National Center for Policy Analysis

Social Security:

Your Taxes, Your Benefits, Some Alternatives

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& Devon Herrick, NCPA Manger of Research

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A Publication of the National Center for Policy Analysis

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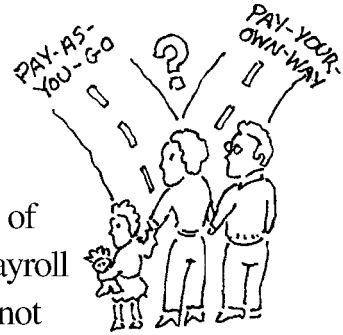
Social Security at the Crossroads

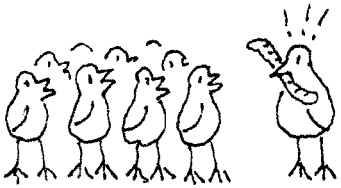
Whether you're a steelworker or a waitress, a bus driver or an accountant, a large part of your earnings goes to the Social Security payroll tax every pay period. If you work for somebody else, part of the tax is withheld from your paycheck, and your employer pays an equal amount on your behalf. If you work for yourself, you pay both parts.



The government keeps a record of what you've paid in, but the payroll taxes you are paying now are not held by the government in an account with your name on it. Most of the money goes back out again to pay the Social Security benefits of people who are currently retired. The remainder is used to fund other government programs. This practice reflects the fact that Social Security is a "pay-as-you-go" system. That means that when you retire, your Social Security benefits will have to be funded from payroll taxes paid by future workers.

That's the way the system has worked from the time President Franklin D. Roosevelt signed the legislation in 1935 and the first benefit check was issued in 1940. But things have changed since 1940, when there were 42 people working for each person receiving Social Security payments. By the middle of the 21st century, there will be only two workers for each person drawing Social Security benefits.

Along the way, we will discover that payroll taxes paid are insufficient to pay promised benefits. Sometime in the not too distant future — the best estimate now is about 2015, when the baby boomers will be retiring — Social Security will begin paying out more in benefits than it is collecting in payroll taxes. As a result, Social Security will



face a daunting challenge: how to collect an ever-increasing tax burden just to pay benefits already promised to you and to others.

But our pay-as-you-go system is not the only way Social Security retirement pensions can be financed. By law, most private pensions provided by employers are required to be funded. That means that you and your employer make periodic payments that are invested in the assets that will be used to fund your pension after you retire.

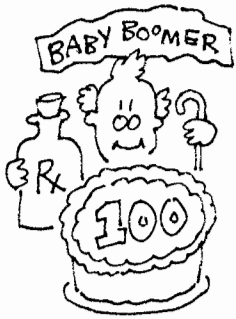
Similarly, a number of other countries have funded social security systems, where the money collected from workers is invested in assets that grow in value over time. Under these systems, each generation pays its own way, instead of looking to the next generation to pay its benefits. If the United States adopted this approach, all or part of your payroll tax would go into a personal retirement account — in your name — which would be invested in stocks and bonds. All or part of the money for your retirement benefit would come out of the principal and earnings in that account. That kind of system would mean that your retirement income would be securely funded, regardless of how many people are working at the time you retire. And it would mean the shrinking percentage of active workers would not have the burden of supporting the growing percentage of elderly people.

Choosing A Retirement Age

Since the beginning of Social Security, the "normal retirement age" — the age at which you could begin drawing your full benefit — has been 65. It still is for those nearing retirement today. However, you can retire as early as age 62 with a Social Security benefit permanently reduced by a certain percent for each month you fall short of the normal retirement age.

For example, you can retire at exactly age 62 for a 20% smaller monthly benefit. Or you can continue to work past age 65, with your benefit increasing each year you delay retirement until you reach age 70. The amount of increase varies, depending on the year you were born.

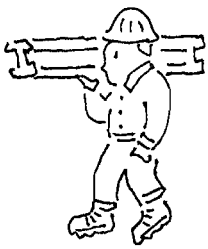
Although 65 is the normal retirement age for those near retirement, it is scheduled to increase for younger workers, as a result of legislation passed back in 1983. For example, if you were born in 1938, you won't reach the normal retirement age for Social Security until two months past your 65th birthday. And the retirement age will continue increasing until it reaches 67 for anyone born in 1960 or later.

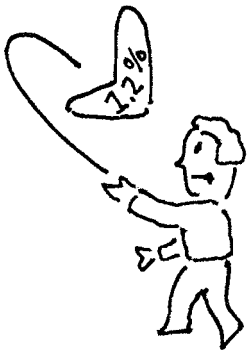


Younger workers can still retire at age 62 and start drawing a permanently reduced benefit, but the reduction will be greater than before. For example, if a person born in 1960 elects to retire at age 62, the retirement benefit will be reduced by 30%.

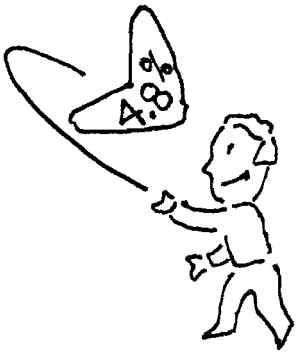
Your Stake

Almost everyone has a personal stake in Social Security. Suppose you're a 35-year-old male construction worker. If your earnings are similar to those of other construction workers, you can expect a Social Security benefit of $1,351 per month in today's dollars during your retirement. Assuming you live a normal lifespan, the real rate of return on the payroll taxes you and your employer paid for 46 years will be only 1.2%.





Now, consider what would happen if those same payroll taxes had been regularly invested, say 60% in stocks and 40% in bonds. Based on the historical performance of the markets, you could expect to retire with a $6,607 monthly benefit — an increase of $5,256 per month, or more than $63,000 per year. In this case, the real rate of return on your contributions would be 4.8%. And if you die before you've lived the typical number of years in retirement, the amount remaining in your account would go to your heirs.



(Bear in mind that the $6,607 and $1,351 numbers are in today's purchasing power. The actual number of dollars will be much higher to reflect inflation that will take place between now and the time of your retirement.)

Our projection of your benefits under the current system assumes that Social Security will continue to pay benefits at the same level in the future as in the past. But your benefits could be reduced. According to projections made by the Social Security trustees, in order to pay benefits to

today's 20-year-olds, the tax burden will have to be at least 50% higher at the time they retire. There is no guarantee that future (not yet born) taxpayers will be willing to bear that burden. Furthermore, the courts have held that you have no legally enforceable claim to Social Security benefits. Congress can reduce or alter your benefits at any time.

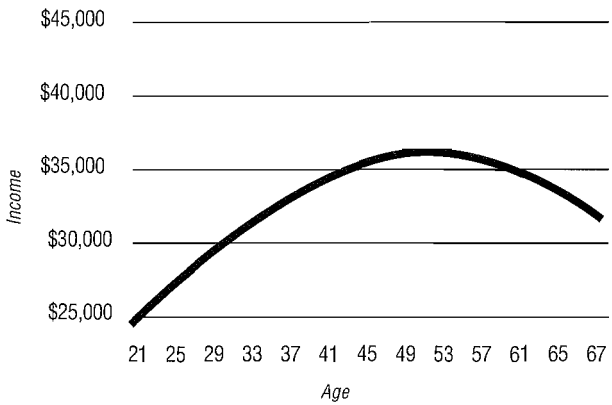
This book is designed to explain how Social Security works, how you can get reasonable estimates of your own benefits and taxes, and how you can compare your stake in Social Security with private investment alternatives. It is designed to assist you when you go online at www.mysocialsecurity.org to get your own personal information.

Male

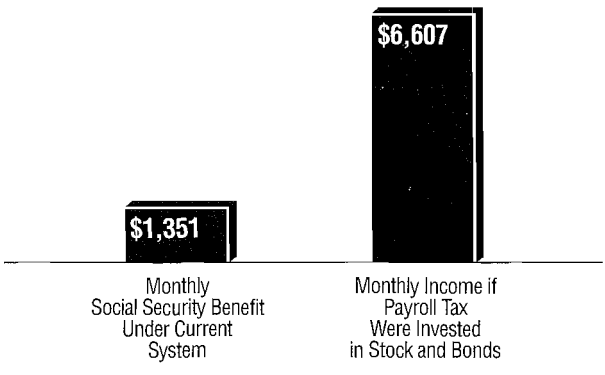
Construction Worker

Age 35 **Current Annual Earnings $35,372**

Pattern of Real Wages, Based on Historical Data



When He Retires at Age 67



Rate of return from Social Security 1.2%
Rate of return from investment 4.8%

Note: all figures are real (year 2000) dollars.

