, incomes, consumption, aspirations, and expectations all rose. The nation launched the interstate highway system, the largest public works project in the history of humankind. A powerful economy supported unprecedented levels of living.

Private employment-based health insurance expanded, usually paid by employer contributions with some employee contributions as well. Social insurance also grew. Unemployment insurance increased coverage and the duration and level of benefits. State workers’ compensations laws, designed for work-connected injury, became universal by the end of the 1940s, when a few stragglers finally adopted them; but many states limited benefits and their duration and provided sparse coverage for illness.

In the mid-1950s, Congress resolved a continuing debate by establishing the Social Security Disability Insurance (DI) program. First limited to those fifty and over when originated in 1956, by 1960 it insured all those who worked under Social Security for extensive periods. The new program added a trust fund for DI with its own modest and separate payroll tax of .25 percent (one-fourth of 1 percent), collected along with the OASI (Old Age and Survivors Insurance) tax. OASI became OASDI. The maximum amount of earnings subject to tax grew to \$4,800 and, as the 1950s closed, the payroll tax rose to 3 percent. Benefits for women as workers and wives also improved, as did minimum benefits.

By 1960, OASDI had grown into a major program with widespread support in the populace and among politicians – at least Democratic politicians. Most Republicans remained

opposed or wary, the business community was concerned about the bite of the payroll tax and the growth of so large a public program. Benefits for all in this period remained modest.

In the 60s and 70s benefits continued to improve and become inflation-proof until they were providing the major source of income for the retired and for survivors. To meet the costs of increased benefits and the introduction of Medicare in 1966, Congress raised payroll taxes and the amount subject to such taxes.

In the 1980s, with the postwar boom past and productivity fluctuating, Americans weathered two oil crises and endured several recessions. Social Security retained massive public support. An ongoing concern at the beginning of a new century has been whether we can continue to afford it, whether future generations of retirees can depend on it, and whether it gives us our money's worth.

Social Security Basics

The Social Security Act and related laws establish a number of programs. Each has the basic objective of providing for the material needs of individuals and families, protecting aged and disabled persons against the expenses of illnesses that could otherwise exhaust their savings, keeping families together, and giving children the opportunity to grow up in health and security. These programs include:

- Retirement insurance
- Survivors insurance
- Disability insurance
- Hospital and medical insurance for the aged, the disabled, and those with end-stage renal disease.
- Black lung benefits.
- Supplemental security income.
- Unemployment insurance.
- Public assistance and welfare services which include:
 1. Aid to needy families with children
 2. Medical assistance
 3. Maternal and child health services
 4. Child support enforcement
 5. Family and child welfare services
 6. Food stamps
 7. Energy assistance

The Federal Government operates the retirement, survivors, disability, hospital and medical insurance, black lung benefit, and the supplemental security income programs.

Mechanics of Social Security

A person must be insured under the Social Security program before retirement, survivors, or disability insurance benefits can be paid to the person or to the person's family. The Social Security Administration determines if a person has fully insured status, currently insured status, or insured status for establishing a period of disability by the number of Social Security credits earned. Social Security credits previously called quarters of coverage, are earned for a certain amount of work covered under Social Security.

Monthly Cash Retirement Insurance Benefits (also called old-age insurance benefits) may be payable to an individual age 62 or over. Additional monthly benefits, called auxiliary benefits, may be payable to other persons, usually spouse or children, based on the earnings record of the retirement insurance beneficiary. These auxiliary benefits may also be payable on the earnings record of an individual entitled to a disability insurance benefit.

A worker is entitled to Social Security retirement insurance benefits if he or she:

- Is at least age 62 throughout his or her first month of entitlement and is fully insured
- Has filed an application for retirement insurance benefits

An application is not required if the claimant is entitled to disability insurance benefits for the month before the month in which he or she reaches age 65. The disability insurance benefit is ended and the retirement insurance benefit is started automatically. If the above requirements were met before the month in which the application is filed, the worker, with certain limitations may be entitled to retirement insurance benefits retroactive to the first month in which those requirements were met.

