THE END OF SOCIAL SECURITY AS WE KNOW IT?

Help Clients Navigate Entitlement Insecurity

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SOCIAL SECURITY CRISIS OVERVIEW

Since its advent in the 1930s, Social Security has provided a retirement safety net and has grown into one of America's most successful and popular social welfare programs. Today, around 65 million Americans receive Social Security payments, with many relying on these checks for the bulk of their income.

For decades, however, experts have warned about an impending crisis in the Social Security system, noting that the dramatic growth in Social Security payments will eventually cause the program to run out of money and will ultimately necessitate dramatic changes to maintain solvency and make payments to future generations.

As the most recent report from the Social Security Board of Trustees demonstrated, the day of reckoning may be closer than we expect.

State of the Social Security Trust

According to the 2020 Trustees report, the Social Security program will see net cash outflows starting as early as 2021. In the absence of serious policy changes, these outflows will continue and will eventually exhaust the program's reserves, leading to dramatic benefit cuts.

Read on for the projected timeline for Social Security benefit cuts, including the expected dates when the program's two trusts – the Old-Age and Survivors Insurance (OASI) trust, which makes payments to retired workers and the survivors of deceased workers, and the Disability Insurance (DI) trust, which makes payments to the long-term disabled – will run out of money.

When Could Social Security Trusts Exhaust Their Reserves?

2021:

First year of **negative cash outflows** (net outflows of $21.1 billion)

2034:

OASI Trust **exhausts its reserves**, necessitating a **24% benefit cut** to retirement payments

2065:

DI Trust exhausts its reserves, necessitating a **cut to disability benefits**

AS INDICATED, ON CURRENT TRENDS, SOCIAL SECURITY RETIREMENT BENEFITS WOULD HAVE TO BE CUT BY 24% IN 2035. THE AVERAGE RETIREE RECEIVES $18,151.56 A YEAR FROM SOCIAL SECURITY, WHICH WOULD MEAN A $4,356 BENEFIT CUT IN 2020 DOLLARS.

How Did We Get Here?

There are many reasons why the Social Security program is facing this crisis.

- **Increased longevity –** One of the key reasons for the funding crisis is that retirees are living much longer than policymakers expected when they created the program. In the 1930s, average life expectancy was just over 60 years. Today, that has risen to over 78 years, meaning that Social Security payments must continue for many years longer than lawmakers expected.
- **Lower birthrates –** Social Security was designed to be funded by contributions from workers – current retirees' benefits are paid by the contributions from younger workers. However, as birthrates in the US have fallen, the number of workers paying into the fund has fallen relative to the growing number of retirees. This means that current contributions are not enough to pay for current benefits, leading to a shortfall. At present, this shortfall can be covered by the Social Security trusts' reserves, but when these are exhausted, benefits will have to fall to match contributions.
- **Lower immigration –** Historically, the US benefited from relatively high rates of immigration. Immigrants tend to be young workers, who contribute to Social Security and help fund current benefits. Over the last 20 years, however, net immigration rates have declined sharply, further reducing the number of workers paying into the program.
- **Political inaction –** A key driver of the severity of the coming crisis has been political inaction. Although the Trustees have warned about the funding shortfall for the last 35 years, Congress has been reluctant to develop a meaningful policy response to address the issue. Sharp partisan divides on proposed solutions have made the problem of political inaction more severe.

- **Low returns –** In recent years, a key problem for the Social Security trusts has been the sharp fall in US interest rates. By law, the bulk of the trusts' assets consist of US Treasury instruments. As interest rates on these have declined, the trusts have generated lower-than-expected returns.

- **COVID-19 impact –** Importantly, the 2020 Trustees report does not include the impact of COVID-19. The pandemic may exacerbate or accelerate many of these problems. Increased unemployment will further reduce contributions, lower mobility will result in even lower immigration rates, and quantitative easing and loose monetary policy will further hurt returns on Treasuries. Conversely, increased mortality among those who receive retirement benefits could temper the impact of COVID-19 on the trust fund.

POSSIBLE SOLUTIONS

Possible solutions to the pending Social Security crisis fall into two broad categories.