Where the Numbers Come From

The estimates in this book, and on ***mysocialsecurity.org****, come from a Social Security Calculator based on an economic model developed by the Private Enterprise Research Center at Texas A&M University for the National Center for Policy Analysis. When you enter your personal information online, you are able to use the model to make your personal calculation.*

The economic model is based on extensive historical population data compiled by the Census Bureau, including the earnings patterns of people in different occupations. It also incorporates historical rates of return on stocks and bonds, and Social Security regulations governing retirement. [Appendix A tells you more about how the calculator itself works, and Appendix B explains the rates of return used in the calculations.]

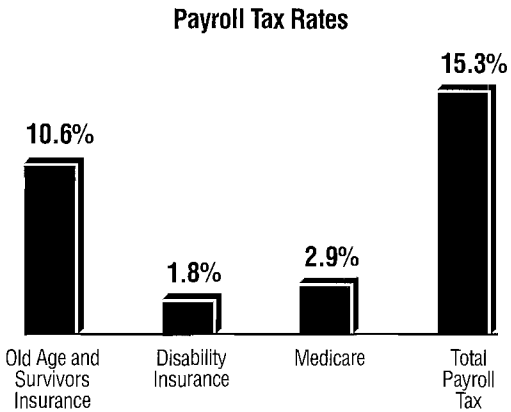
This book is designed to give you an understanding of the principles involved in our current pay-as-you-go Social Security system and in a system where each worker funds his or her own retirement beforehand. For that reason, the examples in this book, and on ***mysocialsecurity.org****, the online calculator, assume that all of your Social Security payroll tax goes into your personal retirement account rather than to the government. None of the major proposals to reform Social Security call for that to happen immediately, and none of those proposals are examined here.*

Social Security: A Short History

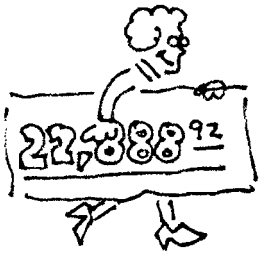
The U.S. Social Security system was born in 1935, during the Great Depression, as a tax-supported system of old-age and survivors pensions. A payroll tax, half on the employee and half on the employer, was implemented in 1937 to fund Social Security. The initial legislation covered only workers, but was amended in 1939 to include benefits for the spouse and minor children of retired workers and survivors benefits for the families of workers who died before retirement.

Beginning in 1950, Congress legislated cost-of-living increases in benefits from time to time, and later legislation provided for automatic annual cost-of-living allowances (COLAs) based on the annual increase in consumer prices. Social Security was expanded in 1956 to pay benefits to disabled workers ages 50 to 64 and to disabled adult children, and again in 1960 to permit payments to disabled workers of any age and their dependents. In 1965 the total payroll tax was increased to finance Medicare, providing health care coverage for persons age 65 and over.

In 1937, the payroll tax was only 2% (on employees and employers combined) on the first $3,000 of wages, and it only paid for retirement pensions. Today the total payroll tax is 15.3% on the first $76,200 of wages, and it pays for survivors insurance, disability insurance and Medicare, in addition to retirement pensions [see the diagram]. Wages over $76,200 are subject to the 2.9% Medicare tax only. Although the payroll tax is divided equally between you and your employer, economists generally agree that the part your



employer pays is a substitute for wages you would otherwise receive. For that reason, in calculating taxes you will "pay," we include your employer's share. Your employer may write the check, but you are ultimately the one who bears the full burden of the tax.



The first recipient of Social Security was Miss Ida May Fuller, who received a check for $22.54 on January 31, 1940. Miss Fuller and her employer had each paid $24.75 in Social Security taxes during the three years she worked while covered by Social Security. She lived to be 100 years old and collected $22,888.92 in Social Security benefits before she died.

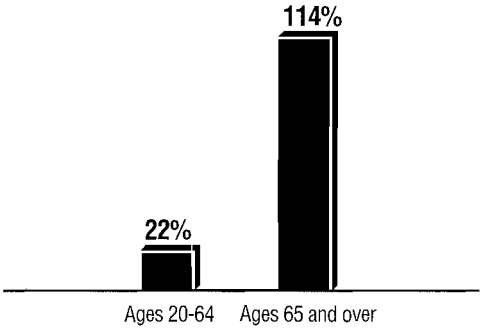
Miss Fuller made out like a bandit. But a far different future faces young workers today.

The Future of Social Security: An Aging Society

Social Security relies on taxes from today's workers to pay benefits to today's retirees, and the ratio of workers to retirees is an important determinant of the payroll tax rate needed to pay benefits. That ratio has been shrinking for two reasons: we are having fewer children and we are living longer. Both trends are likely to continue.

Demographers tell us that women of child-bearing age must have 2.1 children on the average (the fertility rate) to replace the current population. Right now, the U.S. fertility rate is only 2.06. It hasn't been over 2.1 since 1970. If that continues, our population eventually will peak and then decline. Along the way, the composition will change as the ratio of old to young continues to grow. The Social Security trustees expect the population of 20- to 64-year-olds to grow 22% over the next 45 years, while the 65-and-over population will grow 114%!

Projected U.S. Population Growth 2000-2045
(Intermediate Assumptions of Social Security Trustees)

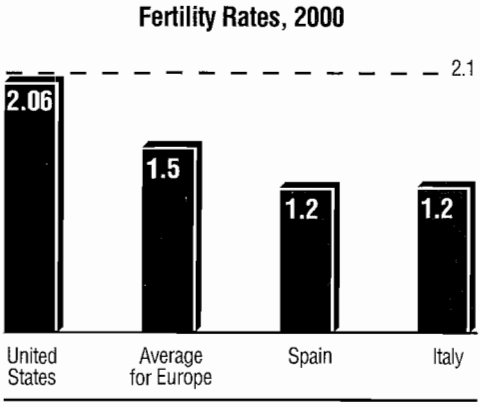


Based on to the intermediate assumptions of the Social Security trustees, the 20-to-64 age group is forecast to increase from 168.2 million to 205.6 million and the 65 and over group from 35.5 million to 75.8 million.

Source: 2000 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *intermediate assumptions, Table II, H1.*

This is not a problem that is going to go away after the baby boomers die. For the near future the total population will continue to grow. But sometime in the 21st century, it is expected to peak and beyond that point to begin to shrink. It's not a problem that's confined to the United States, either. Our fertility rate is one of the

highest among developed nations. The average fertility rate for Europe is 1.5. For Italy and Spain it's 1.2. The United Nations Population Division projects that the population of the entire world may be decreasing by the end of the 21st century.

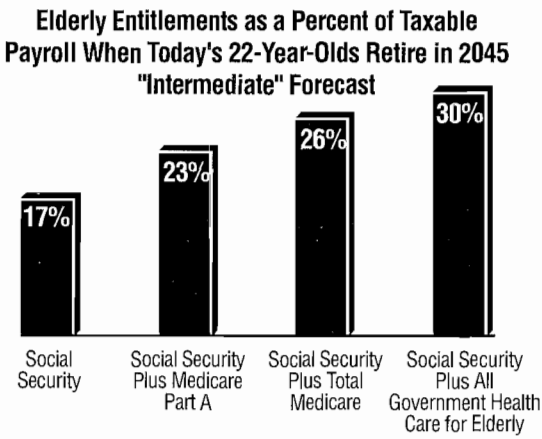


Source: U.S. Census Bureau.