Primary Insurance Amount

The worker's primary insurance amount (PIA) is the figure from which almost all cash benefit amounts are derived, including monthly benefits for workers, their dependents, and their survivors. The lump-sum death payment is \$255, except that it may be less if the PIA was computed by including earnings under a totalization agreement. The only cash benefit not based on the PIA is the special monthly payment made to uninsured persons age 72 or over.

The PIA is based on an individual's taxable earnings averaged over the working lifetime to yield a monthly benefit that partially replaces the earned income lost because of retirement, disability, or death. There are two methods of averaging earnings, depending on when the individual is first eligible or dies.

First eligibility means the year in which an individual attains age 62 or in which a period of disability begins. **Entitlement** means the individual meets all the requirements for receiving benefits, including filing an application.

The PIA is based on the average indexed monthly earnings (AIME). Earnings for years 1951 up to and including the second year before the year of first eligibility or death, whichever comes first, are indexed, i.e., adjusted to put them in proportion to the earnings level of all workers for those years. Actual reported earnings are used to compute the AIME for years beginning with the year before the year of first eligibility.

If the insured worker died before age 62, his or her earnings are indexed differently to compute the PIA on which the widow's or widower's benefits will be based, if this results in a higher benefit. In this case, the worker's earnings are indexed up to and including the earlier of the year in which the worker reached age 60 or the second year before the widow(er) becomes eligible, but never earlier than the second year before the worker died.

The purpose of using the adjusted earnings, rather than the actual earnings is to reduce the disparity between the benefit amounts payable only on the basis of recent earnings (for example, to a younger disabled worker) and the benefit amounts payable to older individuals whose averaged earnings include the lower amounts that were earned and taxable in the earlier years of Social Security coverage. Here is an example:

- Mr. Francis retired at age 65 in 1995. The significant year for setting the index factor is 1990, the second year before the year in which he attained age 62. Average wages of all wage earners in 1990 are compared to average wages of all wage earners in each year after 1950. If Mr. Francis' earnings were \$3,000 in 1951 and the wages of all wage earners in 1990 were 7.51224 times higher than the average wages of all wage earners in 1951, the 1951 factor is 7.51224 and the indexed earnings for Mr. Francis are \$22,536.72. Like or different factors will apply for each year to be indexed depending on the ratio of average wage levels for all wage earners in each year compared to 1990. It is equally true that a different year of attainment of age 62 would change the factors.

In Mr. Francis' situation, earnings in years beginning with 1991 will not be indexed but will be the actual amounts reported. A special minimum PIA is possible for workers who have worked under Social Security for many years at low earnings. At least 11 of these years are required but more are usually needed to bring the amount of the special minimum PIA to more than the PIA computed under the methods explained above.

Computation Years

A person's computation years are those years of highest earnings selected from the base years. The number of years selected as the "computation years" in a particular case is determined in the following steps:

- The "elapsed years" are ascertained
- The number arrived at is decreased by 5 in claims for retirement insurance benefits and for survivors insurance benefits. In claims for disability insurance benefits where the worker is first entitled after June 1980, divide the elapsed years by 5, disregard any fraction, and subtract the result (which cannot exceed 5) from the number of elapsed years.
- For disability insurance benefits for months after June 1981, the elapsed years may be further reduced by years in which a child (of the worker or his or her spouse) under age 3 was chiefly living with the worker provided:
 - the worker did not have earnings in each childcare year
 - the combined total number of childcare years and regular years which is subtracted from the elapsed years does not exceed 3. The formula for calculating a disabled worker's computation years is applicable to the worker until his death unless, before age 62, he ceases to be entitled to disability insurance benefits for 12 continuous months.

The number remaining (but not less than 2) is the number of "computation years" which will be selected from the base years. The years selected are those of highest earnings. For the computation indexed method, the selection is made after the earnings are indexed. The person's total earnings in the computation years are then added together and divided by the number of months in those years to get the AME or the AIME – average indexed monthly earnings.

