money

monetary
The Social Security system includes two programs that provide monthly cash benefits to workers and their families. The Old-Age and Survivors Insurance (OASI) Program provides benefits to retired workers and their dependents and to the survivors of insured workers, and the Disability Insurance Program provides benefits to disabled workers and their dependents. A worker builds protection under these programs by working in employment that is covered by Social Security and paying the applicable payroll taxes. At present, about 96 percent of workers are working in covered employment.

The OASI Program is, by far, the larger of these two programs, and it is usually what people mean when they talk about Social Security. In November, 2004, for example, the program paid benefits to almost 40 million retired workers and their families, and the average benefit was about $886 per month.

These Social Security retirement benefits are incredibly important for the elderly population. For example, in the year 2000, Social Security provided 100 percent of income for 20 percent of elderly households and more than half of the income for another 44 percent of elderly households. Of particular note, Social Security has been especially successful in reducing the level of poverty among the elderly. With Social Security, only 9 percent of beneficiaries in the year 2000 were poor; without it, 48 percent would have been poor.

SOCIAL SECURITY RETIREMENT TAXES

Social Security retirement benefits are financed primarily through payroll taxes imposed on individuals working in employment or self-employment that is covered by the Social Security system. For 2005, employees and employers each pay a tax of 5.3 percent on up to $90,000 of wages earned in covered employment, for a combined OASI rate of 10.6 percent (the lion’s share of the total 15.3 percent of payroll that is collected for OASI, DI, and Medicare). Self-employed workers pay an equivalent OASI tax of 10.6 percent on up to $90,000 of net earnings (again, out of the total 15.3 percent that is collected for OASI, DI, and Medicare).

Additional revenue for Social Security comes from the income taxation of Social Security benefits. The actual amount to be included is determined by applying a complicated two-tier formula. Basically, single taxpayers with incomes over $25,000 (and married couples with incomes over $32,000) must include as much as half of their Social Security benefits in income, and single taxpayers with incomes over $34,000 (and married couples with incomes over $44,000) must include as much as 85 percent of their Social Security benefits in income.
Worker Benefits. Workers over the age of 62 generally are entitled to Social Security retirement benefits if they have worked in covered employment for at least 10 years. Benefits are based on a measure of the worker’s earnings history in covered employment known as the average indexed monthly earnings (AIME). The AIME measures the worker’s career-average monthly earnings in covered employment. In that regard, the AIME takes into consideration only covered earnings up to the maximum applicable annual earnings cap. For example, no more than $90,000 of 2005 earnings could count toward a Social Security retirement benefit.

The starting point for determining the worker’s AIME is to determine how much the worker earned each year through age 60. Once those so-called “benefit computation years” and covered earnings for those years have been identified, the worker’s earnings for years prior to age 60 are indexed for wage inflation. This indexing ensures that the same relative value is given to wages no matter when they are earned. The year that the worker turns age 60 is the year used for indexing the earnings of prior years, and this indexing makes the earnings early in the worker’s career comparable to earnings in later years. Earnings in and after age 60 are not indexed but can enter into the benefit computation formula.

The highest 35 years of earnings are then selected, and the rest of the years are dropped out. The AIME is then computed as the average earnings for the remaining 35 years.

The AIME is then linked by a formula to the monthly retirement benefit payable to the worker at full retirement age, a benefit known as the “primary insurance amount” (PIA). Historically, “full retirement age” was age 65, but it is gradually increasing to age 67 for workers born after 1959 (reaching age 62 in or after 2022 and reaching 67 in or after 2027). For a worker turning 62 in 2005, the PIA is equal to 90 percent of the first $627 of the worker’s AIME, plus 32 percent of the AIME over $627 and through $3,779 (if any), and plus 15 percent of the AIME over $3,779 (if any). Note that the benefit formula is designed to favor workers with relatively low career-average earnings.

A worker’s benefits may be increased or decreased for several reasons. Most importantly, benefits are indexed each year for inflation as measured by the increase in the Consumer Price Index.

Also of critical importance, workers who retire before their full retirement age have their benefits actuarially reduced. For example, a worker who turned 62 in 2003 and had yearly earnings throughout her career equal to the average wage would be entitled to a worker benefit starting at full retirement age (65 and two months) of $1,258 a month. If she, instead, started to draw her benefit at age 62, that benefit would be actuarially reduced by about 20 percent, to $964 per month. As the full retirement age slowly increases to age 67, the actuarial reduction from the full retirement age of 67 to the early retirement age of 62 will increase to 30 percent.

On the other hand, benefits payable to workers who choose to retire after their full retirement age are actuarially increased through the delayed retirement credit. The delayed retirement credit increases the monthly benefit to be paid to a worker who delays receipt of benefits past full retirement age by 8 percent for each year of delay.

Finally, the so-called “retirement earnings test” reduces the benefits of individuals who have not yet reached full retirement age and who continue to work after starting to draw Social Security retirement benefits. In 2005, for example, these early retirees will lose $1 of
benefits for every $2 of annual earnings over $12,000.