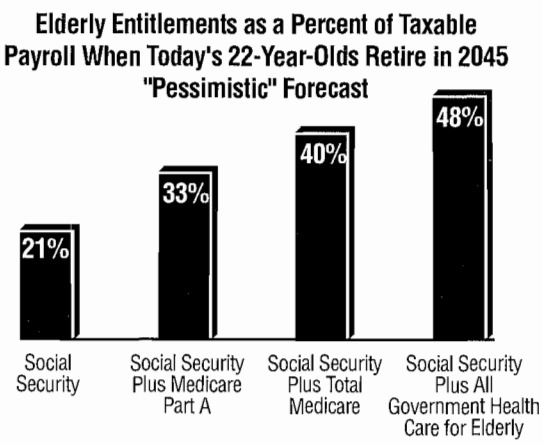
All this spells trouble for pay-as-you-go Social Security systems everywhere. If fewer babies are being born to grow up to be workers paying payroll taxes and, at the same time, people are living longer and drawing more retirement benefits, it will be more and more difficult to pay the benefits to the growing proportion who are retired out of payroll taxes collected from the dwindling proportion who are working.

There have been warnings from some quarters for more than a decade. For example, Federal Reserve Chairman Alan Greenspan said in a 1996 speech, "It is becoming

conventional wisdom that the Social Security system, as currently constructed, will not be fully viable after the so-called baby boom generation starts to retire in about 15 years."



Source: Social Security and Medicare Trustees Reports (First three columns) and NCPA calculations.



Source: Social Security and Medicare Trustees Reports (First three columns) and NCPA calculations.

By 2045, when today's 22-year-olds retire, paying retirement benefits will require anywhere from 17% (intermediate assumptions) to 21% (pessimistic assumptions) of the taxable payroll, based on the forecasts of the Social Security Administration trustees. By contrast, today we need less than 10% of taxable payroll to pay

retirement benefits. When elderly medical care benefits are considered, the future burden will be even greater. Under the Social Security trustees' intermediate assumptions, elderly entitlements will consume 30% of the nation's taxable payroll by 2045. If their pessimistic assumptions turn out to be correct, that figure could be 48%. That's almost half of workers' incomes off the top — before they and their families meet any personal needs, before teachers and police officers are paid, before roads and bridges are built, and before every other government program is funded!

What About the Social Security Trust Fund?

You may have heard or read that the Social Security trust fund has billions of dollars in it that can be used to pay future benefits. Unfortunately, that is not the case. To repeat: Social Security is based on pay-as-you-go finance. Every dollar collected in payroll taxes is spent — the very minute, the very hour, the very day it comes in the U.S. Treasury's door. No funds are being stashed away in bank vaults. No investments are being made in real assets. Most of the money is immediately spent on benefits. Any surplus is spent on other programs. Nothing is saved.

Most countries with pay-as-you-go retirement systems don't have trust funds. The United States does have one, but it has no practical function other than an accounting one. Every Social Security benefit check is written on the U.S. Treasury. Every payroll check sent to Washington is written to the U.S. Treasury. The trust fund does not actually collect taxes, nor does it pay benefits. The trust fund exists solely to perform a record-keeping function. Technically, it holds interest-bearing bonds that represent the accounting surplus of payroll taxes collected minus benefits paid. But those bonds are not counted as part of the government's outstanding debt. The Social Security trustees cannot sell them on Wall Street or to a foreign investor. They can only return them to the Treasury. In this sense, the bonds are nothing more than IOUs the government has written to itself.

On paper, the Social Security trust fund has enough IOUs to pay benefits for about 26 months on any given day. In reality, it can't pay anything. Every asset of the trust fund is a liability of the Treasury. Summing accounts over both government agencies, the balance is zero. The only way the Treasury can write a check is if it first collects taxes or borrows money.

What would the effect be if the trust funds were simply abolished? Nothing, really. No private bondholders would suffer, and the government would not be relieved of any of its existing obligations or commitments. The late economist Robert Eisner suggested that we abolish the trust fund or, with the stroke of a pen, double or triple the number of IOUs it holds. Either option would allow us to dispense with talk about an artificial crisis (the trust fund) and get on to the real problem: how is the Treasury going to pay the government's bills?

Your Social Security Retirement Benefit

What you get back from Social Security depends on how much you have earned in wages (and paid taxes on) during your working years. The more you pay, the more you get back. But the formula is tilted so that the retirement benefit for lower-income workers is a greater percentage of their preretirement earnings that the retirement benefit for higher-income workers. As explained above, your benefit also depends on the age at which you retire. The Social Security Administration uses a very complex method to calculate your monthly benefit. [For a detailed explanation, see Appendix C.]

Private Investment and Retirement

The alternative to a pay-as-you-go system is to fund benefits by saving. Under funded systems, each generation saves for its own retirement benefits and pays its own way. Some countries have already taken this step. Chile requires workers to save for their own retirement by making regular deposits to private pension accounts, similar to our Individual Retirement Accounts (IRAs). Singapore has a compulsory savings program not only for retirement, but also for health care and a wide range of other uses. Australia requires workers to contribute to privately managed retirement savings plans.

This funded approach averts the long-term financial crisis inherent in a chain-letter approach to financing retirement. It also encourages saving, which in turn generates higher economic growth.

Social Security Reform in Other Countries

Many other nations face the same demographic future as the United States: an aging population resulting from a decline in the fertility rate and an increase in life expectancy. Like the United States, many have pay-as-you-go financing of their retirement system, that is, the taxes collected from today's workers are used to pay the benefits of current retirees. However, a growing number have begun reform of their retirement systems by moving toward fully funded systems in which each generation provides for its own retirement. This is particularly the case in Latin America.

In 1981 Chile, the first nation in the Western Hemisphere to establish a social security system, became the first in the world to privatize its system. At that time, workers in the existing system could elect to remain there or move to the privatized system (with credit for what they had paid into the existing system). Most chose the privatized system. New workers were required to participate in the privatized system. The privatized system requires workers to contribute to individual retirement accounts managed by private investment funds. The private investment funds must invest the money conservatively in a diversified portfolio of assets.

Since 1993 seven other Latin American countries have adopted the Chilean model to some degree: Peru, Argentina, Colombia, Uruguay, Bolivia, Mexico and El Salvador.

Britain has taken a different approach to reform. Britain has a two-tier system — a flat-rate basic benefit unrelated to preretirement income and an earnings-related benefit. Employers may contract their employees out of the latter by providing a private pension at least as high as the earnings-related benefit. Employees who are contracted out and their employers receive compensatory payroll tax reductions. In addition, since 1988, individuals have been able to opt out by setting up personal pension accounts, in which case they receive the same payroll tax rebate, which is contributed to their individual accounts.

Singapore has never had a pay-as-you-go system. Instead, in 1955 Singapore introduced a compulsory savings program not only for retirement, but also for hospitalization and a wide range of other uses. The program covers about two-thirds of the labor force. Workers and employers are each required to contribute 20 percent of the worker's wages to a Central Provident Fund. The accounts belong to individuals, who get annual account statements and who can check on their account's status at any time by telephone. Initially, the fund invested the money entirely in government securities, and withdrawals were essentially limited to lump-sum retirement benefits or survivors benefits. Over the years, the program has become more flexible, giving workers more control over the investment of their contributions and expanding the withdrawal options to include purchasing a home and financing a college education. A minimum sum must remain in the retirement account. After age 55, an individual can withdraw all but the minimum amount, which is then paid out in an annuity or a fixed monthly payment from a bank deposit.

What about the United States? What if money now going to the payroll tax (either all or part of it) had been going instead into personal retirement accounts that were invested in stocks and bonds? In that case, your payroll deductions would have been invested each pay period in assets. And over time, each of these assets would have earned additional assets. This kind of growth is called compounding.

A few words about the power of compounding: Albert Einstein once said that "compounding interest is the greatest mathematical discovery of all time." (These may not be Einstein's exact words; at least a dozen versions are circulated, but they all boil down to the same point.) "Compounding" refers to reinvesting any profit from an investment and letting it grow along with the original investment. Your gains earn gains and compound the growth rate.

To give one illustration, if you put $1,000 in an investment that earns 8% each year, and you take out the $80 in earnings at the end of each year, after 35 years you will have accumulated $2,800.

