Social Security Explained

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Introduction

The purpose of this article is to provide a general understanding of how the American Social Security system for retirees works and to dispel a number of myths pro and con without advocating either for or against the program. Sadly, all most people "know" about Social Security are the myths regardless of whether they are in favor of it or against it. Although Social Security is primarily a program for retirees it also handles payments to disabled people and certain death benefits to surviving close family. For simplicity, those aspects are not included in this discussion.

Much of the following goes against the myths that most people believe very deeply to be true. Some statements may be a very unpleasant and even an unbelievable surprise but all are verifiable fact. Some may vehemently think I can not possibly be right as there are high emotions associated with Social Security. People often have concepts of how the world ought to work and that is good – I do not disagree. But the world rarely works those ways. What I will tell you is not inherently good or bad – it just is what it is. The time has come for people to set aside their myths and understand reality.

History and how Social Security basically works

Social Security officially in the United States began with the 1935 Social Security Act. Workers paid one percent of their gross pay and their employers paid an additional one percent of gross pay up to a specified maximum. See the chart in the Appendix for how the rates have changed over the years. See http://www.ssa.gov/history/ for more information. There is quite a bit there including debunking of several additional myths not discussed in this article.

While the method to determine your retirement benefit is not disclosed by the Social Security Administration it is roughly based on a weighted average (biased in favor of your highest earnings) of your last ten years of employment prior to retirement. It is not a proportional function and benefits are relatively higher for lower incomers and lower for higher incomers.

Social Security Explained

The myths:

Three intertwined myths: (1) Social Security is a government guaranteed savings account from which retirement benefits can later be collected. (2) Social Security tax receipts go to the Social Security trust fund. (3) Benefits are paid from the Social Security trust fund.

You do not "pay into" Social Security. You pay to the United States Treasury. There is no account with a balance for you. You own nothing. For its entire history all Social Security tax collections have gone straight to the U.S. Treasury and merged with all other tax and fee collections for spending as the government sees fit.

A numerical accounting entry (known as the trust fund) is credited to the Social Security Administration for all the receipts but that agency has no money of its own. Interest on the numerical value (if positive as it has always been) is credited at the lowest short term rate. Another accounting entry debits that numerical value for payments made to retirees and other beneficiaries. For many years this numerical value has been positive by well over one trillion dollars as more Social Security tax money has been collected than has been paid out. This is referred to as the surplus but it is only a number, not real money.

It makes no difference if the number is positive or negative as all benefits are paid by the United States Treasury. Although benefits paid have exceeded tax receipts in some years (the 1970s and early 1980s for example) the numerical total has never gone negative. All payments to beneficiaries continued uninterrupted. The situation was handled by a technical borrowing from the U.S. Treasury that was later paid back when taxes were raised. In short, Social Security had to borrow from its "surplus" – ponder that. But realize that any surplus has already been spent so all there is to do is borrow. So there is nothing to fear about Social Security "going broke." It has happened before and will happen again with the same solution.

The so-called trust fund represents the accumulative positive difference between Social Security tax receipts and paid benefits. The trust fund (which is property of the government) is technically loaned to the government and put into the general fund. Thus, the government owes the money to itself which makes for some interesting accounting discussions. Don't feel bad if that confuses you – but definitely ponder it for a while.

Benefits are managed by the Social Security Administration but paid by the United States Treasury. Periodically everyone receives a mailing from the Social Security Administration detailing all receipts taken from their wages over their working life. People may erroneously assume that this represents a balance on their behalf. Nope. The Social Security balance of everyone in the country is zero. Always has been, always will be. Not one cent of the Social Security tax you pay ever comes back to you. Social Security is not a savings account. All of what you pay in tax goes to pay those receiving benefits now with any surplus available to be spent on other programs. All of the money you collect from benefits comes directly and immediately from those presently paying the tax. There never has been a trust fund with real money. As discussed previously, the trust fund is only an accounting concept.

Myth: If one political party or the other did not "raid the Social Security trust fund" to squander it on pet projects then Social Security would not be "going broke." A lockbox would solve this problem.

This is just political fodder to rally the troops behind some politician. As previously stated, all of the tax from all sources and fee collections go into a single large pot and the entire pot of money and then some is spent every year. Thus, one hundred percent of the Social Security receipts are spent every year on whatever. There never has been nor can their ever be a so-called "lockbox." Although each side vehemently accuses the other, neither Democrats nor Republicans can "raid" Social Security receipts to spend on pet projects. By law that money is already "pre-raided" when it is merged into the U.S. Treasury.

