Social Security

By Kevin Chambers

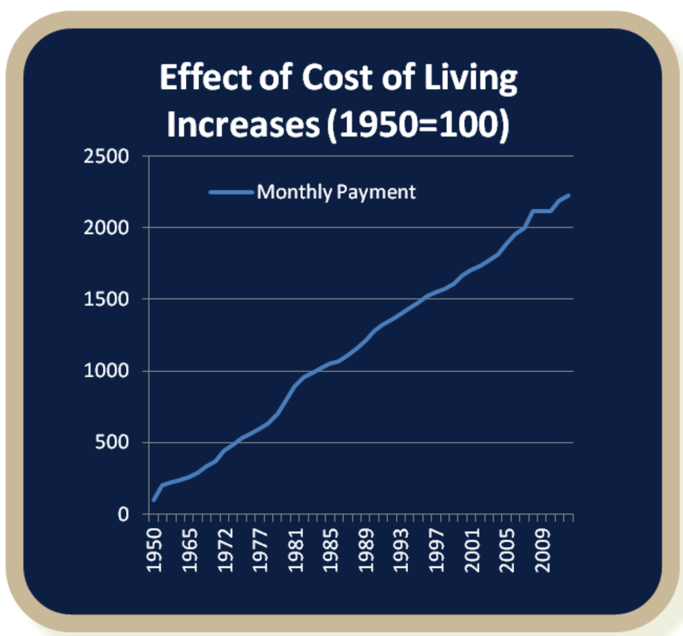
Social Security is often a topic of policy discussion and political division. On a more fundamental level, Social Security is an integral part of retirement income for many retirees. Unfortunately, deciding when to start taking social security, and how to maximize benefits, can be confusing. Let us provide a bit of background into the system and hopefully demystify some questions surrounding Social Security.

History

The 1930s was a pivotal decade in American history, as the country struggled through the Great Depression and transitioned into wartime. President Franklin D. Roosevelt's New Deal, instituted in 1933, was in part an effort to lower the unemployment rate. By 1935, the unemployment rate was still 20%, leaving 10 million Americans out of work. There was also concern about the well-being of the nation's elderly, many of whom lost everything in the market crash. FDR enacted his second phase of New Deal programs, starting with Social Security. The Social Security Act was signed into law by FDR in August, 1935. It provided unemployment insurance and old-age pensions. The program was funded by new taxes on employers and employees. Roosevelt considered social security the "cornerstone of his administration" (Kennedy 1999).

How it Works

The Social Security Administration (SSA) has many rules, laws, and calculations that determine how much each individuals benefit will be. To be eligible for Social Security, you need to work for a minimum of 40 quarters, or an accumulative total of 10 years, earning a minimum prescribed amount, which has been adjusted over the years. In 2014, the required quarterly earnings are $1,200, or $4,800 over the year. Each eligible quarter earns a worker one Social Security work credit. No matter how much you earn, the maximum credits any worker can acquire in one year are 4. Over time the SSA increases the payments to keep pace with inflation. This is called a Cost of Living Adjustment or "COLA".



Source: SSA Annual Statistical Supplement

The SSA uses three factors when determining how much the insurance payments will be (Blankenship 2011):

1) Full Retirement Age (FRA)

At Social Security's inception, full retirement age was 65. In 1983 the Social Security Act was amended to change FRA. Starting with people born in 1938, the FRA was increased periodically every year. For those born in-between 1949-1959, the FRA is between 66 and 67 years old. The early retirement age, 62 and the late retirement age, 70, have stayed the same. Now, everyone born after 1960 has a FRA of 67. FRA is a key figure in determining a person's benefit level.

FULL RETIREMENT AGE

YEAR OF BIRTH	ELIGIBLE AT:
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 or later	67

2) AMIE/PIA

The next step to calculating the benefit amount is determining the amount of money a worker has earned over the course of their life. This determines the amount they have put into the insurance program and thus the equivalent amount they should receive from the program. First, the SSA needs to calculate the Average Indexed Monthly Earnings (AIME). Basically, each year you work, the SSA records the amount of your wages. When you are ready to retire, they only consider the 35 years in which you made the most money. They take the average of those 35 years and divide it by 12 to get a monthly average. Most importantly, understanding AIME shows why working longer usually gives a worker a higher social security payment. Most workers are making their peak income at or near retirement, so continuing to work will raise the AIME as the average will increase. However, if you happen to make a lower amount in the last couple of years of employment, your AIME will not change as the calculation is based on the 35 years in which you made the most money. This is not the benefit you will receive in retirement, but a contributing factor in the final calculation that produces the Primary Insurance Amount (PIA). The PIA is the projected amount a worker can expect to receive in social security benefits. The calculation is quite complicated, so instead of going into detail here, just know that you can look up your PIA online, without bothering trying to calculate it yourself.