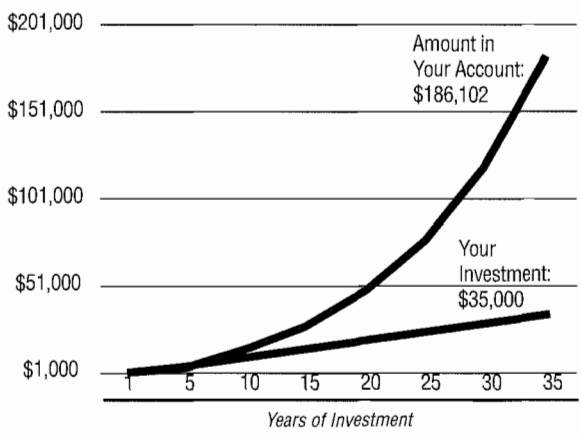
But if you reinvest the $80 each year, at the end of the first year you'll have $1,080 in your account, at the end of the second year $1,166 ($1,080 + 8% of $1,080), at the

end of the third year $1,260, and so on — until at the end of that same 35 years, you'll have $14,785 in your account.

Now, imagine investing $1,000 each year at that rate for 35 years. (That's about what you and your employer would pay in payroll taxes each year if you earned only $10,000.) After 35 years, you'd have $186,102. With that amount, you could buy an annuity that would pay you about the same amount you were earning before you retired — and more than twice what you could expect from Social Security.

Do you have to know about stocks and bonds to have a successful personal retirement account? No. In most countries with funded systems, investment options are limited to ensure that people don't take unreasonable risks, and the accounts grow with the economy. If personal retirement

The Benefits of Compounding: Investing $1,000 a Year at 8% Return



accounts were authorized, you likely would be restricted to choosing one of several professional fund managers to manage your account, and the fund managers likely would be restricted to conservative investments — diversified portfolios that reflect the U.S. economy as a whole. This in effect is the way many 401(k)s and other employer-based retirement plans work.

Comparing Social Security and Private Investment

The online calculator (at mysocialsecurity.org) is able to make comparisons of Social Security benefits and returns from private investment of payroll taxes for workers in more than 500 different occupations. Earlier, you saw a comparison for a male construction worker, age 35. The next several pages show comparisons for some other 35-year-old workers of both sexes, projecting what the worker can expect in benefits at Social Security's normal retirement age and what the return from private investment would be. All the estimates are adjusted for inflation, so you can use today's dollar as a gauge of what the purchasing power of the retirement income will be when each worker retires.

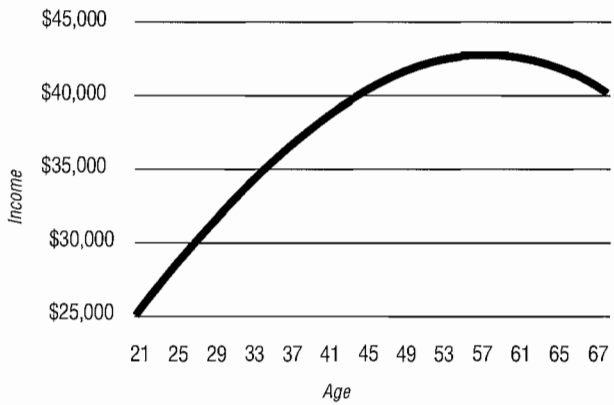
Since nobody is average, and since only 10 of the hundreds of occupations are illustrated here, you may want to make a customized search. You may be older or younger, or of a different sex, than the person in the example. Your occupation may be one of the many not covered here. Even if it is covered here, your own earnings pattern may be different. Or you may wonder what the impact of early retirement would be. You can do your personal calculation online at mysocialsecurity.org.

Female

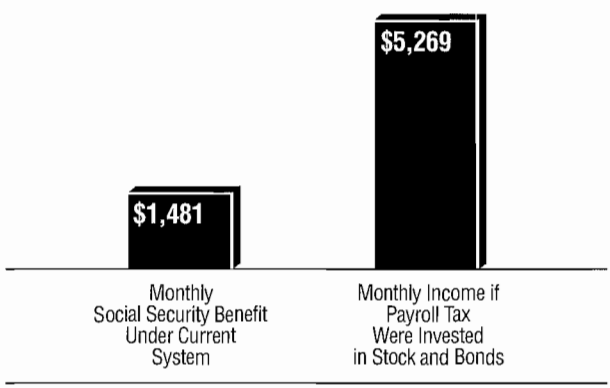
Accountant

Age 35 **Current Annual Earnings $35,372**

Pattern of Real Wages, Based on Historical Data



When She Retires at Age 67



Rate of return from Social Security 2.1%
Rate of return from investment 4.99%

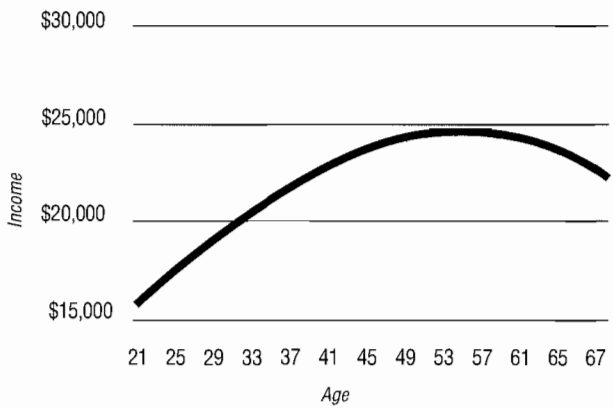
Note: all figures are real (year 2000) dollars.

Female

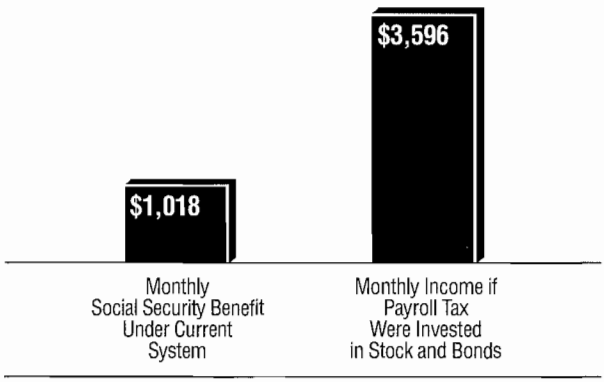
Bus Driver

Age 35 **Current Annual Earnings $21,524**

Pattern of Real Wages, Based on Historical Data



When She Retires at Age 67



Rate of return from Social Security 0.02%
Rate of return from investment 5.11%

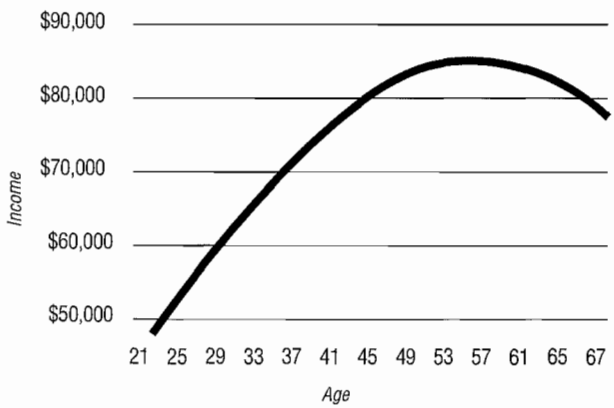
Note: all figures are real (year 2000) dollars.

