SPECIAL REPORT

Social Security Benefits 101: The Windfall Elimination Provision*

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Many individuals feel overwhelmed by investment and retirement decisions. Paralyzed by their own lack of financial knowledge and the increasing complexity of retirement plans and the Social Security and Medicare systems, they acknowledge they don't even know where to begin. As a result, too many ignore the issue and suffer the financial consequences when they are least able to remedy the situation. In a recent study, more than 33% of individuals who are saving for retirement admitted that they do not feel confident about their financial knowledge and expressed confusion about the various components of their retirement plans—including pensions, 401(k) plans, Social Security, and Medicare. *See Understanding the Accidental Investor: Baby Boomers on Retirement* (2011), at http://corp.financialengines.com/employer/Accidental_Investor_April2011.pdf.

While most individuals ultimately rely on Social Security benefits for an increasingly greater percentage of their retirement income, they do not even mention Social Security benefits without prompting about the details of their retirement plans. Social Security benefits seem to be an afterthought or a retirement resource that doesn't need to be analyzed, planned for, or even understood. Many seniors don't want to admit their significant dependence upon Social Security benefits for all or most of their retirement income. In 2010, without Social Security benefits, the number of people aged 65 and older living in poverty would be higher by almost 14 million—increasing the elderly poverty rate by 400%, or up to 45% of all seniors. Yet most Americans do not have basic knowledge about the mechanics of the Social Security benefits formula. We have addressed this gap in understanding in prior scholarship, including two *NewsQuarterly* articles covering various aspects of the "Social Security Benefits Formula 101."§ This article adds to this scholarship by addressing a unique provision for individuals who qualify for both Social Security benefits and for pensions from work that is not subject to or included in the Social Security system.

Investments 101

A fundamental concept of successful investing is the age-old adage "don't put all of your eggs in one basket." As such, retirees should plan to have a variety of sources of post-work income. Diversification of income can protect a retiree from outliving retirement resources. One way to achieve diversification is to consider employment opportunities with government agencies that do not participate in the Social Security tax/benefit system (noncovered work) before, after, or during your participation in employment that is subject to Social Security taxes and qualifies for Social Security benefits (covered work). Approximately 25% of all public employees, or more than five million state and local workers and one million federal workers participate in alternative plans to Social Security. These employers and employees do not pay Social Security taxes or receive Social Security credit for their wages. These non-Social Security pension benefits can supplement and diversify a retirement income portfolio that includes Social Security benefits if the worker can structure his career to otherwise qualify for Social Security benefits. Not surprisingly the interplay of Social Security with alternative pensions can be confusing and involves both traps for the unwary and rewards for strategic planners. Public employers and their employees, including many state and local universities and schools that are financially strapped and challenged to attract top talent, should carefully consider promoting these retirement plans as an opportunity to supplement a worker's existing Social Security and Medicare benefits. This article describes this interplay, demonstrates undue hardships in the existing structure, and suggests strategies for maximizing aggregate retirement income benefits.

Social Security Benefit Windfalls and Burdens

The Social Security benefit formula is designed to provide an income safety net for workers during their retirement years. To achieve this goal, the benefit formula is structured to replace a percentage of, rather than all of, a worker's pre-retirement income. To ensure that qualifying seniors do not have to suffer aged

* An earlier version of this article was published in the *Orange County Lawyer* magazine.

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§ Francine J. Lipman and James E. Williamson, "Social Security Benefits Formula 101: A Practical Primer," *NewsQuarterly* (Summer 2010) and "Social Security Spouse and Survivor Benefits 101: Practical Primer Part II (Or Another Reason to Put a Ring on It)," *NewsQuarterly* (Fall 2010).

poverty, the formula necessarily replaces a greater percentage of covered wages for lower-income workers than for higher-income workers. For example, the lowest-earning workers (up to $9,000 (average wage-inflation adjusted income) per year) receive a Social Security benefit that equals 90% of their pre-retirement covered earnings, while the average replacement rate for the highest-earning workers (up to $95,136 (average wage-inflation adjusted income) per year in Social Security covered wages) is about 25%.

