EDUCATION

Social Security: It's Healthier Than You Might Think!

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Each year, Social Security's Trustees report to Congress on the financial status of the program. This typically generates a number of anxiety-provoking media headlines about if/when it will run out of money. Gail Buckner, CFP, our personal retirement and financial planning strategist, takes a look at the facts. She says Social Security is actually in pretty good shape overall.

Some of the recent headlines about Social Security's financial condition might give you the impression the entire program is going broke. On the contrary, in some ways its financial condition is actually *better* than it was last year!

To understand this, it's helpful to know a few facts about how the program works.

The Basics: Who Pays What

The Social Security taxes we pay go into two "trust funds." The largest is used to pay "Old Age and Survivor Insurance," or OASI. This includes monthly checks sent to retirees as well as survivor benefits provided to spouses and minor children of workers who have died. As its name implies, the "DI," or disability insurance fund, makes payments to individuals who are no longer able to work. Together these are referred to as the OASDI funds. However, separate projections are made for each.

Most of the payroll tax the government collects ends up in the OASI trust fund. A smaller portion goes into the DI fund. Under a law passed in 2015, Congress directed Social Security to divert some of the money earmarked for the "retirement" fund to the "disability" fund, which was in danger of becoming insolvent thanks to higher-than-expected benefit claims. This transfer stops in 2022.[1]

The assets in both trust funds are invested in US Treasuries that pay a market-based interest rate. Last year, Social Security received $39.9 billion in interest, which was added to its reserves.[2]

Social Security tax only applies to *earned* income, that is, income *from a job.* Dividends, capital gains, interest on bank accounts, rent payments you may receive and similar types of income are not subject to the 12.4% tax. In addition, there's a limit on how much earned income is subject to Social Security tax. This year, the maximum is $128,400.[3]

Most of us don't pay the full 12.4% payroll tax. Generally, workers pay half (6.2%), and their employers contribute the other half. Only those who are self-employed (who are both "employer" and "worker") pay the entire 12.4%. (Note, there is an additional 1.35% Medicare tax).

You may still (indirectly) pay taxes to Social Security even after you stop working! If your total income exceeds a certain amount, as much as 85% of your Social Security benefit will be taxed as "ordinary income." The IRS sends this money back to Social Security where it helps replenish the trust funds. Last year, retired Americans paid $37.9 billion in income tax on their Social Security benefits.[4]

Most Americans also do not know that the Social Security program is *self-funded*. That is, the Social Security taxes we pay cover the entire cost of running the program—from employee salaries to office supplies! In 2017, "administrative expenses" amounted to $6.5 billion, all paid for by current and future Social Security beneficiaries.[5]

The Good News

Social Security's total expenses last year were $952 billion. However, income from all sources exceeded this by $44 billion.[6] The extra money went into the trust funds. Together, the retirement and disability trust fund reserves grew to nearly $3 trillion by the end of 2017.[7]

Another positive: the disability trust fund saw expenses decline last year, partly because fewer people have been filing for benefits and average benefit amounts have declined. Because this trend is expected to continue, the disability trust fund should be able to cover all benefits through 2032, four years *longer* than predicted last year.[8]

On the other hand, the latest Social Security Trustees report predicts the excess reserves in the retirement trust fund will be depleted a year earlier—2034.

Predictions Aren't Facts

"It's tough to make predictions, especially about the future." – Yogi Berra

The 1935 Social Security Act requires Social Security's Trustees to report to Congress on the 75-year outlook for the program's finances. In order to do this, actuaries at Social Security must make dozens of assumptions about such things as:

-How fast will the economy grow *in each of the next 75 years?*
-What will the birth rate be *in each of the next 75 years?*
-How much will wages increase *in each of the next 75 years?*
-What will the unemployment rate be *in each of the next 75 years?*
-What will inflation be *in each of the next 75 years?*
-What will the legal immigration rate be *in each of the next 75 years?*

Since these factors are hard to predict even in the short term, Social Security's number-crunchers have to make a lot of "educated guesses." If something changes—for example, inflation spikes or there's an increase in the birth rate, the outlook for Social Security's finances may worsen or improve. In addition, three sets of estimates must be produced: a low-, intermediate- and high-cost estimate of what the retirement and disability benefits programs might need to pay over the next 75 years.

In other words, the annual report that is produced is, at best, an estimate.

Will History Repeat?