3) Age to Start Benefits

Finally, the SSA uses the age of the worker when social security is triggered. At 62, anyone can start to take social security. However, every month before reaching FRA will be discounted. For example, triggering 36 months early will decrease the benefit by 20%. In the same vein, delaying taking benefits beyond FRA will increase your benefit, depending on birth year, by about 7%-8% a year. The maximum age to delay is 70.

Spousal Benefit

The spousal benefit is another social security rule that could impact a household's benefit amount. Like the calculation of benefits, spousal benefit is another confusing aspect of social security. One of the reasons explaining spousal benefits get convoluted are the infinite hypothetical scenarios. Basically, if one spouse was a significantly higher earner than the other spouse, the lower earner qualifies for 50% of the higher earner's PIA. As an example, let's say that George and Mary are married. They are both at FRA of 67. George's Social Security benefit is $2,000 a month, Mary's is $800. Mary will actually qualify for 50% of George's benefit and get a monthly check for $1,000. This example assumes the easiest scenario (Blankenship 2011).

Mary will not qualify for half of George's benefit until George triggers. Therefore, if Mary starts taking social security before George, she will only qualify for her benefit. In an instance where Mary and George are different ages, there will also be a reduction in Mary's benefit if she triggers before her FRA. For example, let's say that Mary triggers at 62 and George triggers at 67 (FRA) in the same year. Mary would only be eligible for 35% of 50% George's benefit.

In the instance of a death of a spouse, if the widow or widower was receiving a lower amount in social security, then the surviving spouse would inherit the partner's higher benefit and forgo their own (Blankenship 2011).

When to take Social Security

Now that we have a background on how social security is calculated, we can talk about some of the strategies of when to start taking it. Tempting though it is to start payments as early as possible, triggering at age 62 comes with some costs. First, you waive the right to future increases in the social security payments. As discussed earlier, when triggering at 63 versus at 66, the social security payment will raise at about 6.6% every year. Plus, by triggering earlier you will not get all of the benefits of possible Cost of Living Adjustments (COLA) increases (Fidelity Viewpoints 2013). With bank interest rates still very low, this is an implicit way get risk free return.

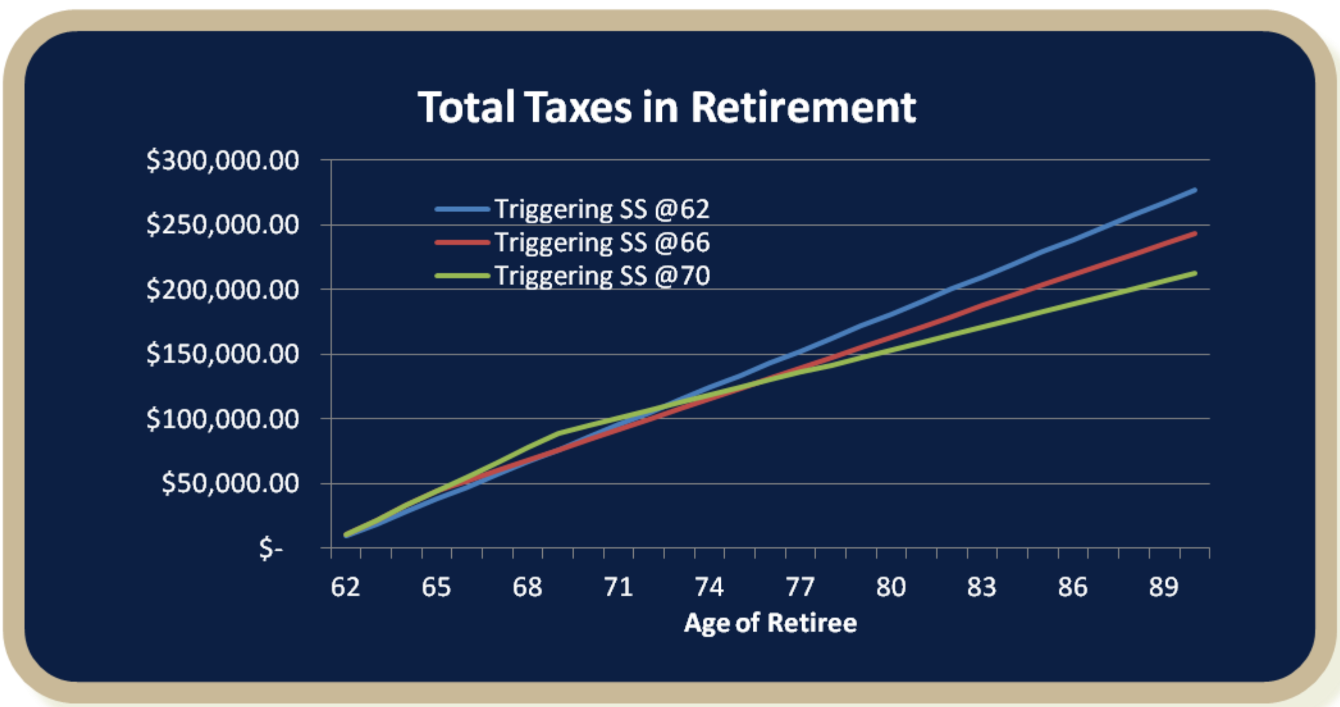
"I PLEDGE YOU, I PLEDGE MYSELF, TO A NEW DEAL FOR THE AMERICAN PEOPLE."
- FRANKLIN D. ROOSEVELT