Myth: One political party or the other stifles any attempt to put the Social Security trust fund in a "lockbox."

Again, this is just political fodder and it has been proven to work very well on the gullible masses. It has worked for decades and it can be expected to be used for decades hence. Any lockbox concept makes no sense when you look at what Social Security is and how it works. Nothing ever has been or could be "stolen" from Social Security so what is the point?

Myth: Social Security is a good deal because I can expect to receive much more from it than I pay into it.

Depending on the situation this is not always a myth. The key factors that can make this statement true are if one is in a position to maximize their wages within the most recent years of retirement (commonly by working a lot of paid overtime or perhaps a second job), or by having the good fortune to live to a very old age. There are some other special cases that can also make the statement true. However, a common accounting mistake is to measure the tax paid and benefits received in absolute rather than inflation adjusted dollars. The effect of inflation over a lifetime is huge and may deceive people into counting inflation as a benefit. So be careful before you make too many assumptions about any "return" with Social Security.

At the other extreme there are situations where someone dies just before retirement or soon thereafter and the "return" they receive is pitifully low. Surviving close relatives may receive some benefit which is certainly better than nothing but it is debatable as to whether the total "return" is a net positive. For some it will be. For others it will not be. On average the statement is a myth. It just depends on where you end up relative to average. You won't know until that time comes. As discussed elsewhere, the Social Security concept depends on forfeiture of benefits by the unlucky that die early. It is not possible for everyone to come out ahead.

Myth: Social Security is one of the reasons that Federal deficits are so high.

The truth is that Social Security is one of the few government programs that actually fully pays for itself via its specific tax collection. Further, because taxes collected exceed benefits paid there is actually a surplus that government regularly exploits. This is just cold fact without any implication of merits or lack thereof concerning Social Security.

Oddly, in recent discussions concerning the massive Federal deficit, Social Security is often spoken of as an expense that must be brought under control. At face value this makes no sense given the fact of the first paragraph. The truth is that very soon the surplus that Social Security tax receipts provide to other government spending will go to zero and then proceed to become negative unless changes are made. The so called "crisis" is that the free money the government obtains from the Social Security surplus is diminishing thus forcing other budget issues. It is a "crisis" when Social Security must tap into its surplus to pay benefits since that surplus has been spent by the government. The money borrowed by the government to pay back the surplus competes with other spending. So if Social Security taxes could be raised or the benefits reduced then the government could keep spending the surplus and never have to pay it back – in essence free money. Understand this and you understand the "crisis."

Myth: If those dadburn "furiners" and other no-count minorities who paid little, if any, to Social Security weren't being paid massive Social Security benefits then Social Security would be in a lot better shape.

While there may be merits about debates concerning rightful beneficiaries it really does not matter for this discussion. The payments that accepted rightful beneficiaries receive are not affected or reduced by whatever number of questionable beneficiaries there might be or how that affects what the Social Security accounting surplus or deficit is. The myth as stated above represents a common collective ignorance.

Myth: Social Security will not be around when the younger generation retires.

Yes, it will be there as it is politically impossible to stop it. See the next section for more details.

Social Security Explained

Question: Why do we keep hearing about a growing crisis with Social Security and that it will go broke in the not distant future?

Much of the talk is fodder to keep the population distracted from all else that goes on in government and the fodder works very well. It also helps to condition the population to accept inevitable tax increases to pay benefits. Social Security has been "going broke" ever since its inception but is always saved by tax increases. A key factor today is that the tax (Social Security plus disability) has not been raised since 1990 – the longest period ever (see the Appendix).

The Social Security concept depends on a significant number of people dying before a large benefit is paid. True, some will live to a very old age and collect high total benefit but that is generally rare. In the early years some then untreatable medical condition limited the lifespan of most retirees and total benefits paid were relatively low and very manageable. The problem now is that thanks to modern medicine people are living longer and total benefits paid are becoming significant. The solution (as has been done in the past – nothing new here) involves some combination of raising the retirement age and raising the tax and possibly lowering the benefits. Take your pick – there are no other alternatives.

Question: Is Social Security secure?

That is a loaded question! Technically, the answer is no because Congress can alter or abolish Social Security at anytime. Practically, the answer is yes because it would be political suicide coupled with the threat of being coated with tar and feathers for Congress to make any change unpopular with the population. Social Security would only be significantly changed or eliminated if a sizable majority of the population wanted that. It will not end arbitrarily. The concept of "going broke" is meaningless since all payments are made by the U.S. Treasury from the general fund of all tax and fee collections and borrowed money as needed. Social Security can not go broke unless the entire government goes broke. Such has happened in the past around the world and can be expected to happen again – it is human nature.