Prior to congressional reform in 1983, employees who primarily worked in jobs that were not covered by Social Security, but earned an alternative pension and also qualified for Social Security benefits—because they worked for at least ten years (40 quarters) in Social Security covered jobs—in many cases received a windfall Social Security benefit. Because the Social Security benefit formula does not include noncovered wages, these workers were treated as lower-lifetime income earners as compared to their actual higher lifetime earnings. Under the traditional Social Security formula the lowest-lifetime earners receive a higher pre-retirement income replacement rate (as high as 90%) than higher-lifetime earners (with overall replacement rates as low as 25%). This mischaracterization results for several reasons, including that the Social Security benefits formula averages Social Security covered earnings for the 35 highest wage earning years over 35 years (including any zero years, which lowers the average for otherwise higher-income earners with noncovered wages). Because this formula does not capture noncovered wages, the calculation can provide a potential windfall benefit by placing more of an employee's wages in the higher benefit ranges providing a 90% or 32% benefit rather than the higher-income, lower-benefit percentage range of 15%.

Congress enacted and President Reagan signed into law on April 21, 1983, the Windfall Elimination Provision (WEP) to mitigate this potential windfall. While members of Congress had introduced an alternative bill that would have perfectly captured and reversed the windfall benefit, the Social Security Administration did not have historical information regarding noncovered wages to implement this targeted solution. Unfortunately, the WEP passed into law (while better than harsher alternatives also proposed) is rough justice in that it does not eliminate the entire windfall for higher-income individuals and is overly punitive for lower-income individuals. Indeed, even with the WEP maximum, Social Security wage-earners receive a better return on their Social Security tax dollars than they would have received had all of their earnings been included in the Social Security tax/benefit system. This is not true for lower-income workers who are unfairly penalized by the WEP. In all cases lower-income workers (45% of average wages) receive a Social Security return that is less than the return they would have received had the benefit been based upon all of their earnings. For an excellent analysis of the distributional effects of the WEP, see Jeffrey R. Brown & Scott Weisbenner, *The Distributional Effects of the Social Security Windfall Elimination Provision*, at http://www.nber.org/programs/ag/rrc/08-05%20Brown,%20Weisbenner%20FINAL.pdf.

The complexity, lack of transparency, and regressive impact of the WEP have generated intense opposition by those affected adversely by the WEP and their advocates. Congressional bills to eliminate or modify the WEP are routinely introduced. Representatives and Senators from California (153,504 Social Security beneficiaries subject to the WEP) as well as from other states heavily affected by the WEP have proposed repealing the WEP (at an approximate cost of $40.1 billion from 2008-2017).

To explain all of the implications of the WEP for beneficiaries, we first present the Social Security benefit formula. Next, we detail the WEP and its impact on the Social Security benefit formula using several detailed examples to illustrate how different situations and economic circumstances are, or are not, affected by the WEP. Finally, we conclude with a summary of the specific issues individuals need to consider when they engage in strategic analyses of potential employment changes between employment that is covered by Social Security taxes/benefits and employment that is subject to alternative plans.

The Social Security Retirement Benefit Formula 101

The Social Security retirement benefit that a worker will receive, if retiring at full retirement age (age 66 (for those born between 1943 and 1954)), is called the primary insurance amount (PIA). PIA is also used to calculate other family benefits based upon the worker's wage records, including spousal and survivor benefits. Congress designed PIA to provide a greater replacement rate (a higher ratio of Social Security benefits to average indexed monthly lifetime earnings) for lower-lifetime wage earners than higher-lifetime wage earners to provide all qualifying seniors with anti-poverty relief during their retirement years.

The first calculation used in determining PIA is a worker's average wage-indexed monthly earnings (AIME) on which Social Security taxes were paid during the 35 highest qualifying earning years. PIA includes 90% of the first level (called a bend point, which is adjusted for wage inflation each year) of AIME. The second level of AIME (from bend point one to bend point two) is included in PIA at 32% of that amount. The third level is measured from bend point two to the maximum AIME. PIA includes only 15% of this amount. This calculation is illustrated in Table I, for a worker who reaches age 62 (the age at which PIA is determined) in 2011, with an AIME of

Table I
Calculation of PIA for 35-Year Maximum Wage Earner

	FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL	
0	**$749**		**$4,517**		**$7,928**	
Range	($749 * 0.90)	+	(($4,517 – $749) * 0.32)	+	(($7,928 – $4,517) * 0.15)	
PIA	$674	+	$1,206	+	$512	= $2,392

Table II
Substantial Earnings as Defined by the Windfall Elimination Provision

YEAR	SUBSTANTIAL EARNINGS ($)
1937-54	900
1955-58	1,050
1959-65	1,200
1966-67	1,650
1968-71	1,950
1972	2,250
1973	2,700
1974	3,300
1975	3,525
1976	3,825
1977	4,125
1978	4,425
1979	4,725
1980	5,100
1981	5,550
1982	6,075
1983	6,675
1984	7,050
1985	7,425
1986	7,875
1987	8,175
1988	8,400
1989	8,925
1990	9,525
1991	9,900
1992	10,350
1993	10,725
1994	11,250
1995	11,325
1996	11,625
1997	12,150
1998	12,675
1999	13,425
2000	14,175
2001	14,925
2002	15,750
2003	16,125
2004	16,275
2005	16,725
2006	17,475
2007	18,150
2008	18,975
2009-11	19,800
2012	20,475

$7,928 (maximum AIME, $95,136 per year, for individuals reaching 62 in 2011).