For couples, another factor to consider is trying to maximize the survivor benefit. When one spouse dies, the other is eligible to start receiving the deceased's benefit if it is higher than his or her own. By triggering social security early, a higher earning spouse may be limiting the potential benefit his/her spouse will receive after his/her passing (Fidelity Viewpoints 2014).

Another strategy that couples can use to maximize social security is called "file and suspend." For spousal benefits to take effect, the higher earning spouse has to be at FRA and start taking social security benefits. The SSA allows the higher earning spouse to file for social security, then immediately suspend the benefits. This allows the lower earning spouse, as long as he/she is at least 62, to start receiving the spousal benefit. This strategy is only applicable in a few rare occasions. One scenario is the higher earning spouse wants to keep working past FRA, and his/her spouse is retired, and the spousal benefit would be significantly higher. There are occasions when it may make sense to allow the higher earning spouse's social security benefit to continue to grow. This strategy allows the couple to receive a slightly higher benefit now. The file and suspend strategy can be a powerful tool, but is specific to each unique situation.

Like File and Suspend, our last strategy allows a couple to start taking social security, but allow one of the benefits to continue to grow. In this plan, the lower earning spouse takes social security first, and the other spouse files for the spousal benefit. Then they let the higher benefit grow until the maximum, when the higher earning spouse is 70. Then that spouse stops the spousal benefit, and starts taking their own. The lower earning spouse, however, cannot take the spousal benefits on the new higher payment. This is because only one member of a couple can file for spousal benefits. This strategy can be effective for couples that can afford to relinquish some of their social security benefits for a few years. It is also most effective for couples for which neither couple would qualify for a spousal benefit because their own individual benefit amounts are over 50% of the others. Again, this is a strategy that can be very effective, but you should make sure that it applies to your situation before making any decisions (Fidelity Viewpoints 2014).

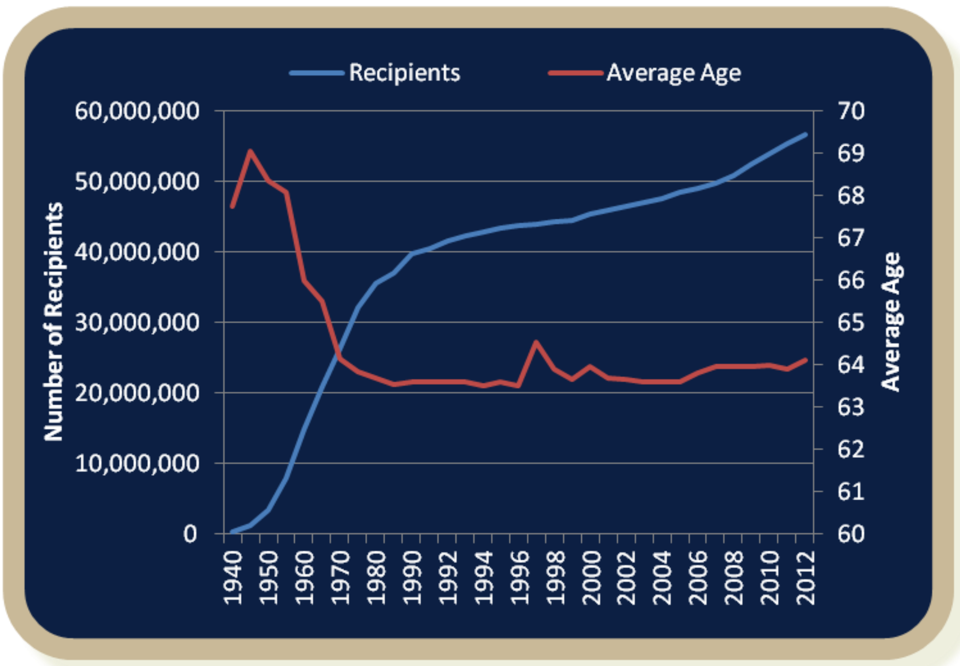
There can also be some tax benefits to delaying social security. For most retirees, delaying social security means they are going to be living off assets in an IRA or other retirement account. This strategy can end up saving taxes in the long run. This might be counter intuitive because keeping money tax-deferred in an IRA makes sense, even if it means you take less social security. However, this might not always be the case. The difference is made up because social security is only about 85% taxable. Therefore, the more of your required income you can cover with social security, the better (Blankenship 2011).



