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A Beginner's Guide to Social Security[1]

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Introduction

This document attempts to outline the nuts and bolts of the present system of Social Security. The 2000 Presidential election was perhaps won and lost on the single issue of Social Security. Both candidates had widely different views on saving Social Security, with retirees and minority groups (the main recipients) favoring Mr. Gore and white males favoring Mr. Bush in the 2000 election. While social security benefits can apparently continue at the present level until 2037, the present level of expenditure will exhaust all the principal and interest and be unsustainable. Consequently something has to be done. (Interestingly, Congress has its own retirement program, and its members do not contribute to Social Security.)

Social Security protects over 150 million workers and pays benefits to more than 44 million people. It provides cash income to retirees, family members of deceased workers, and disabled workers and their families. Three out of four workers worry that they will not have enough money to live comfortably in retirement. Most retirees will need about 70% of their pre-retirement income to do so, which cannot come from Social Security alone (Social Security supplies 40% of an average worker's salary) but must be supplemented with pension income and the retiree's savings and investments. Yet Social Security is currently still the largest source of income for most of America's elderly and hence a political weapon.

The Problem

In 2000, about 12% of the population were over the age of 65. Between 2008 and 2033 (the significant period for Social Security), this proportion will rise to 20%. Employers and employees now jointly pay 12.4% of their income towards Social Security. The program currently needs 10.8% to fund the present level of recipients, but this will rise to 11.4% by 2007. Consequently the system will remain in surplus for a few years more. However, after this time it will rise inexorably between 2008 and 2033 to 18%. This is simply because retirees are increasing faster than workers. During this period, retirees will grow from 45 million to 85 million while workers will only increase by 20 million.

History of Social Security

On June 8, 1934, President Franklin Roosevelt announced his intention to provide a program for Social Security. It was signed into law August 14, 1935, as the Social Security Act, designed to pay retired workers, age 65 and older, a continuing

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income after retirement. Between 1937 and 1940, there were lump sum payments; monthly payments only started in 1940.

The 1939 Amendments to Social Security added two new categories of benefits: payments to the spouse and minor children of retired workers, and survivor's benefits paid to the family if premature death of the worker occurred. With these additions, Social Security started to change from a simple retirement program for individual workers to a family-based economic security program (www.ssa.gov/history).

By 1950, about 50% of America's workers were covered. More amendments in that year raised benefits for the first time since the inception of the program and started Social Security on the path towards universal coverage. The main amendment was an automatic cost of living allowance (COLA) which only became annual in 1972.

In 1956, an amendment added disabled workers as beneficiaries. In August 1965, President Lyndon Johnson added Medicare as health coverage for Social Security beneficiaries. In October 1972, a supplemental security income (SSI) also became available for beneficiaries with limited incomes.

Social Security became an independent agency on August 15, 1994, and is currently headed by Kenneth S. Apfel, the Commissioner for Social Security.

Beneficiaries and Amounts

In 2001, approximately one in six Americans receive Social Security, and 98% of workers are in jobs covered by Social Security. Today's beneficiaries have changed substantially since the program was started. Fewer than a third are retirees (classifications: 56% are disabled, 31% are retirees, and 13% are children).

Over the past 40 years, recipients have increased three times and their benefits 35 times. For example, in 1960, 15 million people received $11 billion from Social Security; in 1970, 26 million received $32 billion; in 1980, 35.5 million received $120 billion; and by 1999, 44.5 million people received $386 billion.

Who Pays and Who Receives Social Security?

Everyone who works (with the exception of some federal employees) pays Social Security. For employees who are not self-employed, exactly 6.2% of the employee's salary is automatically deducted by the employer from wages plus a matching sum from the employer and forwarded to Social Security. For example, if an employee is paid $100 in wages, $6.20 is deducted from the employee's salary plus another $6.20 contribution from the employer, or $12.40. Those who are self-employed must deduct the full 12.40% of their wages for their Social Security contribution. These proportions are effective up to $72,600 in salary. Any salary above this level has no Social Security deductions. Thus someone earning $72,600 and a person earning $10,000,000 pay the same amount of Social Security.

An additional 1.45% is taken out of the employee's salary for Medicare and Medicaid combined, plus the employer's matching contribution of 1.45%. Those who are self-employed pay 2.90%. There is, however, no salary limit.

The combined contribution of Social Security, Medicare, and Medicaid is therefore 7.65% for employees plus 7.65% for employers, and 15.3% (with the Social Security limit of $72,600) for the self-employed. All three deductions are shown on the worker's payslip and W-2 Form as FICA (Federal Insurance Contributions Act).

The qualifications for receiving Social Security benefits are hardly stringent. An individual has to earn "credits" (each $780 of earnings earns one credit). Four credits per year are needed, or 4 x $780 = $3120 per year to qualify. It is impossible to earn more than four credits in any one year regardless of salary. However, an individual needs 40 credits, or 10 years of at least $3120 in annual earnings, to qualify for benefits. These benefits mainly start at age 65 for retirees, with penalties for early withdrawals and bonuses for withdrawals after 65. The benefits are essentially based on the average earnings for a lifetime's work. For most people, this is an average of their highest 35 years of salary.

What About Benefits?

Benefits are reduced by five-ninths of 1% for each month that benefits are taken before full-retirement age. This is approximately a 20% reduction if the worker retires at age 62 (the earliest permissible age). Those born after 1937 will have retirement ages above 65, and consequently will face deeper cuts if they retire early. For example, those born in 1941 must work until they are 65-years-and-eight months-old to receive full benefits. Beginning in 2003, the retirement age will gradually increase until it reaches 67.

Cost-of-living (COLAs) benefit increases begin at age 62, and are added continually until the worker retires and begins drawing benefits. These COLAs are based on the Consumer Price Index. For example, the adjustment for 1999 was 2.4%, so all benefits were increased by this percentage starting in January 2000 (www.ssa.gov/OACT/COLA).

Individuals can work beyond retirement age, with benefits automatically increasing by a certain percentage each month. For example, if retirement age is 65 and an individual born between 1931 and 1932 works until age 70, the annual benefit increase is 5%. (Benefits may be taxed if the retiree has taxable income in addition to Social Security).

Choosing the Retirement Date

It is a good idea to contact a Social Security office a year before the retirement age is reached. Note that some months are better than others to start retirement. Recorded information and services are available 24 hours a day, seven days a week, via telephone (1-800-772-1213). Representatives are available between 7am and 7 pm on business days. However, the best method is to plan your retirement first and then ask the questions (www.ssa.gov).

How Much Will You Receive?

Individuals can calculate their own benefits using the "Benefits Planner" (www.ssa.gov). The calculators in the Benefits Planner can provide accurate assessments or approximations. For example, a person earning around $40,000 per year should get about $1,300 per month. Family benefits are more difficult to calculate. They depend on the amount of the retiree's benefit and the number of qualifying family members. The family members who qualify include spouses older than 62 unless caring for the retiree's child who is under age 16 or is disabled; former spouses age 62 or older; children up to age 18, or between 18 and 19 if a full-time student past the twelfth grade; and disabled children over age 18.

In general, however, Social Security will probably not provide enough for rent, mortgage, or car payments. Consequently, most people should plan to have other sources of income when they retire if their dwelling and vehicle have not been paid off.

Conclusion

Social security will be around for awhile and will continue to meet general living expenses. There is currently considerable debate whether to follow the example of several European countries and privatize part of the individual's contributions. There is no doubt that a major change is required if the fund is to stay viable after the next 20 years or so. Any decision will take courage. But as the decision is unfortunately a political as well as an economic one, it does not seem likely that much will be done in the near future.