Male

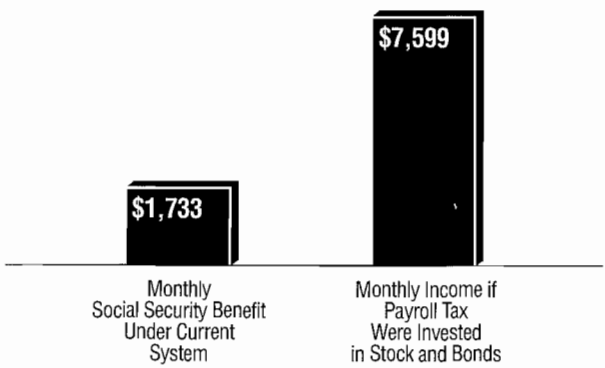
Computer Programmer

Age 35 **Current Annual Earnings $47,744**

Pattern of Real Wages, Based on Historical Data



When He Retires at Age 67



Rate of return from Social Security 0.8%
Rate of return from investment 5.07%

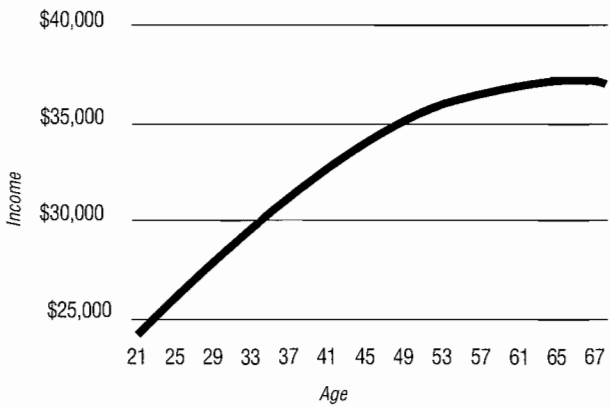
Note: all figures are real (year 2000) dollars.

Female

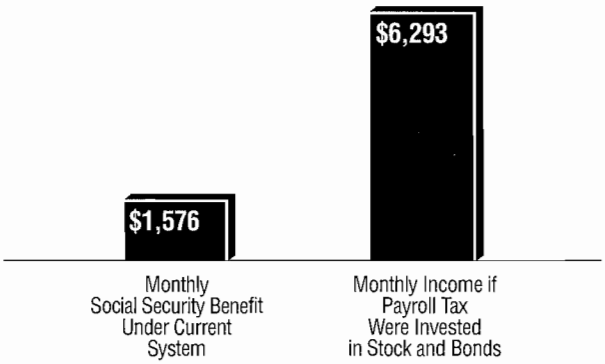
Dental Hygienist

Age 35 **Current Annual Earnings $39,000**

Pattern of Real Wages, Based on Historical Data



When She Retires at Age 67



Rate of return from Social Security 1.8%
Rate of return from investment 5.06%

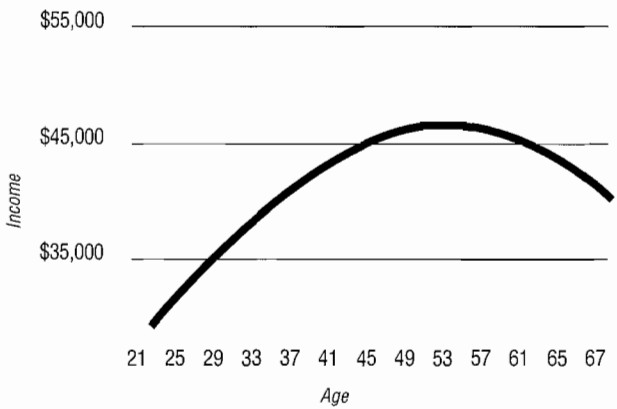
Note: all figures are real (year 2000) dollars.

Male

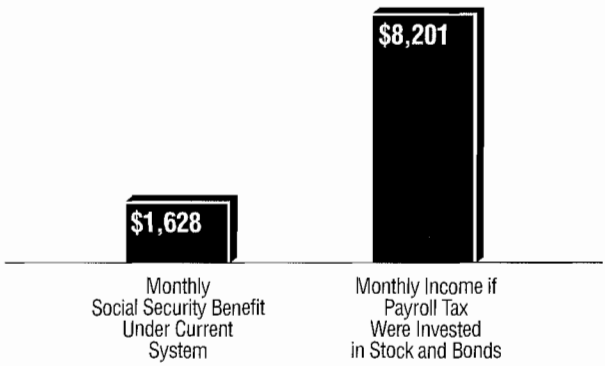
Electronic Technician

Age 35 **Current Annual Earnings $43,994**

Pattern of Real Wages, Based on Historical Data



When He Retires at Age 67



Rate of return from Social Security 0.9%
Rate of return from investment 5.21%

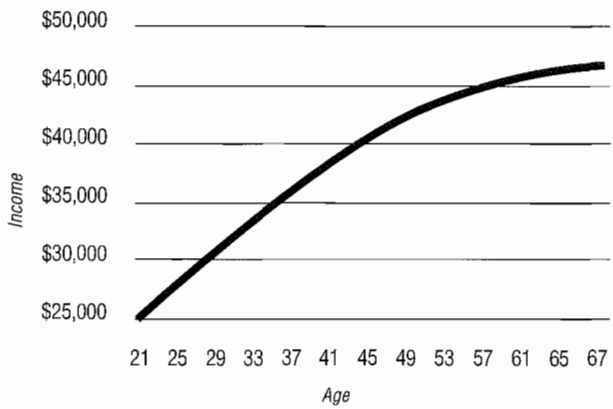
Note: all figures are real (year 2000) dollars.

Female

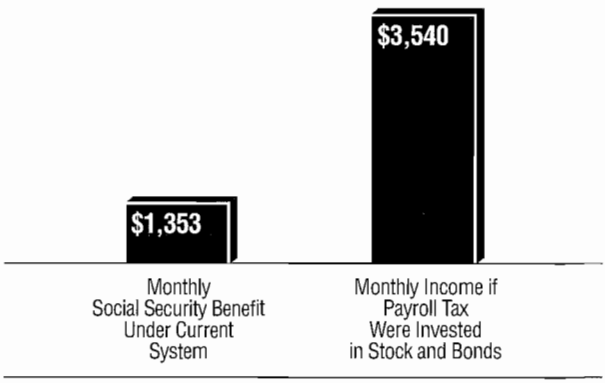
High School Teacher

Age 35 **Current Annual Earnings $28,635**

Pattern of Real Wages, Based on Historical Data



When She Retires at Age 67



Rate of return from Social Security 2.6%
Rate of return from investment 4.81%

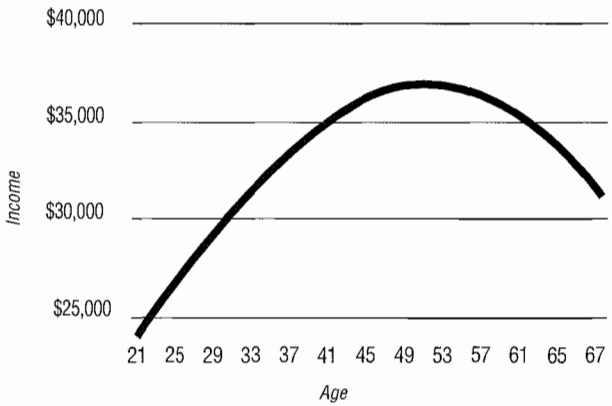
Note: all figures are real (year 2000) dollars.

Male

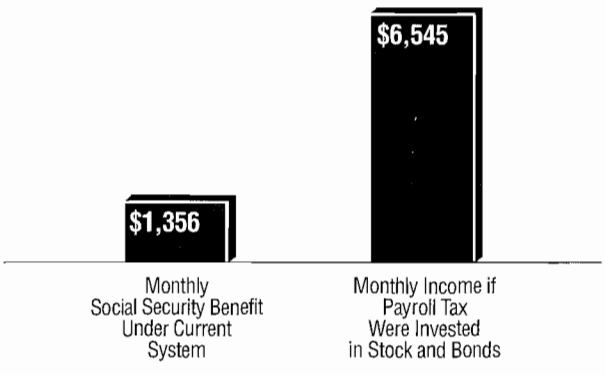
Machinist

Age 35 **Current Annual Earnings $33,057**

Pattern of Real Wages, Based on Historical Data



When He Retires at Age 67



Rate of return from Social Security 1.2%
Rate of return from investment 5.27%

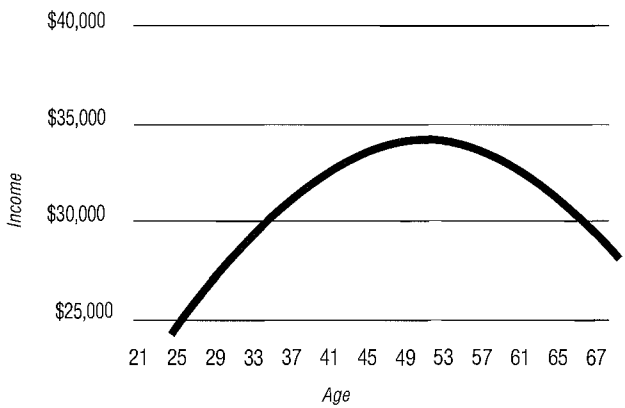
Note: all figures are real (year 2000) dollars.

