

Social Security and Pensions

A Primer

By **Chris Martin**

Social Security, pensions and other retirement plans are in the news. President Bush called for allowing workers under age 55 to convert a portion of their Social Security taxes into “voluntary personal retirement accounts” in his State of the Union address last week. Employees at United Airlines are being asked to give up their defined benefit pensions to rescue the airline from bankruptcy. Business and anti-tax groups are calling for state and local governments to shift their employees from traditional employer-paid pensions to self-directed plans similar to private-sector 401(k) plans. And with tax season upon us, we are reminded of Individual Retirement Accounts (IRAs) and other retirement savings plans as we prepare our income tax returns.

So in the interest of clarifying terms likely to be bandied about in the coming weeks, *Library Worklife* offers the following primer:

- **Social Security:** Founded in 1935 as part of the New Deal, this federal program pays benefits to the elderly, the disabled, and surviving spouses and minor children of breadwinners who die before retirement. Employees pay a Social Security tax of 6.2 percent of their first \$90,000 in wages. Employers pay another 6.2 percent. If you're self-employed, you pay the entire 12.4 percent. Together with the 1.45 percent Medicare tax (again, employers match the employee tax), these taxes constitute the 7.65 percent payroll tax that most of us see taken out of our paychecks. Some public employees, including some teachers, fire fighters, and police officers, are covered by state or local government pension plans, not Social Security. Social Security benefits are based on what you pay in. If you earned a lot, you receive a higher monthly benefit than your lower-wage counterpart. A participant must work 40 quarters (i.e., ten years) to qualify for an old-age benefit. Social Security has always been a pay-as-you-go program. Governed by the Federal Insurance Contributions Act (FICA)—part of the Internal Revenue Code—current contributions fund payments to current recipients, with surplus contributions stashed in a trust fund backed by U.S. government bonds. In 2018, the government will have to start cashing in some of those bonds to fund retiree benefits. According to the Social Security Administration (and Bush in his State of the Union address), the surplus will run out in 2042, forcing benefit cuts, tax increases, or both. As has been widely publicized, President Bush has suggested allowing, but not forcing, workers under age 55 to divert some of their Social Security taxes into individual investment accounts.
- **Medicare:** Medical insurance for those age 65 and over (and some younger disabled people) sponsored by the federal government. Not to be confused with Medicaid, which is federally-funded medical assistance for low-income individuals of all ages. Some elderly are on both Medicaid and Medicare, particularly if a lengthy illness forces them to deplete (or “spend down”) their assets. Like Social Security, Medicare is funded by a payroll tax (1.45 percent, with employers paying a like amount). Unlike Social Security taxes, which hit only the first \$90,000 in wages, Medicare taxes are deducted from all earned income. Most public employees are covered by Medicare even if they are not covered by Social Security. Legislation passed in 2003 expanded Medicare to include prescription drug coverage.
- **Pension Benefit Guaranty Corporation (PBGC):** Created by the federal Employee Retirement Income Security Act of 1974. A federal agency that takes over private-sector pension plans when they fail to pay promised benefits. PBGC is funded by insurance premiums paid by plans, not general tax revenue. Last week, the PBGC announced it would assume a pension liability of \$2.3 billion for more than 51,000 flight attendants, machinists, and other employees of US Airways, a bankrupt air carrier based in Virginia. Together with the PBGC's 2003 bailout of the same airline's pension plan for its pilots (\$726 million), the US Airways bailout is the second-largest in PBGC history. Only the Bethlehem Steel pension liability (\$3.7 billion) was larger. In December, the PBGC said it would assume a pension liability of \$1.4 billion for more than 14,000 active and retired United Airlines pilots if the airline terminates their pensions. At the time, the PBGC said the United pilots' claim would be its third largest ever. According to the U.S. Department of Labor, the PBGC recently

reported a record deficit of \$23 billion. In January, the Bush Administration, possibly hoping to avoid a bailout similar to that required by the savings and loan industry 15 years ago, announced that it would rewrite PBGC funding rules for covered employers.

- **Defined benefit pension:** Traditional pension in which an employer pays a regular (usually monthly) benefit to a retiree based on years of service and wages earned. Defined benefits are so called because the benefits do not change (they are defined) regardless of market conditions. It is usually very safe for employees because the employer bears all the risk. If the stock market plunges just when an employee retires, the employer, not the employee, must figure out how to make up the difference. But inflation can erode benefits in these plans if they do not include annual cost-of-living increases. Defined benefit pension plans have been called “golden handcuffs” because fear of losing a pension can keep an unhappy employee on the job long after she otherwise would have left. Public employees are much more likely to have a defined benefit pension plan than their private-sector counterparts. Some business and anti-tax groups support legislation that moves public employees into defined contribution plans because they think it will provide public employers with more certainty as to future costs and provide government employees with more freedom. For example, Americans for Tax Reform, a Washington, D.C. group headed by conservative activist Grover Norquist, endorses a public employee shift to defined contribution plans as “pension liberation.”
- **To “vest” in a pension plan:** To gradually acquire the right to receive employer-paid pension benefits. For example, an employee may not be vested at all for the first two years, but may be vested 20 percent per year after that (e.g., 60 percent vested after five years and 100 percent vested after seven years).
- **Defined contribution pension plan:** Pension plan in which only the annual monetary contribution made on behalf of an employee is defined. The value of the plan at retirement depends solely on how the money has been invested and what market conditions are at the time. In the private sector, these are the familiar 401(k) plans—governed by Section 401(k) of the Internal Revenue Code. Similar programs, governed by other articles of the same Code, include 457 (b) plans for government workers and 403 (b) plans for those employed by hospitals, museums, universities, and other not-for-profit organizations. Defined contribution plans are portable, and they usually allow employees at least some choice in how their funds are invested. These plans are most attractive to employees who feel confident making investment decisions and who like being free to change employers. Defined contribution plans are not protected by the Pension Benefit Guaranty Corporation.

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