SOCIAL SECURITY: THE THIRD RAIL ISSUE
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Introduction

With more than three-quarters of the American population falling into poverty during the Great Depression, the US Government began brainstorming ideas on ways to prevent a socioeconomic disaster of this degree from happening again S4. By 1935 the nation began hearing about a new program: Social Security S8. Less than a century after its inception, American politicians, economists, and citizens assess, discuss, and feud over the program's effectiveness and place in our modern nation. We are all very familiar with these arguments: the program is promising too much, the program isn't providing enough, the rich aren't being taxed enough, people rely too heavily on government support, et cetera, et cetera. This paper will not focus on the hotly contested arguments of how Social Security needs to change, but rather on the history of changes to the program, how it functions today, and how we should view Social Security in terms of financial planning.

The History of Social Security

Just the Beginning

The basic premise of Social Security has stood since its inception in 1935: workers with covered employment pay a tax on their earnings and receive cash benefits upon reaching their full retirement age. While that basic premise remains true, beneficiaries of Social Security were much different from today's structure. Only those who worked in "commerce and industry" were eligible for Social Security benefits and benefits even applied to those who did not have any earnings in the early days of the program. Furthermore, benefits were not provided for spouses or children, and if a worker were to die before receiving the amount of their contributions in benefits, a lump sum was paid to the worker's estate S8.

Controversy is Nothing New

Arguments over the Social Security Administration's efficacy are not a recent development; in fact, people have been displeased with the program since its establishment in 1935. As previously mentioned, the Social Security Act only applied to those working in "commerce and industry" S8. The first version of Social Security excluded just about half of the working population with workers in agriculture, domestic service, government, patient care, and other industries not being covered by the new program. These exclusions meant approximately half of female workers and nearly two-thirds of African American workers were not covered by Social Security in the beginning S9. By contrast, 93% of the American labor force is covered by the program as of 2020 S8.

Not only was exclusivity a point of tension regarding the creation of Social Security, but many argued as to whether the program would help to invigorate the economy or make an already stagnant economy even more so. Americans feared that providing retirement funds to older workers would shrink the labor force during a time when the main concern was getting people back to work. But proponents of the program argued that allowing those older workers to exit the labor force would open more opportunities for young workers to step in and help get the economy back on its feet S9.

Early Implementation

By 1940 the Social Security Act had made its way through the Supreme Court with the Helvering v. Davis case ultimately affirming the constitutionality of the Social Security Act, while also bringing some fundamental changes to the program. Because most families relied solely on male earnings, the program restructured its benefits to protect widows and surviving children, getting rid of the previous lump sum payment to the deceased's estate. The Old-Age and Survivors Insurance Trust Fund was also created at this time and new evaluations as to whether a worker had been employed long enough to receive benefits were implemented S8.

Social Security Post-War

Like most things in America post World War II, the Social Security program went through some major changes. With the appointment of an advisory council in 1947, three main issues in the program were illuminated and the Social Security Administration was tasked with addressing them.

By 1950, the program made many changes to close the gaps of "inadequate coverage, unduly restrictive eligibility requirements for older workers, and inadequate benefits" by making participation in the program compulsory and as universal as possible, while also increasing the minimum benefit to account for post-war inflation. Social Security Disability was eventually established in 1956 (eight years after it was proposed by the council), with benefits only paid to those 50 years of age or older.

Social Security Today

The final adjustments to the program that made it what we recognize today were the establishment of automatic cost-of-living adjustments (COLA) in 1972 to ensure that benefits were not being diminished by inflation, an increase in taxation on employers, employees, and those who are self-employed in 1983, as well as up to half of the benefits being taxable for high-earning beneficiaries and an increase in the Full Retirement Age to 67 instead of 65 years old.

The Current State of Social Security

How it Works

Since it was first established, Social Security has been funded through a dedicated payroll tax, with employers and employees in 2023 paying 6.2% of wages until the maximum contribution of $160,200 is reached. The Federal Old-Age and Survivors Insurance trust fund was established in 1940 and the Disability Insurance trust fund became effective at the beginning of 1957 S8. These trusts were created to store excess tax revenue from the Social Security program since the program collected more in taxes than it paid in benefits for many decades. With baby boomers retiring, that narrative has started to shift, and instead of excess funds being put into the trust, money is being taken out of the trust to pay benefits for current retirees S6.

The Trust Funds

There are many myths and misconceptions surrounding the Social Security trusts: above all, the myth that these trusts were dedicated solely to paying Social Security benefits. While Social Security may look and feel like an ordinary pension plan, the money that is contributed does not get stowed away for each beneficiary, it goes to current retirees and often helps the government to pay down debts or fund other projects S5.