Source: A Social Security Owner's Manuel, Jim Blankenship

The Future of Social Security

In recent political discussions about entitlement spending in America, the future of Social Security seems to be in doubt. However, Social Security is one of the most popular government programs (Desilver 2013). This is probably because it benefits about 58 million Americans paying about $69 million every month. Social Security is known as a "pay as you go" system (Blankenship 2011). This means that the current generation of workers pays for the current retiree's benefits. The Baby Boom threw off this system. As the baby boomers entered the work force they paid



Source: SSA Annual Statistical Supplement

much more into the system, then the SSA paid out. The surplus was invested in treasury bonds and put into two trusts (one for retirement benefits, one for disability). Now that the baby boomers have started taking benefits, the current work force cannot support their benefits. There are more recipients and the average age that people are starting to take social security has not changed materially for 40 years, even though Americans are living longer than ever before (see below chart). This is the essential problem when you hear about social security going broke. This sentiment is slightly misleading. Because there are not as many workers as retirees, and Americans are also living longer than expected when the system was introduced, the system is dipping into the trust fund to cover the gap. Until 2020, the interest of the trust fund will cover the short fall, but then the SSA will be eating into the principal of the trust. Currently, the SSA estimates that the trust fund will run out by 2033. At this point there will still be tax revenue, but it is estimated to be enough to cover only about ¾ of all benefits (Desilver 2013).

As a result of Social Security facing this funding gap, legislation will be required. Considering its popularity, Social Security will probably not go away. There are 4 main actions (Kubarych 2004) that can be taken (or a combination of them) as possible solutions to the social security shortfall:

Lower Benefits:

In any budgetary situation, if costs are larger than revenues, the most obvious solution is to reduce costs. This could take the form of across the board decreases, a change in the COLA calculation, closing loopholes, or other changes in the law. Decreasing benefits could have significant impacts on millions of seniors in America. During the budget negotiations of 2013, Congressional Republicans offered up a plan that would change the way the SSA calculates the COLA adjustments, essentially lowering the benefits across the board (Editorial 2013). This proposal was hugely unpopular and was not enacted. However, we could see stricter limits on who is allowed to take social security, for example those who already have large IRAs or 401(k) might be excluded from taking social security (Blankenship 2011).

Raise Taxes:

By raising taxes, the SSA could cover the gap that will exist when the trust funds run out. This is probably the most unpopular among voters, thus the hardest political action. Especially with the anti-taxation rhetoric prevalent in Washington, this seems a fairly unlikely solution.

Raise the Retirement Age:

This solution would not affect current retirees. As life expectancies have increased, some policy makers think it makes sense that Social Security benefits should be pushed back farther too. People are more physically fit; therefore, they can work for longer. However, opponents of this idea claim that it unfairly affects poorer Americans, as hard labor jobs are harder to continue versus white collar jobs.

Privatization:

The fourth option is to privatize some or the entire social security pension. This would allow the assets of the pension to be invested much like IRAs or 401(k)'s. Currently the SS security trust is only invested in safe government bonds that are yielding very low interest. Most privatization plans opt to move out of the pay as you go system into an "advance funding option" (Cornwell 1997). An advance funding option would create a defined benefit plan as a part of the social security tax (Schieber 1999). Opponents of privatization plans claim it would be a boon for the financial industry and introduce too much risk into the traditionally 100% reliable retirement income.

It is impossible to know exactly how Social Security will be reformed. However, if we want to continue this program for the next 75 years or longer, some type of change has to be made. A study by the National Academy of Social Insurance (NASI), a non-profit, non-partisan, research organization, used an online survey and focus groups to find out how most Americans think Social Security should be fixed. The survey found that 82% agreed that preserving Social Security is critical even if it means raising taxes paid by working Americans and 87% believe in raising taxes on wealthier Americans (Tucker, Reno and Bethell 2013). Obviously, there is no easy solution, especially when the two easiest things to do are raising taxes or cutting benefits. One misconception is that social security will one day not exist. This is impossible, as tax revenues will always be able to partially fund it.

Conclusion

Social Security calculation is perplexing because each person or couple has a completely unique situation. Everyone gets a different amount based on their work history. The rules and laws that dictate Social Security are complicated and apply only to certain people in certain situations. It is important to remember to always consult with the SSA and find out your benefits and the best way for you to maximize them. Although we are not experts, Headwater Investment Consulting does our best to stay on top of the issues and workings of Social Security. We are happy to answer any questions you may have and work with you to try and find the best solution.

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