Tax Increases

Tax increases would raise the amount of money flowing into the Social Security system, allowing it to maintain benefits at their current levels. There are various proposals on how best to increase taxes.

- One option is to raise the payroll tax that currently funds the program. Employers and employees each pay a 6.2% tax on earnings up to $137,700. Various proposals would see this net 12.4% rate increased.

- Another option is to raise or eliminate the so-called payroll tax cap. As noted, currently no Social Security taxes are paid on earnings above $137,700. Some propose eliminating or dramatically increasing this cap, thereby increasing the amount of income subject to Social Security taxes.

- A third option is to further tax Social Security benefits. These benefits already are taxable for many recipients, but they could be increased to provide the government with additional tax revenue. While this would not directly contribute to the system, it would represent an offset to the cost of maintaining benefits.

Benefit Cuts

Benefit cuts would reduce the amount of money flowing out of the Social Security system, allowing it to meet its obligations with current contributions. There are various proposals on how best to cut benefits.

- One option would be to raise the retirement age. At present, Social Security recipients can choose to take early retirement at age 62. Those born in or after 1960 can get their full retirement benefits at age 67. Alternatively, recipients can delay their retirement until age 70 and take advantage of the delayed retirement credit to earn a higher Social Security benefit. Proposals would see the age of full retirement raised to 70 and the delayed retirement age raised to 72.

- Another option is to adjust how the annual cost-of-living adjustment (COLA) is made. Currently, the COLA is linked to changes in the consumer price index (CPI). Some propose linking it instead to the chained CPI, which includes adjustments to account for changing shopping patterns in response to rising prices.

- A third option would be to introduce a form of means-testing for Social Security benefits. This would see those with significant sources of retirement income such as high savings, workplace pensions, or independent wealth receive a lower Social Security benefit, while those with no or few other sources of retirement income would receive full benefits.

The examples above reflect some of the proposed measures under debate. There are, however, many other potential options suggested by retirement experts. Which – if any – of these ultimately become proposed legislation will depend on future political developments.

TALKING TO CLIENTS ABOUT SOCIAL SECURITY INSECURITY

In the face of an impending crisis in Social Security and an apparent lack of Congressional will to solve the problem, how should advisors talk to their clients about Social Security insecurity? The best approach is to tailor the conversation to each client's stage of life.

Retired Clients

Clients who are retired and drawing Social Security benefits are unlikely to be affected by any changes to the system. Their benefits are expected to remain stable for the foreseeable future – benefit cuts will likely fall on those who retire after the Social Security trusts exhaust their reserves.

Retired clients are also unlikely to be affected by any changes to payroll taxes or the retirement age. However, as mentioned above, one important consideration may be eventual changes to how their retirement income is taxed. Proposals to subject a greater proportion of benefits to income tax may affect retired clients should they be enacted, although at present, there are no major reforms under Congressional consideration.