That is not to say that value is being removed from the trust funds – Social Security funds can only be used to pay Social Security benefits. The government simply takes loans out against the Social Security trusts. Think of it like a bank: when you deposit $100 into a bank account, that money does not just sit there. The bank will likely use your $100 to give someone else a loan; but when you check your bank account, the $100 will still be there. When banks loan out money from customers' accounts, the amount of money they are managing does not shrink, and the same holds true for Social Security. When the government takes out a loan against Social Security funds, the value of the trust funds remains the same S6. Of course, if the government is unable to pay back its debts, that would have a very large impact on Social Security.

Will the Trust Funds Deplete?

Like many other times in Social Security's history, the program is at a crossroads when determining its next steps. For much of the program's life, the trust funds have not been relied on. For example, in 1985, the trusts would have been able to fund only two months of benefits. This was not an issue at the time because the working population was growing faster than the retiring population, allowing today's workers to pay for today's retirees, and then some S5. As more and more people entered the workforce, the more surplus there was to fuel the trust funds, a very positive thing. However, that initial boom of individuals entering the workforce is now retired or retiring, and today's contributions cannot fully fund today's benefits, requiring some of the funding to come from the surplus held in the trusts.

Most economists agree that if the program does not change, the trust funds will run dry by 2034 or 2035. While the American labor force is growing and is expected to continue to grow, the number of individuals retiring is also increasing every year. Furthermore, life expectancy has increased by nearly 20 years since 1935 while the full retirement age has increased by 2 years S1. While a much-improved life expectancy rate is always a great thing for a nation, it does cause some issues with a program that was designed to pay benefits for five years as opposed to fifteen.

If nothing were to change in the way that the Social Security program is run, the trust funds will be depleted in just over a decade, but that does not mean that Social Security would disappear alongside the trusts. By current estimates, contributions made by employers and employees would be able to fund 80% of the benefits given out each year.

That means that if you were receiving $2,000 in benefits per month, starting in 2034 you would receive $1,600 instead. This would have a very large impact on older American citizens considering that Social Security benefits lift approximately 15 million people above the poverty line each year S6. However, a 20% cut in benefits is not nearly as impactful as the program collapsing altogether, which is not likely to happen because of its importance in millions of Americans' lives.

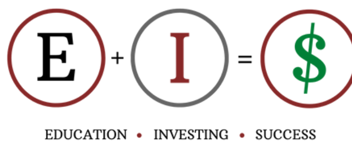
How Should We View Social Security?

While the program might not be going anywhere, that is not to say that change is not coming. Social Security was never designed to fully fund Americans' retirements; it was designed to supplement retirees' incomes and insure against poverty within the aged community during an economic crisis. As investors, we are fortunate enough to be able to save for the future and know the importance of diversification. Especially when considering the uncertainty of changes to the Social Security program in the coming years, it is imperative to focus on saving for retirement individually and think of Social Security benefits as only a small part of retirement planning.

For those already enjoying or quickly approaching retirement, we do not expect a change in your benefits. It would not be in the government's best interest to change a source of income millions of Americans are currently relying on, and for that reason, they likely will not change benefits for those who are already receiving them or will be soon. For those planning to retire after 2034, we believe it is worthwhile to plan for a change in Social Security benefits and we will help you to do that. In our view, it is important to prepare for the worst-case scenario of a 20% cut in benefits and save for retirement accordingly.

We are confident that Social Security will not entirely disappear, even if the trust funds run dry, but we cannot be certain that the program will look the same or continue to provide similar benefits as we get closer and closer to 2034. Planning and saving for retirement ensures financial security and stability beyond Social Security benefits for when we no longer have a regular income. If 2034 comes and goes and there are no cuts in benefits, having saved for the worst-case scenario will give you that extra boost in retirement and an even wider safety net.

While the future of Social Security is fairly uncertain, the history of the program shows us that this is not the first time it has been tested. The program has a history of adapting to the nation's priorities and we can expect it to continue to do so. Americans demanded the program to be more universal, and now Social Security covers the vast majority of the population. Families spoke out about the financial threats of losing the main earner in a family and today, over four million surviving spouses are receiving benefits as a result. As inflation rose, citizens demanded a fairer valuation of their monthly benefits, and now cost of living adjustments are calculated every year. Disabled workers who were forced to retire early highlighted the unfairness of not receiving retirement benefits, and today the program supports 12 million disabled workers under 64 years old. Today, Americans are making it known that they do not want to pay into a system that might not give them the support that was promised in retirement, and we can expect the program to adjust and adapt accordingly.



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