As illustrated, the worker paying the maximum amount into the Social Security system for 35 years would receive a monthly PIA of $2,392 or $28,704 annually at full retirement age. However, a middle-income worker paying into the Social Security system on $54,204 ($4,517 * 12) would receive a monthly benefit of $1,880 ($674 + $1,206) or $22,560 annually. This example illustrates the benefit advantage to the middle-income worker relative to the higher-income worker. The higher-income worker receives only $512 (27%) more per month than the middle-income worker while having paid 76% more in Social Security taxes. When compared to the lower-income worker, the higher-income worker pays more than 10 times as much tax as does the lower-income worker while receiving a benefit of less than 4 times that of the lower-income worker. This progressive benefit formula (coupled with a regressive tax structure) is consistent with the anti-poverty relief and safety net goals of the Social Security benefit system.

Details of the WEP

The WEP is intended to remedy the unintended windfall inherent in the design of the Social Security benefit formula for individuals who receive pension benefits from noncovered work in addition to Social Security benefits. Because the Social Security benefit formula only includes covered wages in its analysis, these individuals are treated as lower-income earners relative to their actual earnings. Because the Social Security benefit formula is designed to provide a higher replacement rate for lower-income individuals as compared to higher-income individuals, these individuals often receive a higher replacement rate than they would receive if all of their income were covered by Social Security.

The WEP reduces the Social Security benefit that such individuals would otherwise receive by modifying the PIA calculation formula. In the formula, the 90% benefit rate is reduced to 40% for the first range of covered wages—a maximum of $375 in 2011 (50% of the first range of covered wages—for beneficiaries reaching 62 in 2011, $375 = 50% of $749). However, the 90% rate is not reduced if the worker has at least 30 years of "substantial earnings" in Social Security covered employment (Table II). If a worker has 21 to 29 years of "substantial earnings," the 40% rate is increased in 5% increments up to 85% in year 29 and full benefits of 90% in year 30 (Table III).

The WEP is capped for individuals who receive a relatively low pension benefit for their noncovered wages. The WEP reduction to the worker's Social Security benefit cannot be more than one-half of the alternative pension benefit. While derivative Social Security benefits, such as spousal and dependent benefits are calculated based upon PIA after any WEP reduction, survivor benefits are not subject to the WEP. This exacerbates the potential burden and

Table III
Percent of Factor Reduction

YEARS OF SUBSTANTIAL EARNINGS	PERCENT FACTOR
30 and above	90%
29	85%
28	80%
27	75%
26	70%
25	65%
24	60%
23	55%
22	50%
21	45%
20 or less	40%

benefits of the WEP and should be included in any analysis of its impact.

In addition to the WEP, another provision—the Government Pension Offset (the GPO)—adjusts any spousal benefit for a worker who has noncovered wages. Similar to the WEP, Congress enacted the GPO in 1977 to make certain that a worker does not receive a spousal benefit in addition to her noncovered pension because relative to a similarly situated couple, where both spouses are covered by Social Security, the spousal benefit is considered a windfall. The presumption is that the government pension for noncovered workers is intended to replace both Social Security and a private sector pension. The GPO reduces spousal benefits by $2 for every $3 of any alternative Social Security government pension. While the focus of this article is the WEP, the Social Security Administration website has an informative publication on the GPO at www.ssa.gov/pubs/10007.html as well as a GPO calculator at www.ssa.gov/retire2/gpo-calc.htm.

An Example of Changing from Covered Employment to Noncovered Employment

Professor Adams worked for Private University for fifteen years subject to Social Security and Medicare taxes. She then accepted a position at State University where Social Security taxes were not withheld from her pay because the state system provided an alternative pension benefit to its employees. Professor Adams reached age 62 on January 15, 2011.

The calculation of Professor Adams' PIA is illustrated in Table IV. We have assumed that she, for each of fifteen years, earned the maximum amount of Social Security covered wages ($95,136 in 2011). However, because AIME is based on the average of the taxpayer's 35 highest qualifying earning years or 420 months (35 * 12 = 420 months), **including zero income years**, for purposes of calculating the Social Security benefit, Professor Adams' AIME is $3,398 [($95,136 * 15 = $1,427,040) / (420) = $3,398].

