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summaries

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Addressing Social Security's Underfunded Status

The Social Security Old Age, Survivors and Disability Insurance program (OASDI) provides payments to retirees, surviving family members of workers, and disabled workers. Over the program's 80-year history, it has collected roughly $19.0 trillion and paid out $16.1 trillion, leaving reserves of between $2.8 and $2.9 trillion as of the end of 2015. That may sound like a lot of money, but according to the latest annual report from the Social Security Trustees, the combined Social Security trust funds are projected to be depleted by 2034.

Social Security plays a critical role in the long-term financial plans for most of our clients. As the program stands today, the maximum retirement benefit for a worker who elects to start receiving payments at their full retirement age (66) in 2016 is $2,639 per month, or $31,668 per year. Of course, the calculation of Social Security retirement benefits depends on how much a worker paid into the Social Security system and when they elect to start receiving benefits (workers and their spouses can claim retirement benefits as early as age 62 and as late as age 70).

When we are helping clients with Social Security planning, the question of whether or not their retirement benefits are going to be reduced comes up often. After the most recent election results, I've spoken with several retirees who now have a heightened fear that the incoming administration is going to go after their Social Security retirement benefits. After all, the program is on an unsustainable path as the bulk of the Baby Boom generation enters retirement. However, we don't feel that a reduction in benefits for the majority of current Social Security retirees is likely.

When looking at the fundamentals that drive the funding status of the Social Security OASDI program, there are a number of adjustments that can and likely will be made before the benefits of current retirees are reduced. The remainder of this piece focuses on potential changes that may take place within the old age and survivors portion of the Social Security OASDI program because this is the portion of Social Security that affects almost every one of our clients. There are also potential changes to the disability portion of the program, but we will table that discussion for another time.

Adjusting full retirement age

When the Social Security Act of 1935 was passed under Franklin Delano Roosevelt, the original full retirement age for receiving benefits was 65.

According to the Social Security Administration, life expectancy at birth in 1930 was 58 for men and 62 for women. The system was built under the assumption that workers would retire at 65 and draw benefits for just a few years on average. Today, the UN World Population Prospects Report estimates that children born in the United States have life expectancies of 76 and 81 for males and females, respectively. This represents an increase in life expectancy of more than 18 years for the average American newborn over the last 85 years. At the same time, the full retirement age for the youngest Social Security participants (those born after 1960) has only been increased by 2 years to age 67.

Our anticipation is that the full retirement age for Social Security retirement benefits will be pushed back significantly for those who are many years away from collecting. While there are no guarantees, we are of the opinion that those who are a decade or less away from their current full retirement age are likely to be unaffected by these changes. However, participants who are in their 20's, 30's, and 40's may see a gradual phase-in of older retirement ages based upon birth year, with the youngest of today's workers potentially looking at a full retirement age in their early to mid-70's.

As the long-term health prospects of the average American continue to improve, an older retirement age does a couple of things for the Social Security trust funds. First, it pushes back the date that an average worker will start receiving benefits. Second, and perhaps more importantly, many of today's younger workers will be physically and mentally able to stay in the workforce longer than previous generations, which means that their contributions into the Social Security trust funds may continue for much longer than previously expected.

Increasing the level of wages that are subject to the Social Security portion of FICA

Social Security is currently funded through the Federal Insurance Contributions Act (FICA) by way of a 12.4% tax on wages; 6.2% is paid by the employer, while the other 6.2% is paid by the employee. For 2016, this tax is due on all wages up to $118,500. To put this into historical context, the original Social Security tax was equal to 1% from the employer and 1% from the employee on the first $3,000 of wages.

We can envision a scenario where the Social Security portion of FICA is applied to a higher and higher wage base over time in order to improve the long-term financial stability of the program. At present, Social Security taxes are paid on all wages up to $118,500 and workers are given incremental credits for each tax dollar that is paid into the system. Once a worker goes above $118,500 of annual wage compensation in 2016 they stop paying in for the year and stop accruing incrementally higher benefits. A simple edit to the computation of benefits could result in a scenario where benefits stop accruing at a wage base limit of $118,500, but employees and employers continue to pay FICA tax on wages well in excess of $118,500.

When it comes to current retirees worrying about having their benefits cut, we tend to think that the amount of wages that are subject to taxation will be increased significantly before any cuts in benefits take place. While this adjustment would not likely affect current Social Security recipients, high wage earners and their employers would have to navigate higher FICA taxes.

Means testing benefits

The Social Security Administration could also improve the overall stability and long-term viability of the OASDI program by means testing retirement benefits. This is a sensitive subject for those who have paid into the system for their whole career and won't be reliant on Social Security in retirement, but want to see a 'return on their investment'.

Means testing refers to a determination of whether an individual or family is eligible for a benefit, based upon whether the individual or family possesses the means to do without that help.

Means testing can be income or asset based, with the former probably being easier to implement than the latter. If a retiree has several hundred thousand dollars of annual income or tens of millions of dollars in assets, there is a chance that their retirement benefit could be reduced or eliminated. However, because a relatively low percentage of the retiree population is likely to exceed certain income and asset test limits, means testing may be the least impactful adjustment of the three that have been suggested in this piece.

The bottom line

There is no denying that the current path that Social Security is on is unsustainable. Further, the manner in which the current system is going to be altered to avoid a depletion of the Social Security OASDI trust funds hasn't been spelled out clearly for the general public. However, we tend to believe that there are a number of adjustments that can and likely will be made prior to a reduction in benefits for the bulk of current retirees and those who are close to full retirement age. These options include increasing the full retirement age for younger workers, raising the maximum level of wages that are subjected to the Social Security portion of the FICA payroll tax, and means testing benefits for the wealthiest recipients.

Last, but certainly not least, implementation of policies that lead to higher labor force participation, wage growth, and a higher rate of overall economic growth would certainly help the long-term viability of the Social Security OASDI trust funds by way of higher overall contributions.

We would like to encourage our clients to reach out with any questions that they may have regarding Social Security. This may include assistance with determining benefits, discussing various claiming options, or simply discussing how Social Security fits within one's overall financial plan.

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