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FLIP FEATURE

Understanding Social Security

By Thomas M. Garr

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In my last article for the KSU Financial Literacy Improvement Project, *Reverse Engineering your REAL Retirement Costs*, I highlighted the hidden costs that you must incorporate when you make a financial plan to achieve a successful retirement. In that article, in addition to highlighting Health Care and Long-Term Care expenses, I also discussed some additional sources of retirement income away from your investments including Defined Benefit pension plans. But one type of Defined Benefit plan that everyone can be eligible for is Social Security. Most students know someone on Social Security, but there are many misconceptions. In fact, it seems to me, if you put 5 people in a room and ask a question about Social Security, you will probably get about 9 opinions. Everyone thinks they know, but in my experience, most people do not have a clue and get a big surprise when they least expect it. This can be a small or a large part of your retirement plan, and that means that if you are thinking about planning for retirement now, you need to know how this works.

First, let's briefly go over what exactly Social Security is and why it was created. Prior to the 1929 stock market crash, banks used retail deposits to invest in the stock market, both by purchasing securities for their own accounts and by providing extensive loans to individuals for buying stocks on margin. There were no federal regulations, such as the Glass-Steagall Act of 1933 which came later, that strictly separated commercial banking from investment banking and protected depositors. The crash wiped out savings because the value of people's deposits in their savings accounts collapsed when stocks they were invested in collapsed. Massive unemployment (over 20% by 1932) and bank failures ensued, leaving many elderly and working families destitute.

In response to this crisis, Social Security was created in 1935 by President Franklin D. Roosevelt's Social Security Act, primarily to provide economic security for the elderly and vulnerable during the Great Depression, addressing widespread poverty among seniors when families could no longer provide support due to urbanization and job insecurity. It established a contributory system in which employed workers pay taxes through payroll deduction for future retirement, disability, and survivor benefits, creating a national safety net against unemployment, old age, and other hardships.

Now, as I said, in my last article on *Reverse Engineering your REAL Retirement Costs* I discussed Defined Benefit Pension plans. This is basically what Social Security is, i.e. a system where, based on how long you work, and in this case, how much you pay in, at retirement, you get a lifetime pension/Social Security benefit of a fixed amount every month (which is only ever adjusted, once each year in January, for inflation).

There are lots of comments in the media about Social Security not being around when people today who are younger eventually retire. I don't personally subscribe to that, and I believe that in one form or another it will always be there, but more on that later.

How does Social Security work? The bottom line is that Social Security is primarily funded by a dedicated payroll tax paid by employees and employers (split 50/50), and self-employed individuals pay the full amount (*keep that last part in mind if you are thinking of starting your own business – the part you would have to cover as your own employer is called Self Employment Tax*). The bottom line concept is that you pay into the system all your life out of your earnings to pay for Social Security and Medicare benefits provided back to you when you are a senior citizen or

at least reach a certain age. The more years you work and the more money you make, which in turn determines how much more you pay into the system, the more benefits you get later.

If you look at your paycheck, you will see a line for a payroll deduction called FICA, which stands for **Federal Insurance Contributions Act**. Each employee of a company has 6.2% of their paycheck deducted on the first \$184,500 of pay (2026 limit) and sent to the government and nothing deducted on any pay they make in a year above \$184,500. Your employer is required to match that and contribute another 6.2%. In addition, you are also required to pay 1.45% of your pay to the government for Medicare and your employer is required to also pay 1.45% of your pay. Those two items combined get you to the 7.65% for FICA that you see deducted on your pay stub. There is no limit to your income in determining what you owe for Medicare, and if you are married and earn more than \$250,000 (2026 threshold) you also have to pay another 0.9% of your pay for Medicare. (This additional tax was established as part of the 2013 Affordable Care Act, a.k.a. Obamacare.) FICA taxes are a mandatory payroll tax for most U.S. workers.

Now let's talk about Eligibility to receive benefits. The Key Term you want to remember is **Full Retirement Age (FRA)**. The original FRA for full Social Security benefits established in 1935 was age 65, with benefits for those claiming earlier (starting at age 62) permanently reduced, though you still pay Social Security tax on earnings no matter your age (even if you work past age 65) to fund the system. In 1935, the average life expectancy at birth in the U.S. was around 61.7 years for both sexes combined, with women (approx. 64 years) generally living longer than men (around 60 years), though these figures were heavily skewed by high infant mortality, meaning those who survived childhood could expect to live much longer. But even adjusted for that, life expectancy was a whole lot lower then, than it is today. Put another way, the average retiree at age 65 is likely to live a lot longer today than they did in 1935, which means that today's retiree will draw Social Security payments for more years than a retiree did back then.