Regardless of the future of Social Security everyone should fund a primary retirement account and consider Social Security to be a supplement.

Conclusion

Social Security is very popular with some people and viewed as a rip-off by others (to be honest, I must disclose that I am in the latter camp). Both sides of the argument nurture their myths thus rendering any sensible discussion impossible. I hope that this brief article can lay those myths to rest. Whether you are for Social Security or against it your basis must be on sound fact. Changes are going to be required in coming years and it would be a shame to make bad decisions based on myth.

Appendix

Figure 1 shows the historical Social Security tax rates for retirement, disability, and Medicaid over the years. Keep in mind that traditional Social Security includes a disability benefit and that data is separated in this chart. Medicaid is also a separate item but combined in what are known as employment taxes. The rates as of 2010 are Retirement: 5.3%, Disability: 0.9%, and Medicaid: 1.45%. The total of Retirement and Disability is 6.2% and this amount is generally thought of as the Social Security portion of employment taxes. The total of all is 7.65%. Each amount is paid by both the employee and employer up to some maximum level that generally increases each year (except Medicaid which now has no upper limit).

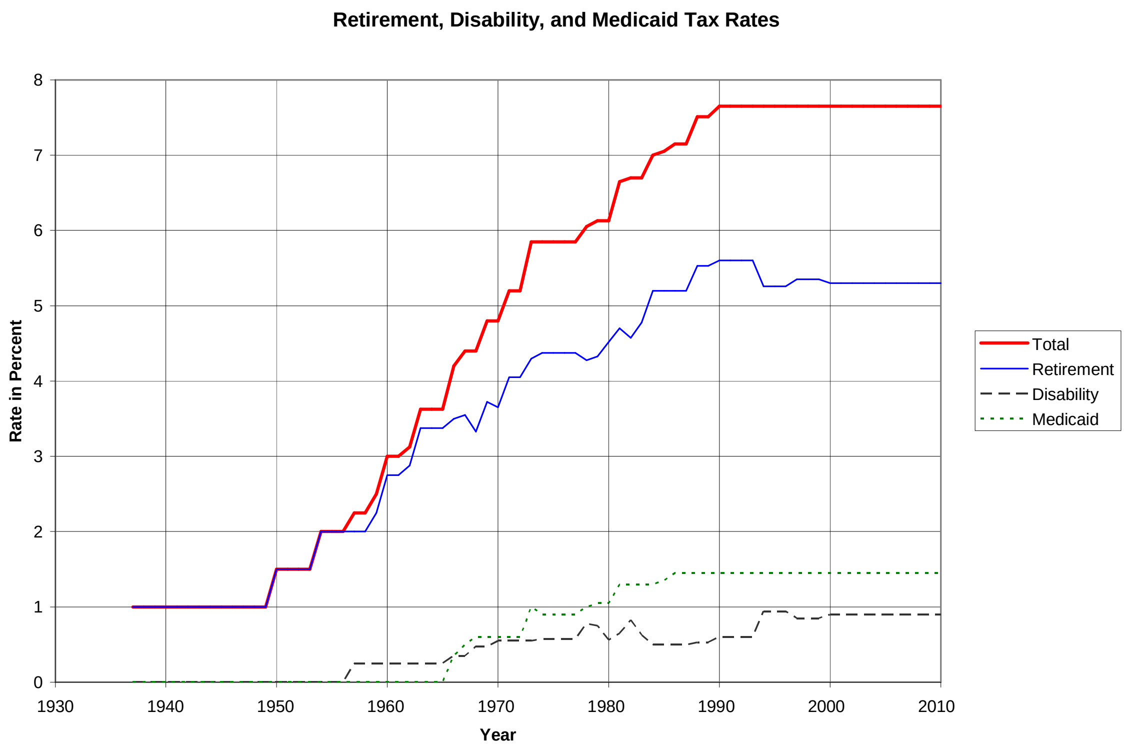

Figure 1: Social Security tax rates over the years
adapted from ssa.gov/history

Note that for the last twenty years the tax rates have been mostly constant. Tax rates in previous years kept increasing to avert the situation of Social Security "going broke." If people really want Social Security to continue in its present form then it is clear that the tax rate will have to increase. It is interesting to look at this chart and ponder what kind of increase would be needed.

One note: Medicare and Medicaid are often confused. Medicare is a health system for persons over 65. Medicaid is a health system for the indigent regardless of age.