While the benefit percentage in the lowest income range for Professor Adams has been reduced from 90% to 40% by the WEP, she is entitled to 48% of the benefit she would have been entitled to if she had 35 years of covered wages instead of only 15 years ($1,148/$2,392 maximum earner benefit). While any derived spousal benefits will be based upon her PIA of $1,148, the survivor benefit will be increased to $1,522 [(90% * $749) + (32% * ($3,398 – $749))].

If Professor Adams had worked only ten years for Private University (the minimum years required to qualify for Social Security retirement benefits), her PIA would have been $785 based on an AIME of $2,265 (($95,136 * 10)/420), or 33% of the 35-year maximum earner benefit. Any derivative survivor benefits will be increased to $1,159 [(90% * $749) + (32% * ($2,265 – $749))] (Table V).

Table IV
Calculation of Professor Adams' PIA
(15 years in Social Security system)

	FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL	
0	**$749**		**$4,517**		**$7,928**	
Range	($749 * 0.40)	+	(($3,398 – $749) * 0.32)	+	(($3,398 – $4,517) * 0.15)	
PIA	$300	+	$848	+	$0	= $1,148

Table V
Calculation of Professor Adams' PIA
(10 years in Social Security system)

	FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL	
0	**$749**		**$4,517**		**$7,928**	
Range	($749 * 0.40)	+	(($2,265 – $749) * 0.32)	+	(($2,265 – $4,517) * 0.15)	
PIA	$300	+	$485	+	$0	= $785

If Professor Adams had worked for Private University for 20 or 25 years her AIME would have been $4,530 (($95,136 * 25)/420) or $5,663 (($95,136 * 20)/420) and her PIA would have been $1,508 (63% of the 35-year benefit) or $1,865 (78% of the 35-year benefit) (Table VI) with survivor benefits of $1,882 and $2,052, respectively.

If Professor Adams had worked 30 or more years for Private University there would be no reduction in the percentage benefit allowed for the first income range, but her AIME would be lower than if she had worked for 35 years. As a result, her PIA would be $2,222, or 93% of the 35-year maximum earner. And, if she had worked at least 35 years for Private University and then switched to State University there would be no effect on her Social Security retirement benefits although she would have been relieved from paying Social Security taxes in these subsequent years.

Similar PIA results for middle-, lower-, and highest-income earners with the WEP and the same wage scenario without the WEP are set forth in Table VII. (Note that these PIA amounts might be higher to the extent that the WEP exceeds one-half of the alternative pension amount.) The Social Security Administration has an online Social Security benefits calculator, which includes the WEP, at www.ssa.gov/retire2/anyPiaWepjs04.htm.

As Table VII illustrates, the WEP affects low earners proportionally more than higher earners. This is a direct result of its structure. First, the WEP reduction applies only to the first range of PIA ($749 in 2011). For all workers with covered AIME above this range, the maximum reduction is $375 per month, or $4,500 per year. As AIME rises, the reduction becomes a smaller percentage of PIA (starting at 50% reduction $375/$749 per month and dropping to less than 5% for a maximum earner $375/$7,928). Second, the WEP structure provides that if a worker has more than 20 years of coverage, defined as any year in which an individual has substantial covered earnings ($20,475 in 2012), she earns a 5 percentage point increase in the 40% rate applied to the first AIME range. Thus, at 30 years of coverage or more, the rate returns to the 90% rate applicable without the WEP. Both of these provisions adversely affect lower-income earners relative to higher-income earners.

Table VII demonstrates that even if a lower-income worker has 35 years of covered earnings she is entitled to only 59% of the Social Security retirement benefit she would otherwise receive if she had not earned a pension from noncovered wages. By way of comparison, middle- and higher-income earners can effectively eliminate the WEP by participating in the Social Security system for at least 30 years. Notably, these reduced PIAs are used to derive spousal and dependent derivative Social

Table VI
Calculation of Professor Adams' PIA
(25 years in Social Security system)

	FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL	
0	**$749**		**$4,517**		**$7,928**	
Range	($749 * 0.65)	+	(($4,517 – $749) * 0.32)	+	(($5,663 – $4,517) * 0.15)	
PIA	$487	+	$1,206	+	$172	= $1,865

Table VII
PIA for Social Security Beneficiaries Subject to the WEP and Not Subject to WEP