As noted, it's estimated that by 2034, the surpluses in both trust funds will have dried up. However, that's not quite as dire as it sounds. At that point, payroll taxes that Social Security will continue to collect should cover 79% of the benefits Social Security expects to pay.

While that doesn't sound comforting, it could be worse—and has been. Shortly after President Ronald Reagan was inaugurated in 1981, he was told Social Security would be "technically insolvent" in just *two years*—meaning that by 1983 it would not be collecting enough in payroll taxes to fully cover the benefits it would owe.

Reagan appointed a special presidential commission comprised of experts from a variety of disciplines whose job was to make recommendations that would put the program on a firmer financial footing. The commission's chairman? Alan Greenspan, an economist few people had ever heard of at the time (who we know later became chairman of the Federal Reserve). The commission met for two years and presented its findings to Congress. These became the Social Security Amendments of 1983. Among the changes Congress adopted:

- No more special pension for federal workers. All new hires would be covered by and contribute to Social Security. Contributions from new federal employees shored up the program's finances in the immediate term.
- Increase in the full retirement age. In the nearly 50 years since the Social Security Act was passed, life expectancy had significantly improved. As a result, Social Security was paying benefits to more individuals for a longer period of time. That got expensive. The full retirement age (set at 65 in 1935) would be gradually increased to 66. But this wouldn't start until the year 2000.
- In light of further expected increases in life expectancy, the 1983 amendments call for the full retirement age to increase again—to 67—starting in 2021.
- Increase the payroll tax higher than needed to cover current retirees. This would enable the program to build up a surplus by the time the large baby boom population began to retire.

Thanks to the annual reports the trustees must make, back in the 1970s Congress was well aware that Social Security was headed for trouble. But did Congress address the looming shortfall? Nope. It waited until the 11^{th} hour to act.

Chalk it up to human nature and politics: why tackle an unpleasant task (such as raising taxes) before you have to? Leave it to the next person in office.

Déjà vu? Or Something New?

Keep this in mind: Since passage of the 1983 Amendments (with minor tweaks along the way), *Social Security has worked just fine for the past 35 years*. Today we are simply at another point where we need to make some relatively minor adjustments—again, primarily due to *demographic* changes. Life expectancy continues to increase and the birth rate remains relatively low. As a result, fewer people will be entering the workforce and contributing to Social Security in the future.

In its recent report, the Social Security Trustees stated that to ensure both trust funds remain solvent over the next 75 years, the payroll tax would need to immediately go up by 2.84%. Translation: If the current Social Security tax rate of 12.4% were increased by 2.84% to 15.2%, *everyone* would get their benefits for the next 75 years. Keep in mind that employees and their employers would each pay half of the increase—1.4%.

In other words, if we all chip in $14 more for every $1,000 we earn up to the maximum taxable earnings (currently $128,400), Social Security would remain solvent *for the next 75 years*.

While it is extremely unlikely Social Security's shortfall will be corrected by simply raising the payroll tax rate, this does illustrate how small an adjustment is needed. Numerous think tanks have suggested ways to make small adjustments to the many components that go into Social Security's equations so the gap can be closed without increasing the tax rate substantially. Of course, the longer Congress delays, the larger the changes will have to be.

But, remember, *we have 16 years* before this becomes a serious concern. Reagan had two. I am confident Congress will eventually pass legislation to ensure that future retirees can count on Social Security. After all, Americans 60 and older turn out to vote in larger numbers than any other age group![9]

Though not often mentioned, one factor that would significantly help Social Security's finances is… a strong economy. If more Americans have jobs, Social Security will collect more payroll tax. If wages increase because of greater competition for workers, Social Security will collect more payroll tax. If today's baby boomers remain in the workforce longer because of attractive wages and benefits, they will not only be contributing to Social Security, but they will also delay claiming benefits.

A lot can happen in 16 years.

Learn more about developing a strategy to fund your own retirement: www.franklintempleton.com/whatsnext.

And, ask your professional advisor to run your personal scenario though the independent third-party LifeYield Social Security Optimizer tool, which can help you and your advisor consider your personal goals and circumstances, and begin to determine when the right time to start taking Social Security benefits might be.

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1. Source: Social Security Administration Legislative Bulletin, November 3, 2015.

2. Source: The 2018 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

3. Source: Social Security Administration.

4. Source: The 2018 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

5. Ibid.

6. Ibid.

7. Source: Social Security Administration, "Actuarial Status of the Social Security Trust Funds," June 2018.

8. Source: Ibid.

9. Source: United States Election Project, Voter Turnout Demographics.

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