**Family Benefits.** Spouses, dependents and survivors of the worker may also receive additional monthly benefits. These family benefits are also based on the worker’s primary insurance amount (PIA). In particular, a retirement-age wife or husband of a retired worker is entitled to a monthly spousal benefit equal to 50 percent of the worker’s PIA. Consequently, a retired worker and spouse generally can claim a monthly benefit equal to 150 percent of what the retired worker alone could claim. Also, a retirement-age widow or widower of the worker is entitled to a monthly surviving spouse benefit equal to 100 percent of the worker’s PIA.

Like worker benefits, family benefits are subject to the retirement earnings test. In addition, under the so-called “dual entitlement rule,” when an individual can claim both a worker benefit and a benefit as a spouse, survivor, or dependent of another worker, only the larger of the two benefits is paid to the individual.

**SOCIAL SECURITY IS IN FINANCIAL TROUBLE**

The Social Security system operates largely on a pay-as-you-go basis. Social Security benefits are primarily paid out of current-year Social Security payroll taxes, and the Social Security Trust Funds maintain only enough reserves to cover a few years of benefits. In 2002, for example, the Old-Age and Survivors Insurance Trust Fund collected $455 billion in payroll tax contributions, paid out $388 billion in benefits, and had $1.2 trillion on hand at the close of the year.8

Unfortunately, however, the long-term picture is bleak. Social Security retirement and disability benefits will exceed trust fund income starting around 2018, and the system will be unable to pay full benefits after about 2042.10 The Trustees of the Social Security Trust Funds estimate that the deficit over the traditional 75-year projection period is about 1.89 percent of payroll, and the unfunded liability of the system is $3.7 trillion.11

The primary reason that Social Security is in financial trouble is that people are living longer and retiring earlier. As a result, there are a lot of Social Security beneficiaries, and there are fewer workers to support them. Of course, it is great that we are living longer, and it is terrific that we can expect to have long and leisurely retirements. But it has led to the current financing problem.

Social Security must either find new sources of revenue, or benefits will have to be cut. According to the Trustees of the Social Security Trust Funds, the system could be brought into actuarial balance by an immediate increase in payroll taxes of 15 percent, an immediate reduction in benefits of 13 percent, or some combination of the two. Any delay in reform will mean even larger tax increases and/or benefit cuts in the future, and that is one of the reasons that President George W. Bush has put Social Security reform at the top of his second-term agenda.

**SOME THOUGHTS ABOUT REFORM**

The Social Security system was designed in the 1930s, and it is time to reconsider its structure with an eye on what we want the system to do today and into the future. Ideally, the sys-
tem should ensure that every elderly American has an adequate income throughout her retirement years. One way to achieve that result would be to have a two-tiered Social Security system.

The Basic Social Security Benefit. The first tier of this new Social Security system would provide a basic Social Security benefit to every older American. For example, the government might guarantee every retiree a first-tier benefit equal to, say, 100 percent of the poverty level. In the year 2004, for example, the poverty level for a single individual was $9,310, yielding a monthly benefit of about $776.13

That benefit, $776 per month, would be the benefit payable to every individual at full retirement age. In that regard, there is every reason to think about increasing the full retirement age to 70 and increasing the minimum retirement age to 65. If a $776-per-month benefit were payable at age 70, then the actuarially-reduced benefit at age 65 would be about 30 percent less, or $543 per month.

Benefits paid in subsequent years would be increased for inflation, as measured by the Consumer Price Index. In any event, these first-tier benefits would terminate at death.

These first-tier benefits would replace the current Supplemental Security Income (SSI) program and all of the redistributive features of the current Social Security system. Also, like the current SSI program, these first-tier benefits would be paid for out of general revenues.

An Additional Earnings-Related Benefit. In addition to the first-tier benefit, every worker would also earn an additional retirement benefit based on earnings. These second-tier benefits would be financed with a much-reduced system of payroll taxes. In effect, each worker

would have an individual account — like an individual retirement account (IRA) or a 401(k) account. Each worker’s payroll tax “contributions” would then be credited to her account, along with investment income on the balance in that account.

At retirement, the balance in a worker’s second-tier individual account would typically be used to purchase an additional inflation-adjusted annuity over and above the individual’s first-tier benefit. Workers with large enough account balances might also be allowed to take partial lump-sum distributions. In the case of any worker who died before withdrawing all of her funds, the balance in her account would go to her spouse or other heirs.

Replace Spousal Benefits with Earnings Sharing. Finally, Social Security spousal benefits should be replaced with an “earnings sharing” system. Under earnings sharing, the current Social Security system’s spouse and surviving spouse benefits would be eliminated. Instead, each spouse in a married couple would be credited with one-half of the couple’s combined earnings during marriage. At retirement, each spouse’s second-tier benefit would be based on her half of the married couple’s earnings during marriage plus whatever she earned before or after the marriage.

Instead of tinkering with the Social Security system, I believe that we should redesign it. In the 21st century, it would make sense for Social Security to provide every elderly American with an adequate income throughout her retirement years. A two-tiered Social Security system could achieve that result, and we should be able to solve Social Security’s financing problem at the same time.


4. Id. at 9.


6. I.R.C. § 86.


8. Id., 1-20 to 1-21, 1-49 (Table 1-16).


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