YRS. COVERED	LOWER-INCOME ($18,000)		MIDDLE-INCOME ($54,204)		HIGHEST-INCOME ($95,136)	
	WEP	NO WEP	WEP	NO WEP	WEP	NO WEP
10	$171 / 44%	$386	$473 / 56%	$847	$785 / 64%	$1,226
15	$257 / 44%	$579	$680 / 65%	$1,054	$1,148 / 72%	$1,588
20	$335 / 47%	$709	$886 / 70%	$1,260	$1,512 / 78%	$1,951
25	$403 / 52%	$777	$1,280 / 87%	$1,467	$1,865 / 91%	$2,052
30	$472 / 56%	$846	$1,673 / 100%	$1,673	$2,222 / 100%	$2,222
35	$540 / 59%	$914	$1,880 / 100%	$1,880	$2,392 / 100%	$2,392

Security benefits. Thus, not only is the lower-income worker subject to the WEP, but if her spouse and/or dependents receive a Social Security benefit based upon her work record they will also suffer the burden of the WEP. Therefore, lower-income senior households are harmed disproportionately and exponentially. Upon the death of the worker, any survivor benefits are not subject to the WEP and are increased to the benefit without the WEP reduction.

Maximizing Benefits from a Career Combining Social Security Covered and Noncovered Employment

If everything else is equal, the Social Security benefit calculation is not affected by whether a qualifying year (or quarter) occurred at the beginning or the end of the worker's career. Therefore, there is, at least theoretically, the possibility of increasing the worker's overall retirement benefits by working in the noncovered employment first and the covered employment at the later part of one's career. This is illustrated by comparing two careers that are identical except for this timing difference.

Maria Adelante began working for State University at age 26; it had a defined contribution pension plan as an alternative to Social Security. At age 56, she transferred to Private College, which withheld Social Security and Medicare taxes from her pay for ten years (40 quarters) until she reached her full retirement age of 66. Jesus Pasado, on the other hand, worked at Private College from age 26 to age 36. He then transferred to State University and participated in its defined contribution plan until his full retirement age of 66.

Because the Social Security benefits formula does not take into consideration when the qualifying years occurred, other than the wage-level inflation adjustment, if we assume everything else is equal, Maria will receive exactly the same Social Security benefits as Jesus. Assuming, for purposes of this example, that they both had the maximum amount of covered Social Security wages for the ten years that they worked for Private University, they would both have a PIA of $785 [($749 * 0.40 = $300)] + [(($2,265 – $749) * 0.32 = $485)] based on an AIME of $2,265 [($95,136 * 10 / 420) = $2,265].

Maria, however, will have almost twice the amount in her defined contribution account at age 66 as Jesus' balance. While the Social Security benefit calculation does not consider when the qualifying years were worked, deposits in defined contribution accounts do accrue earnings tax-deferred over time. If we assume that Maria and Jesus will both average an annual rate of return of 6% on their defined contribution accounts, at age 66, Maria's account will be about 1.8 times as large as Jesus' account, because it continued to accrue additional benefits during the last ten years that Maria worked for Private University.

Summary and Conclusions

Individuals contemplating changing jobs from covered to noncovered employment (or vice versa), or considering any noncovered employment must include the impact of the WEP on their family Social Security benefits in the analysis. The analysis should include the following key strategic objectives.

To qualify for Social Security retirement and Medicare benefits a worker, or a worker's spouse (or former spouse from an at least ten-year marriage) must have at least ten qualifying years (40 quarters) of minimal covered wages. Our analysis indicates that, everything else being equal, these ten years could be more beneficial if worked at the end of the worker's career rather than earlier in the worker's career.

In addition, the impact of the WEP is reduced if a worker has substantial covered earnings in more than 20 years. The benefit of meeting these earning thresholds for every year of covered employment is significant not only for the worker's Social Security benefits, but also for any derivative benefits. The ability to qualify for mitigation of the WEP could have a meaningful impact on a retiree's household retirement income. Notably, once a worker has at least 30 years of substantial covered earnings, the WEP is completely eliminated for the worker as well as for any spousal or dependent derivative benefits.

Most critically, understanding the mechanics of the WEP and using the work incentives and disincentives strategically could make noncovered employment attractive as an opportunity to diversify one's retirement income portfolio as well as supplement unreduced Social Security benefits. Finally, as we continue to debate Social Security reform, the disproportionate impact of the WEP on lower-income workers must be addressed and remedied. The most vulnerable public workers and their families, who like most retirees are ill equipped to understand the technical, opaque morass of the WEP, deserve nothing less. ■