Believe it or not, if you ask most people, even those in the 40's and 50's how old they have to be to start receiving Social Security Benefits, they will tell you Age 65. Pretty simple, right? **WRONG**. In 1983, the Government passed something called the Social Security Amendments Act of 1983. This raised the FRA from 65 to 67 which was phased in gradually over time between 2000 and 2022 with increases every month. So, to make it simple, it means that depending upon your age, i.e. when you were born, your full retirement age is likely HIGHER than 65. For example, I was born in October 1954, so my full retirement age was age 66. My wife was born in March 1958, so her full retirement age was age 66 years and 8 months. Or to simplify further, for anyone born in 1960 or later, including those who are currently age 67, the (FRA) is **67 years old**, meaning you receive 100% of your earned monthly benefit by claiming benefits at that age and not before.

Full Retirement Age matters because your lifetime payments are based **ON THE YEAR YOU START DRAWING BENEFITS**. So for example, if you start taking Social Security at age 62, you will get a lower monthly payment than if you started taking benefits later – and, importantly, the monthly benefit payment will remain lower for the rest of your life than for someone the same exact age as you who starts taking benefits at a later age (up to the maximum payout age of 70). If you don't need the money, there is a case to be made for waiting for age 70 when your payout will be maximized based on your income and years of work, while if you do need the money you may choose to take it sooner.

But there is another wrinkle and that centers around whether you start taking Social Security before FRA, say at 62, but you decide to keep working. You don't want to get this one wrong. Basically, remember that Social Security is designed to assist you when you **RETIRE**. But

if you keep working after you start claiming benefits **BEFORE** Full Retirement Age (FRA), the government claws some of the money back. Specifically, for every \$2 per year you earn above the 2025 limit of \$23,400, the government withholds \$1 of your Social Security Benefit. This is essentially an additional 50% marginal tax on all income earned above \$23,400! Then when you reach Full Retirement Age, the government pays you your full FRA amount, *but you don't get back the amount they held back while you were still working before FRA*. Or put another way, after you reach FRA, there is no limit to what you can earn and still receive full benefits. There are financial advisors out there who may tell you to take Social Security the minute it is available to you, but they neglect to include this little tidbit and if you get this wrong, it can really sting.

Income that counts toward this work requirement includes Wages from Employment, Net Earnings from Self Employment, Bonuses and Commissions, Vacation Pay and Sick Pay (if still employed). Income that you might earn before FRA that does NOT count includes Investment Income, Pension and Annuity Income, IRA Distributions, Veterans Benefits and Government Benefits.

So how do the payout mechanics work? Let's walk you through it.

- 1) Social Security is calculated based on how much you pay in as a percentage of your income, over your working lifetime. If you make more money, you pay more into the system. If you never work, you don't get any Social Security benefits, but if you do work, there is a complex formula. All this information about your income is collected by the Government from your Tax Returns.
- 2) To qualify for benefits you have to work at least 40 quarters (i.e., 10 years). Those 40 quarters do not have to be consecutive (e.g., if you leave the workforce for a year and come back, the count of quarters picks up and you have to get in 40 in your working life).
- 3) Your highest 35 quarters of real (i.e., inflation adjusted) earnings are used to calculate your monthly benefit. Note that that 35 quarter average can include any years where you did not work.
- 4) Every month the Labor Department reports something called the CPI-W which stands for the Consumer Price Index for Urban Wage Earners and Clerical Workers. It is a key U.S. inflation measure tracking price changes for about 30% of the population, primarily blue-collar workers and office staff. The Social Security Administration takes the monthly average of the July, August, and September monthly increase (or decrease) and that average is the inflation adjustment from which Social Security benefits are increased (or decreased) for the following year starting in January. Then based on that, they calculate your new individual payment for the next year and that payment remains constant for 12 months until the following January.
- 5) At any point in your working life, you can request a Social Security statement (go to SSA.GOV and punch in your Social Security number) and it will tell you based on your contributions so far (with an assumption for pay if you have not worked 35 quarters yet), how much you would get at Full Retirement Age, how much you would get at age 62 or how much you would get at the maximum age of 70. These statements are adjusted each year both for inflation and the amount of earnings from which your payroll deductions are made including any and all raises and pay increases over time, as well as your actual payroll deductions paid in so far.
- 6) To give you some numbers on this, look at it this way. The key number is the payment that you would get at your Full Retirement Age, let's say age 67. Suppose that number in today's dollars is \$1,900 per month pre-tax. If you begin receiving benefits right at age 67, that is your benefit and it will increase or decrease each January based on the CPI-W calculation mentioned above.