Clients Nearing Retirement

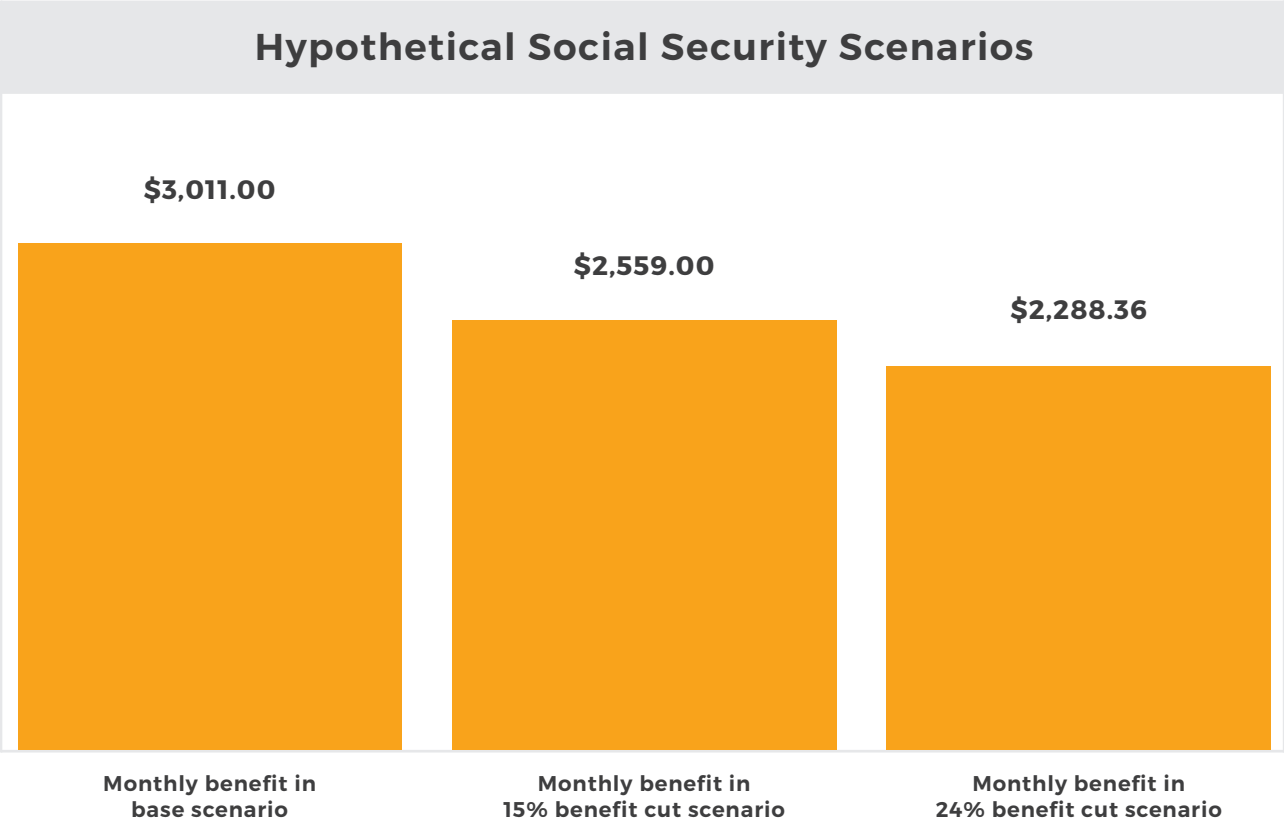
For clients approaching retirement, it may be worth discussing the timing of taking Social Security benefits. Many advisors suggest that their clients wait until age 70 to benefit from the delayed retirement credit. It is important to be aware of how changes to the retirement age or future benefits may affect clients' plans in this regard. Advisors should work with clients to plan what sources of retirement income will be available and how best to structure the timing of payouts.

In addition, potential tax changes may affect clients nearing retirement. They may be impacted by any changes in current tax rates as well as any changed tax rules upon retirement. Again, it is important to be aware of what – if any – proposals are before Congress.

Clients Many Years From Retirement

For younger clients who are 15 or 20 years from retirement, the issue of Social Security insecurity is more pressing. Barring political intervention, these clients will face a real risk of lower Social Security benefits and higher taxes. Therefore, it may make sense to model their planned retirement income with several scenarios, including a worst-case scenario in which the 24% cut in Social Security materializes and reduces the client's benefits.

For example, you may create financial plans that include a baseline scenario with no changes in taxes or benefits, and alternative cases – one in which payroll taxes rise 2% and benefits are reduced by 15%, for example, or another in which taxes remain constant and benefits are reduced by 24%.



By modeling multiple scenarios, an advisor can help clients prepare for a worst-case scenario without unnecessarily alarming them. As in the other cases, advisors should also prepare these clients for the potential impact of tax changes or changes to the retirement age.

The looming crisis in Social Security is a source of anxiety for many younger clients. Advisors can help by reassuring these clients that, while Social Security may change, it will almost certainly still be there for them when they retire. And by helping young clients and near-retirees prepare for a range of potential changes, advisors can help ensure that a comfortable retirement remains an achievable reality for the next generation of Americans.

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