Male

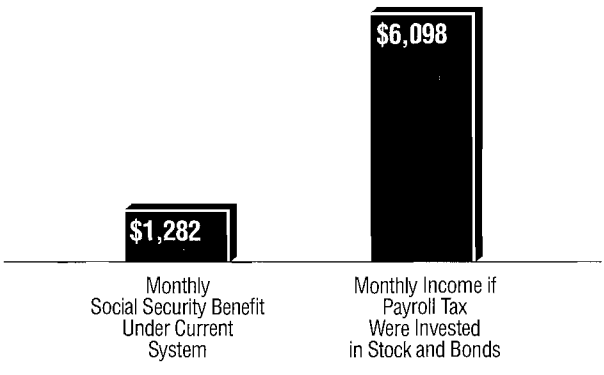
Mechanic

Age 35 **Current Annual Earnings $30,923**

Pattern of Real Wages, Based on Historical Data



When He Retires at Age 67



Rate of return from Social Security 1.3%
Rate of return from investment 5.27%

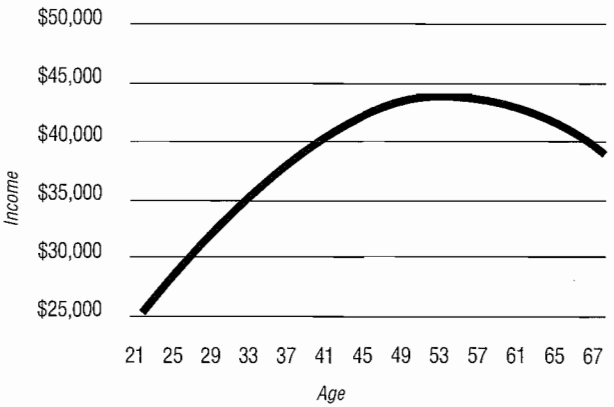
Note: all figures are real (year 2000) dollars.

Female

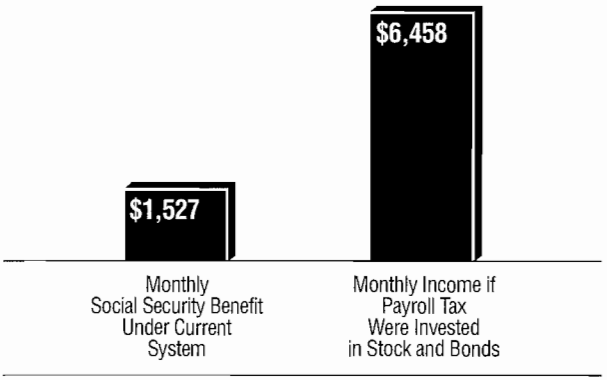
Real Estate Agent

Age 35 **Current Annual Earnings $37,554**

Pattern of Real Wages, Based on Historical Data



When She Retires at Age 67



Rate of return from Social Security 2.0%
Rate of return from investment 4.98%

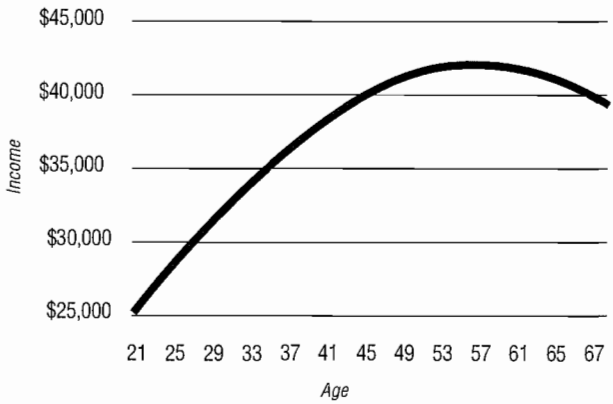
Note: all figures are real (year 2000) dollars.

Female

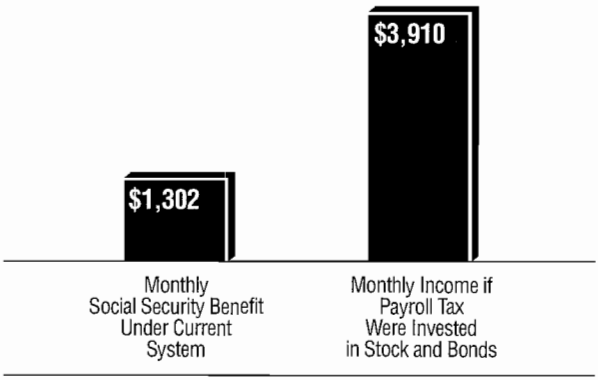
Social Worker

Age 35 **Current Annual Earnings $29,495**

Pattern of Real Wages, Based on Historical Data



When She Retires at Age 67



Rate of return from Social Security 2.4%
Rate of return from investment 4.89%

Note: all figures are real (year 2000) dollars.

The Social Security Administration's Calculators

The Social Security Administration (SSA) has three online calculators — each with different levels of detail used in making estimates of retirement income. You may inspect these at the SSA Web site, www.ssa.gov. However, there are a number of differences between the Social Security Administration calculators and the NCPA calculator.

The NCPA calculator estimates earnings based on the typical earnings history of a person of your age and sex in your occupation. This takes into account future pay increases you are likely to receive, adjusted for the effects of inflation. The Social Security Administration's calculators assume your earnings, in real terms, will remain the same from now until you retire. They also do not use occupational data.

If you are nearing retirement, the Social Security Administration's calculators can give you a more accurate forecast of your likely retirement income, since they use your actual earnings history. However, if you are years away from retirement, the NCPA calculator probably will give you the more accurate estimate because it is based on the earnings experience of other workers of your age, sex and occupation.

There are other features found only on the NCPA calculator. It shows how your taxes would have grown if invested privately, based on actual year-by-year returns from the stock and bond markets rather than assuming a historic average. Based on your personal information, it also calculates the rate of return you can expect to receive from Social Security and from the same amount of money invested privately.

Frequently Asked Questions about Social Security

1. How much am I paying for Social Security?

You are paying 5.3% of your wage earnings, and your employer is paying another 5.3% on your behalf, for a total of 10.6% for the Old Age and Survivors Insurance Program (known as OASI). This program finances Social Security retirement and survivors benefits. You and your employer are each also paying 0.9% of your wage earnings for the government's Disability Insurance program, which pays a monthly benefit in case you are disabled and unable to work. These payroll taxes (a total of 12.4%) apply to the first $76,200 of your earnings. If you are self-employed, you are paying the entire 12.4% directly. An additional payroll tax of 2.9% of earnings (with no wage ceiling) is levied for Medicare, half on you and half on your employer, making the total payroll tax 15.3%. Only the 10.6% OASI portion is considered by the NCPA Social Security Calculator.

Although the payroll tax is divided equally between you and your employer, economists generally agree that the part your employer pays is a substitute for wages you would otherwise receive. For that reason, in calculating taxes you will "pay," we include your employer's share. Your employer may write the check, but you are ultimately the one who bears the full burden of the tax.

2. *What happens to my Social Security payroll tax payments?*

Social Security is a pay-as-you-go program. Every dollar collected in payroll taxes is spent — the very minute, the very hour, the very day it comes in the Treasury's door. No funds are being stashed away in bank vaults. No investments are being made in real assets. Most of the money is spent on Social Security benefits. Any surplus is spent on other programs, or (more recently) is used to buy back government debt. Nothing is saved. This means that today's tax payments are used to pay benefits to today's retirees. When today's workers retire, their benefits will be fully paid only if the government is able to collect enough in taxes from future workers. In this sense, Social Security differs from most private pensions, which put aside funds and invest in real assets. These are called funded programs.