But if you start taking Social Security at age 62, your benefit will start at 70% of your full retirement calculation which in this case would be \$1,330 per month before tax and all inflation adjustments would be using that as a starting point. And remember if you keep working from age 62 to age 67 while receiving benefits, they can withhold some of that until you reach age 67. Instead suppose you decide to wait until age 70 to receive Social Security benefits. In that case, your first benefit payment will be 124% of your FRA calculation or \$2,356 per month pre-tax. There is a sliding scale for any year between age 62 and 70 for when you might start receiving benefits. The logic behind this is that if you start taking benefits later, you have fewer years left so your benefit per month should be higher.

- 7) Now let's talk about taxation of benefits. The Security Amendments Act of 1983 also provides that the Federal government can tax your Social Security Benefit. For a married couple in 2025, if your annual income in retirement is under \$32,000, there is no federal tax on your monthly payments. But if your income is between \$32,000 and \$44,000, then 50% of your benefits are taxable, and if your retirement income is above \$44,000 then 85% of your benefits are taxable. Individual states can additionally tax Social Security benefits. Some do and some don't. Georgia, where Kennesaw State University is located, does not, but as of 2025, nine states do tax Social Security benefits (Colorado, Connecticut, Minnesota, Montana, New Mexico, Rhode Island, Utah, Vermont, and West Virginia).
- 8) Finally, there are a few additional smaller items to take into consideration. Those include: (A) Spousal Benefit – Calculated using Full Retirement Age, if one spouse makes substantially less than the other spouse and has substantially less Social Security Benefit, than the lower earning spouse can get extra benefits up to 50% of the Full Retirement age benefit of the higher earning spouse. This is also important because even if two people are married, the social security for each person is initially managed separately. (B) Divorce – Calculations are tricky here because length of marriage is considered. (C) Disability – In some cases, there are social security benefits paid if you become disabled permanently but there are work credit requirements here as well. (D) Survivor Benefits.

Now let's talk about the big elephant in the room which centers around funding for Social Security, both in each year and long term. Basically, Social Security funds that are collected are held in one of two funds. They are The Old-Age and Survivors Insurance (OASI) Fund and the Disability Insurance (DI) Fund. The two funds are primarily funded by payroll taxes, plus interest on investments and taxes on high-income beneficiaries' benefits. The balance in these funds determine the financial viability of the system and how payments are made. Put another way, from an annual cash flow standpoint, the money that comes in every year goes to the people collecting benefits. The Treasury Department has a board of Trustees that oversees the system.

We have a problem if there are more seniors collecting benefits than younger people paying into the system. That is the direction we are heading in now. There are all kinds of solutions being proposed, but it seems to me that based on my long experience, regardless of how sensational the media chooses to present it, one way or another Social Security will not go away. Some possible solutions that have been floated (Source: AARP), each with pros and cons, are:

- A) Raise the Full Retirement Age – Remember that when Social Security was implemented the average life expectancy was in the mid 60's and now it is much higher. This would be phased in for younger people not at retirement age currently, while not harming seniors who are taking Social Security now based on the promise they have lived under their whole working lives.

- B) Change the cost of living adjustment formula to something lower.
- C) Raise the payroll tax cap to a level above the 2026 \$184,500 amount or eliminate the cap entirely.
- D) Increase the Payroll tax rate from current 6.2%.
- E) Reduce benefits for higher earners – This will be tough to implement for current recipients because they have been promised a certain amount their entire working lives but you might be able to do it for future high earners who are not yet 62 years old.
- F) Increase the number of years required to qualify for benefits as an incentive for people to work more and pay in more.

So, what does all this mean for you, regardless of whether you are at the beginning or end of your working life? It means that when you focus on financial literacy you need to keep in mind that while Social Security may be a big deal or a small deal for you, it will be a critical factor that has to be considered as part of your retirement income calculation. If you manage your finances and your retirement planning well, such that you do not need to depend on Social Security, then when it comes time to receive it, it is a nice bonus. If you have to rely on Social Security in retirement, you should know now what is coming so you can plan accordingly. If you do not account for future Social Security benefits, you are not doing the full analysis and you will never know what your true retirement picture looks like. Remember that you cannot make a good decision without good information, so one way or another you need to understand this important part of retirement.