Retirement Insurance Benefit Rate

The retirement insurance benefit rate is equal to the primary insurance amount, the basis for all benefits, except that a special minimum benefit is provided for some individuals. These amounts may be increased by a cost-of-living benefit increase.

A worker, age 62 to 65, and otherwise eligible for retirement insurance benefits, can choose to receive a reduced benefit, or to wait until age 65, the normal retirement age, and receive the full retirement insurance benefit rate. If a worker chooses to receive and does receive benefits for one or more months before age 65:

- The benefit rate ordinarily received at age 65 is reduced by a certain percentage for each month the worker is under age 65
- A reduced benefit rate will continue to be paid after age 65 is reached

Retirement Age

The normal retirement age for Social Security increased for 150 million working Americans beginning in January 2000. Although 62 remains the earliest age at which individuals can retire and collect reduced benefits, the age for collecting full Social Security benefits will gradually increase from age 65 to 67 over a 22-year period. For those born in 1938 (age 62 in 2000) the new retirement age is 65 and 2 months. The increase in the retirement age was included in the Social Security Amendments of 1983.

Deciding when to retire is probably one of the toughest and most important decisions American workers have to make. Because it is so important, it is crucial for workers to have all the facts regarding the impact of their retirement decision on their current and future Social Security benefit.

The increase in the full retirement age begins with individuals born in 1938 whose normal retirement age will be 65 and 2 months. The age increases in two-month increments for workers born between 1939 and 1943 until the retirement age reaches 66 and remains there for all workers born through 1954. For those born after 1954, the retirement age begins to increase again in two-month increments until it reaches age 67 for those born in 1960 or later.

An additional provision of the 1983 law gave workers who continue working, and delay collecting Social Security benefits until after their normal retirement age, higher benefits. The amount of the increase, known as the "delayed retirement credit," is determined by a set

percentage and increases the longer retirement is delayed. Currently, workers born in 1938 who delay retirement receive a 6.5% credit for each year they do not collect benefits. The yearly credit will increase to 8% for those born in 1943 or later. For individuals who work a partial year, the yearly percentage is broken into monthly increments. The increase stops at age 70, regardless of when a worker starts collecting benefits.

Social Security benefits are the foundation of most Americans' retirement. It is important that everyone know how the retirement choices they make can have an impact on their benefits.

Each October, the Social Security Administration mails Social Security Statements to all workers age 25 and older who are not receiving Social Security benefits. The statement tells workers their full retirement age and provides a retirement benefit estimate for age 62, full retirement age, and age 70. The Social Security Statement is a valuable financial planning tool that will help Americans prepare for their long term financial security. **It is never too early to start retirement planning, but it can be too late!**

Social Security as a Retirement Plan

Social Security benefits were never intended to be the sole form of income for retirees. The program is currently designed to replace only around 42 percent of the average retiree's pre-retirement income. Most retirees will need to replace at least 60 to 80 percent of their income in order to maintain their standard of living. Social Security benefits are based on one's average earnings over 35 years. So unless one's earnings were consistent throughout his career on an inflation-adjusted basis, he should expect Social Security to replace an even lower percentage of his final earnings.

Misconceptions about Social Security

- ***The Social Security System is in the red.*** Actually, as of late 1998, the system had a \$700 billion surplus, which is expected to grow to \$4 trillion by 2013. A quick check of our country's demographics makes it obvious that this surplus won't be enough to pay for the retiring baby boomers, unless changes are made.
- ***My payroll taxes go into a trust fund with my name on it.*** The taxes paid into the Social Security system by today's workers mostly go to pay today's retirees – or into the government's general tax coffers. Current workers' benefits will have to be paid by future generations if the system is going to continue.

- ***All of my payroll taxes go to retirement benefits.*** Only around 70 percent of payroll taxes end up as retirement or survivor benefits. Around 19 percent of the Social Security tax dollar go to the Medicare system, and the remaining 11 percent to disability benefits.