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Let's Face Retirement

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Planning for New and Impending Social Security Changes

From middle-aged wage earners to current retirees, just about everyone is eager to know what they can expect of Social Security in the coming years. People are living longer lives and requiring longer-term sources of income, yet rising health care costs, government deficits and a still-shaky economy could jeopardize their retirement prospects.

Despite the consistent media attention over benefits reductions and opt-out programs, however, it looks like Social Security is here to stay for a while. Still, experts agree that it will have to undergo a few changes in order to remain viable. The following are a few of the recent roadblocks and proposals that will affect retirement planning over the next few decades.

Exhausting Funds

While opinions on proposed changes vary wildly, most advisors agree that Social Security is in financial trouble. "Eventually Social Security is going to run out of money," said Anthony Saccaro, president of Providence Financial and Insurance Services. Government estimates suggest the SS trust fund will be exhausted by 2033, a troubling figure for soon-to-be retirees.

The situation isn't as dire as it may seem, however. "When people hear the word 'exhausted,' they think 'zero,' but the FICA [Federal Insurance Contributions] tax will still cover 77% of benefits," said Seth Stewart, president and co-founder of PlanMyBenefit. Trust fund depletion within 20 years is a worst-case scenario, and Congress is looking at a number of proposals which would curb or eliminate that 23 percent deficit.

Reductions in Benefits
Those proposals aside, people planning for retirement, particularly those in their 40s and younger, may not be able to count on their currently-projected benefits. “Long-term planning is to prepare our younger clients for the shortfall, which certainly will affect people who are in their 20s, 30s and 40s right now,” said Saccaro. While Congressional action may prevent the potential 23 percent benefits reduction for current retirees, future actuarial imbalances will most likely lead to losses for Gen Xers and Millienials.

The minimum age for full benefits collection is currently 67 for people born after 1960. This will likely rise, as well. “It will probably creep up to 70 over time,” said Laura Stover, President of Laura H. Stover Financial Group. After all, the retirement age was 65 at the program's 1935 inception, a time when average life expectancy was only 62. “Social Security was never intended to be the primary source of income for any retiree, yet it's the cornerstone of retirement accounts for about 60 percent of its recipients,” she said.

Ultimately, whatever reductions do occur will have to take place gradually. “If there's a 25 percent cut across the board in 2033, there will be an uproar in this country,” said Saccaro. Using a 2033 retiree entitled to maximum benefits as an example, he notes that such a person would have to save an additional $10,266 per year, starting now, in order to offset such a dramatic reduction. Of course, that would only happen in the unlikely event that Congress doesn't raise taxes, alter cost of living adjustments or update the consumer price index (CPI).

Proposed Tax Increases
A tax increase in one form or another will likely be necessary to preserve benefits, and the FICA tax seems the most plausible place to start. “The FICA tax is the lowest hanging fruit,” said Stewart. “The threshold affects only 6 percent of wage earners, and it would only take minimal changes to make the system solvent.”

One of the most popular proposals would gradually raise total employer-employee contributions from 12.4 percent to 15 percent, likely at a quarter of a percent per year. Alternatively or simultaneously, Congress could increase the limit on taxable earnings, which was already bumped from $110,000 to $113,700 in January.

While FICA tax hikes shouldn't worry current retirees, the near future may also hold more taxes on Social Security benefits themselves. “Because of the deficit, there were already increases on Social Security tax in the 1980s and 90s, and that was before we had the huge deficit we have now,” according to Stover. Current taxable limits range from 50 to 85 percent of benefits depending on combined income, and according to Stover, “the next place to go might be 100 percent.”

Even so, historically low marginal tax rates, not to mention the lifelong guarantee of a monthly check, make Social Security a tax-preferred income stream. "Right now taxes are on sale, and they're probably going to increase in the future," said Stewart. In regards to 401Ks and IRAs, he advises retirees to "spend some of that money on the front end, and leave Social Security benefits and other tax-preferred benefits until tax rates for other things are higher."

Inflation and Adjustments

Aside from direct taxation and benefits reductions, changes to the cost of living adjustment (COLA) could reduce seniors' spending power in the coming years. Even before the fiscal cliff, the Ways and Means Committee began discussing a "chained" CPI, which more heavily weighs consumers' product substitutions when prices rise. This switch would ultimately lead to a lower calculated rate of inflation, and thus a lower annual COLA for Social Security recipients.

Though many advisers do not expect the chained CPI to have a large impact in and of itself, Congress may also reduce the connection between the CPI and COLA. They're currently tied, so increases in Social Security benefits are directly proportional to the inflation rate. The COLA may only be a fraction of the CPI in the future, and long-term price increases could take an increasing toll on seniors' savings.

These proposals won't affect all retirees equally, however. Saccaro draws a distinction between the CPI-calculated inflation rate and "personal inflation," noting that some consumers' spending habits are far more susceptible to price hikes than others'. For instance, gas price increases will have little effect on those who no longer commute to work, nor will higher home values affect seniors who've paid off their houses.

Still, Saccaro said that "Inflation is probably the biggest concern for retirees."

Stover agrees, urging that "Retirees must have their financial accounts set up to protect against inflation." Whether or not Social Security benefits increase proportional to consumer prices, retirees need to use a variety of assets and income streams to protect themselves from inflation.

Caution for Younger Planners

Ultimately, younger generations will be most affected by any Social Security changes that pass in the next 10 to 20 years. "I'm 38, and it would be ridiculous to look at my projections and plan for 100 percent of those benefits," Stewart said. Whether the trust fund is depleted, benefits are reduced or both, mid-career wage earners won't be able to rely on Social Security nearly as much as their parents and grandparents.

"Personal savings are what people really need to fall back on," added Stover. "That's the surest way to prevent potential shortfalls."