3. *What is the Social Security Trust Fund?*

The Federal Old-Age and Survivors Insurance Trust Fund is basically an accounting system used to keep track of Social Security taxes and benefits. Many people mistakenly believe that the trust fund collects taxes and pays benefits. In reality, the trust fund performs no real economic function. Every payroll tax check sent to Washington is written to the U.S. Treasury. Every Social Security benefit check is written on the U.S. Treasury. By contrast, the trust fund neither cashes checks nor dispenses them.

Technically, the trust fund holds interest-bearing U.S.

government bonds, representing the accounting surplus of payroll taxes collected minus benefits paid. But these are very special bonds. They are not counted as part of the government's official outstanding debt. The Social Security trustees cannot sell them on Wall Street or to foreign investors. Nor can they use them to pay benefits. They can only hand them back to the Treasury. In this sense, the bonds are nothing more than IOUs the government has written to itself. And the only thing the government can do with these "assets" is hand them back to itself.

Further, every asset of the trust fund is a liability of the Treasury. Summing over the accounts of both agencies of government, the assets and liabilities cancel each other out, adding up to zero. Ultimately, for the government to write a check, it must first tax or borrow. For this reason, knowing how many IOUs are in the trust fund does not convey any useful information about the government's ability to pay Social Security benefits.

4. Do I have a legally enforceable right to Social Security benefits?

No. In a 1960 case, the U.S. Supreme Court ruled that the mere fact that you have paid taxes does not by itself create a legally enforceable claim to benefits. The Court also ruled that a future Congress has no obligation to keep promises made by a past Congress. So the only right to benefits you have is whatever the government decides to give you during your retirement. Note that this is very different from a private pension. If your employer fails to

keep pension promises you can take your claim to court. Unlike private employers, the government can unilaterally break its promises to pay.

5. *What is the Social Security retirement age?*

The normal retirement age for persons born before 1938 is 65. The normal retirement age for those born in 1938 and later will be increased in gradual steps, beginning in 2003, until it reaches 67 for those born in 1960 and later. Details about the retirement age can be found on the Social Security Administration's Web site at http://www.ssa.gov/pubs/10035.html.

6. *What is early retirement?*

You can start receiving Social Security benefits as early as age 62, but the amount you receive will be permanently reduced by a certain percent for every month you fall short of your normal retirement age. The Social Security Administration Web site contains a full explanation of early retirement at http://www.ssa.gov/OP_Home/handbook/handbook.03/hbk-0302.htm.

7. *Can I delay my retirement?*

You may continue working past the full retirement age and delay receiving Social Security benefits. In that case, your benefit amount will be increased by a certain percent for every month that you are past your full retirement age but do not receive benefits. These increases are automatically added to your benefit until you reach age 70.

8. *Why is the future soundness of Social Security in doubt?*

When the first Social Security check was issued in 1940, there were 42 workers for each retiree. Today there are just over three, and by the time today's 18-year-olds reach retirement age, there will be only about two active workers for each retiree. Since the money to pay benefits comes from payroll taxes on active workers, this implies that the tax burden for workers will continue to rise, that future retirement benefits will have to be reduced, or both. The Social Security trustees' intermediate assumptions imply that the Social Security payroll tax will have to be increased by 72% by 2045 to pay benefits equal to today's — and Medicare and other government benefits for the elderly will require still other increases in payroll taxes.

9. *What happens if I die before I reach retirement?*

Your Social Security contributions are not part of your estate. When you die, you lose everything. If you have dependents, a special one-time payment of $255 may be made to your spouse or minor children when you die. Your dependents may also be eligible for benefits if you earned enough Social Security credits while you were working. Your spouse can receive full benefits at the normal retirement age, or reduced benefits as early as age 60. If you are divorced, your ex-spouse could be eligible for a benefit based on your record.

10. *What benefits does a non-working spouse receive?*

A non-working spouse is entitled to a monthly payment

equal to half the monthly benefit of the working spouse. If the working spouse dies, the non-working spouse is entitled to 100 percent of the working spouse's monthly benefit.

11. My spouse and I both work. Can each of us draw Social Security benefits based on our earnings?

You can. But you each have the option of drawing a spouse's benefit instead. Since a spouse's benefits is 50% of a primary worker's benefit, the two of you can claim 150% of the largest benefit. So if one of you has earned more than twice as much as the other, your total benefit will be larger if you choose this approach. Otherwise, your total benefit will be larger if each of you draws a benefit based on your own earnings. When one of you dies, the survivor is entitled to the larger of the two individual benefits.

12. How do I find out about my Social Security earnings record?

If you are over 25 years of age, you are supposed to receive a statement from the Social Security Administration showing what earnings have ever been credited to you. The statement should be mailed to you about three months before your birthday each year. You can request one at any time by calling Social Security or online at http://www.ssa.gov/mystatement/index.htm.

13. Does Social Security treat everyone the same?

The Social Security system pays vastly different rates of

return to different populations. Some people do better than others. For the most part, people born before World War II are getting a decent return on their Social Security tax dollars. By contrast, most people born after World War II would have been better off investing their Social Security dollars — even in government bonds.

14. *What determines my 'rate of return?'*

The amount of money you pay into the Social Security system, your monthly benefit and the number of years you are able to collect the benefit (your life expectancy) determine your rate of return. The Social Security benefit structure is tilted in favor of lower incomes. Thus, other things equal, people who earn higher incomes tend to get a lower return than those with lower incomes. However, this disadvantage is offset somewhat because those with higher incomes generally have a longer life expectancy, and those with lower incomes (and less education) tend to pay taxes for more years. Someone who drops out of high school and begins working, for example, may pay taxes from age 16 to age 67. A medical doctor, by contrast, may not start paying taxes until his or her late 20s. Since Social Security benefits are based on the 35 highest earning years, extra taxes paid by those who begin work early do not earn any additional benefits. In general, people born prior to World War II paid much less in taxes relative to what they can expect to receive in benefits. On the other hand, a recent college graduate with a high tech degree can expect a rate of return that is slightly negative.

Frequently Asked Questions about Personal Retirement Accounts

1. Who is proposing personal retirement accounts?

All of the members of the 1994-96 Advisory Council on Social Security recommended that part of the Social Security surplus be invested in the private market, although they disagreed on the mechanics of doing so. The council, appointed by the president and the congressional leadership, presented three proposals. Two called for allowing workers to invest part of their payroll tax in stocks and bonds. A third called for the government itself to invest up to 40% of the surplus in stock index funds. A number of Social Security reform proposals providing for personal retirement accounts have been introduced in Congress or are being proposed.

2. What is a personal retirement account?

It is an individual account into which some portion of a worker's Social Security payroll tax is deposited for private investment in stocks, bonds and other assets, and is the private property of the account owner.

3. How would I know which stocks to pick if I had to invest the funds in my personal retirement account?

In most countries that already have personal retirement accounts as part of their social security system, participants do not select individual stocks. They select a fund managed

by one of several professional asset management firms. All of the funds hold portfolios consisting of many different stocks and bonds. If personal retirement accounts were authorized in the United States, they almost certainly would have similar restrictions.

4. How would the asset management firm invest?

Each management firm would likely be required to follow prudent investment guidelines — investing in a diversified portfolio of stocks, bonds and other assets, so that the growth of the fund would tend to reflect the growth of the economy as a whole over time.

5. How safe would the private investment funds be?

They would be completely safe. First of all, the management firms would manage and administer accounts, but would not own them. So even if a management firm went bankrupt, your account would not be affected.

6. What happens if I don't do well in the stock market?

Investing for retirement is a long-run process, and the markets go up in the long run. The average annual real rate of return for the past 75 years has been 7.56 percent in real terms. Even in the 20-year period from 1929 through 1948, which includes the Great Depression, the real rate of return was 3.36 percent — much better than the real rate of return that young workers can expect from Social Security. Personal retirement accounts are not Las Vegas or the lottery. They are about saving and funding your retirement.

