

SOCIAL SECURITY

Q & A

Center for American Progress



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Q: *What is Social Security?*

Social Security's official name is Old-Age, Survivors, and Disability Insurance (OASDI). It essentially insures workers and their families against the potential loss of earnings due to retirement, disability and death. Almost all U.S. workers pay for Social Security through their payroll taxes (FICA) and employers match the amount contributed by their employees. Currently, employers and employees each pay 6.2 percent of payroll, on the first \$90,000 of earnings.



Social Security offers basic benefits that help retired workers, disabled workers, or the survivors of deceased workers to stay out of poverty. In 2000, 40 percent more people over the age of 65 would have been living in poverty if not for Social Security.

However, Social Security's benefits provide only a basic minimum. The average monthly benefit was \$840.60 in 2003.

Q: *Who can get Social Security benefits?*



Social Security benefits are earned insurance benefits. Workers become eligible for retirement and disability when they have contributed to the system for a certain amount of time. For retirement benefits, the minimum is 40 quarters or about 10 years. The time necessary to reach eligibility for any of the benefits varies from benefit to benefit. Also, the surviving spouse and children of a worker are eligible for survivorship benefits if a worker dies.



Q: *How are Social Security benefits calculated?*

Since Social Security is an earned benefit, benefit levels vary according to a worker's lifetime earnings. For example, since women tend to have lower earnings than men, their benefit levels also tend to be lower. In 2003, the average monthly retirement benefit for men was \$1,038.70, while the average benefit for women was \$797.60. Because it is an insurance program, Social Security benefits are progressive, redistributing income from high to low lifetime earners.



Q: *What kinds of benefits does Social Security provide?*

The benefits Social Security provides are similar to those provided by insurance companies. Disability and survivorship benefits resemble life insurance. Retirement benefits are guaranteed monthly benefits that increase each year at the rate of inflation, and thus are similar to inflation adjusted lifetime annuities.



Contributions to Social Security are based on a worker's earnings. Consequently, any benefit from Social Security depends on the number of years a worker has contributed to the program and on the earnings during those years.

Workers are entitled to their full retirement benefits once they reach the normal retirement age, which is between 65 and 67 depending on year of birth. Additional benefits can be paid for dependents, such as elderly parents or children, or for spouses, who receive either their own benefit or 50 percent of their spouse's benefit, whichever is larger.

Disability benefits are payable to workers no longer able to work. Survivorship benefits are paid to a surviving spouse and dependent children upon a worker's death.

Q: *Is Social Security still important?*

Social Security has increased in relative importance as retirement income adequacy has declined. Underlying this trend are three factors. First, pension coverage has remained low and declined in recent years. Second, retirement wealth has become distributed increasingly unequally.

Finally, the increased use of defined contribution employer-based pension plans, such as 401(k)s, has shifted risk and investment responsibility onto workers.



In comparison, Social Security's coverage is almost universal; 97.7 percent of households nearing retirement in 1998 could expect some Social Security benefits. Social Security favors lower earners because it offers higher relative benefits to lower-lifetime earners. Finally, it has guaranteed, lifetime, inflation adjusted benefits, and these are particularly valuable for older retirees as they begin exhausting their savings.

Q: *Why are people talking about reforming Social Security?*

Social Security is not going bankrupt. Social Security is a successful government program that is facing neither an immediate crisis nor some explosion of costs that will place an onerous burden on society. Instead, Social Security may face a financing shortfall after 2041 if the pessimistic assumptions of



Social Security's trustees pan out. Even then, a number of options within the system are available to pay for the shortfall, such as tax increases, new government debt, or benefit cuts. An immediate and permanent 1.92 percent increase in the payroll tax, for example, would allow Social Security to pay all its promised benefits for at least the next 75 years. It is a policy question of how we want to pay for Social Security, not an economic inevitability that requires us to restructure the program.



Q: *How does the financial future of Social Security look?*

In their annual report for 2005, the trustees project that Social Security will take in more than it will pay until 2017.

Between 2017 and 2027, interest income earned on the trust fund assets is forecasted to make up the difference between income and expenditures. After

2027, Social Security is expected to draw on its trust funds to pay for the expenditures that are not covered by income. Finally, in 2041, the trust fund surplus is expected to be depleted, and annual revenue into the program is projected to be less than expenditures. However, the trustees project that Social Security will still be able to pay between two-thirds and three-quarters of its promised benefits from 2042 to 2081, the farthest date they project.



Q: *How do the trust funds work?*



Social Security has two trust funds: one for the retirement and survivorship parts of the program, the other for disability. Social Security has been building up its trust funds since 1983 in preparation for the baby boomers' retirement. When the baby boomer retirement is underway, Social Security will draw on these accounts to help pay for promised benefits.

Because income is currently exceeding expenditures, Social Security is accumulating assets in its trust funds. In the beginning of 2005, Social Security held just over \$1,690 billion in assets. Though the size of trust fund assets may seem very large in absolute terms, it is not large relative to the size of the program.

The Social Security trust fund assets are invested in special non-tradable government bonds. This investment allocation was chosen because government securities are the most secure financial investment. During 2004, the effective annual interest rate earned on the bonds held by the trust funds was 5.7 percent, a rate similar to the market interest rate for tradable government bonds.

Q: *Are private accounts a viable substitute for Social Security?*



No, private accounts cannot substitute for Social Security's guaranteed benefits. We are discussing two different systems: private accounts are individual savings accounts, whereas Social Security is a social insurance program.

Q: *What are some important considerations with Social Security privatization?*



Social Security privatization has become a hot button issue. With privatization, part of Social Security would be replaced with individual accounts. Based on estimates by the Social Security trustees and the non-partisan Congressional Budget Office, it is clear that privatization will entail more government debt, fewer benefits, and greater risks.

Privatization means that money that is currently used to pay for benefits is diverted into individual accounts. Since Social Security has already promised benefits to workers and retirees, this diversion of funds creates a new financial hole. According to estimates by the Social Security trustees, Social Security would need more than \$2 trillion immediately, which would, together with interest earnings, pay for the creation of individual accounts. In other words, privatization would make Social Security's long-term financial outlook worse, not better.



To improve Social Security's financial outlook, those who favor privatization have proposed sharp benefit cuts. For younger workers, these cuts could be between 45 percent and 50 percent compared to currently promised benefits. According to estimates from the non-partisan Congressional Budget Office, savings in individual accounts will compensate for only part of the lost benefits. As a result, younger workers can expect to have more than 20 percent fewer benefits than they could expect under the current Social Security system.



At the same time that workers could expect to have fewer benefits, they would also face greater risks. These risks include the risk of individuals making unlucky or unwise decisions as well as the risk that financial markets could stay down for long periods of time, providing retirees with a lot less money than they had expected. These and other risks ultimately translate into higher costs for workers. Higher costs, though, will reduce retirement savings. The Congressional Budget Office estimates that administrative costs alone would reduce savings by 20 to 30 percent over a 40-year career.

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