7. What if the stock market crashes on the day before I retire?

You would still fare better than you would have under Social Security. William Shipman of State Street Global Advisors has looked at the effect on workers born from 1930 to 1976 if they invested all of their Social Security payroll taxes only in the U.S. stock market. He calculated that even if the market were to fall as dramatically as its worst day, month or quarter in history, in every case but one workers of all income levels and dates of birth would still receive substantially greater retirement benefits from the market than from Social Security. In addition, almost all reform proposals currently before Congress guarantee minimum benefits regardless of how your personal retirement account performs. Several guarantee that you can do no worse than under Social Security.

8. What would happen if I died before retirement?

Since the money in a personal retirement account would be your private property, any accumulation would pass on to your heirs as part of your estate.

9. How do we know a system based on private accounts would work?

Many Americans already have a personal retirement account alternative to the current Social Security system. Before 1983, federal law allowed state and local governments to opt out of Social Security. More than five million state and local government employees remain outside the Social Security program today. For example, in

1981 employees of Galveston County, Texas, chose to opt out of Social Security and set up a completely private pension alternative. Neighboring Brazoria and Matagorda counties soon followed suit. The cost to the employee and employer is virtually the same as Social Security, but the benefits are far greater. In addition, privatized systems are already in operation in many countries, including Britain, Australia and a number of Latin American countries.

10. With private retirement accounts, won't we be paying big administrative fees to Wall Street managers?

There's no need to pay big administrative fees for managing private accounts. The Federal Thrift Savings Plan, in which federal workers can choose among a variety of investment options, has an average administrative cost of 0.09% and offers the worker a choice of funds. The administrative costs for privately managed index funds average 0.19%.

11. Since Social Security now has a progressive benefit formula that favors low-income workers, won't low-income workers suffer if all workers switch to personal retirement accounts?

A system with personal retirement accounts would actually benefit low-wage workers because the much higher returns from the personal accounts would make it likely they would receive higher retirement benefits than they would have done under the current system. Further, as noted above, almost all proposals currently before Congress guarantee minimum benefits, and some

guarantee that they will do no worse than under the current Social Security system.

12. What about suggestions that the government, rather than individuals, invest part of the payroll taxes in the market?

This approach is fraught with peril. It gives government too much control over private enterprise. Even if the money were invested in index funds and the government weren't allowed to vote the shares, politicians would be tempted to try to influence investments to encourage or discourage certain industries, achieve social goals, reward friends or punish enemies. Many state and local public employee pension funds make investments now that have a primary goal of stimulating the economy or protecting jobs instead of providing the best return to employee benefit plans. Studies have shown that these targeted investments result in a reduction of as much as two percentage points in investment returns.

13. Under a system of personal retirement accounts, what would happen to the retirement benefits of people already retired or those nearing retirement?

The benefits of retired people would not be affected. They would be paid out of the remainder of the OASI tax that would continue to go to the government. Reform plans generally provide that persons already working can choose between remaining in the current system or switching to the personal retirement account system and receiving credit for taxes already paid.

Appendix A

The Social Security Calculator combines past history and projections for the future in making its calculations. Among the estimates and projections are these.

Taxes. The estimate of past taxes paid and future taxes likely to be paid is based on the earnings experience of other people whose age, sex, occupation and current income are similar to yours. All calculations of expected taxes assume you will live to your chosen retirement age.

Benefits. All calculations of expected benefits assume that you will enjoy the normal life span of male or female, given that you reach your chosen retirement age. The estimates of your monthly Social Security benefit and the family maximum benefit are based on the formulas used by the Social Security Administration.

Private investment in real assets. The estimates of what your Social Security taxes would grow to if they were invested privately are based on the historic rate of return on stocks and bonds during the years in which you have paid them plus the assumption that in the

future the stock market and the bond market will pay annual real (inflation-adjusted) rates of return of 6.3% and 2.5%, respectively.

The calculator also makes some specific assumptions about the worker: that he or she lives to retirement age, remains in the same occupation in each year until retirement, and upon reaching retirement has the same conditional life expectancy as other individuals of the same sex born in the same year.

Appendix B

How Market Alternatives Are Calculated

The monthly amount you would receive if your payroll taxes were invested privately and the total value of the investment are calculated by assuming that all past and projected OASI tax payments grow at the historical and projected rates of return. The investments accumulate from age 22 to the normal retirement age for the user's age group and are then converted into an annuity. The real rate of return on the annuity is equal to the rate on indexed government bonds, about 3.6%. The term of the annuity is cohort- and sex-specific and is equal to the conditional life expectancy at age 65 age for your age group. The expectancies are based on the Census Bureau's intermediate estimates. The historical equity rate of return is based on the S&P 500 including dividend reinvestment. The bond rate of return is the AAA bond rate. Forecasted rates are the average of the rates of return experienced on completed 35-year portfolios which began in 1940 and later. Thus there are 23 completed portfolios with 35-year holding periods — 1975 to 1997. For these long holding periods:

- The average real rate of return on a portfolio made up entirely of stocks is 5.48%, with the lowest real rate of return 4.42% and the highest 8.17%.
- For a portfolio divided 60% stocks-40% bonds the average real rate of return is 4.66%, with the lowest real rate of return 3.42% and the highest 6.83%.
- For a portfolio divided equally between stocks and bonds the average real rate of return is 4.4%, with the lowest real rate of return 3.1% and the highest 6.43%.

Appendix C

How Social Security Calculates Your Benefits

The Social Security Administration uses a very complex method of calculating your retirement benefits. Social Security regulations vary by the year in which you become eligible for benefits. If you were born in 1937 or earlier the normal retirement age is 65, but over time the normal retirement age will rise to 67 for individuals born in 1960 and later.

Social Security Amount. Your monthly Social Security benefit is based on what is called your Average Indexed Monthly Earnings (AIME). First, your past earnings are adjusted for inflation by an index so that each dollar earned in the past is equal in value to a dollar in the year in which you become eligible to receive Social Security. Your AIME is then calculated by considering only your 35 highest-earning years; the earnings from those years are added up and divided by 420. Your AIME is converted to what is known as the Primary Insurance Amount (PIA), using a formula set for the year of your retirement. For example, suppose you first become eligible for Social Security in 2000. In that year your PIA will be equal to:

- 90 % of the first $531 of your AIME
- Plus 32 % of your AIME greater than $531 and less than or equal to $3,202

- Plus 15 % of your AIME above $3,202.

Thus if your AIME was $3,500 in 1999 your PIA would be :

(0.9 X $531) = $477.90

+ (0.32 X ($3,202 - $531)) = $854.72

+ (0.15 X ($3,500 - $3,202)) = $44.70

or $1,377.32, which the Social Security Administration rounds down to $1,377.30.

Maximum Family Benefit. If your spouse does not claim benefits in his or her own right, your spouse is entitled to a monthly payment equal to 50% of your PIA. Additionally, if you have dependent children under age 18 at the time of your retirement (or under age 20 and still in high school), each child is entitled to a benefit equal to 50% of your PIA. Thus it is possible that your PIA can be more than doubled, depending on your family situation. This is part of the "insurance" component of Social Security. However, there is a maximum benefit your family can receive based on your own earnings.

To illustrate how the family maximum is applied, let us take the $1,337.30 PIA from above and assume that you have a non-qualifying spouse and one dependent child. In 2000 the family maximum formula limits the amount paid on a single PIA to:

- 150 % of the first $679
- Plus 272 % of any amount between $679 and $980
- Plus 134 % of any amount between $980 and $1,278
- Plus 175 % of any amount above $1,278.

Thus the family maximum associated with this PIA is:

(1.5 X $679) = $1,018.50

+ (2.72 X ($980 - $679)) = $818.72

+ (1.34 X ($1,278 - $980)) = $399.32

+ (1.75 X (1,337.30 - 1,278) = $103.78

or $2,340.32, which the Social Security Administration rounds down to $2,340.30.

Before applying the family maximum, the total benefits would have been $2,674.60, but by applying the formula the benefits are capped at $2,340.30.

If both you and your spouse qualify for Social Security, each of you can claim benefits in your own right. However, depending on earnings, one spouse may be better off claiming benefits as a dependent. Dependent children can receive benefits based on the parent's account with the highest PIA.

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