Making Social Security Work

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Social Security is the largest social welfare program in the United States. In 2000, for example, Social Security's Old-Age and Survivor's Insurance (OASI) program alone collected some $421 billion in payroll taxes and distributed more than $352 billion in benefits to elderly Americans and their dependents. The program has been remarkably successful in reducing the levels of poverty among the elderly. Unfortunately, however, many features of the current Social Security system tend to discourage individuals from working, just when the system should, instead, encourage people to stay in the work force longer so that they can accumulate the additional economic resources that they will need to support themselves over ever longer lives and ever longer retirements.

The purpose of this Article is to discuss how the Social Security system could be redesigned to make it more work friendly. At the outset, Part II of this Article provides an overview of the current Social Security system, and Part III of this Article explains the need for reform.

Finally, Part IV of this Article discusses how to restructure the current Social Security system in order to increase work incentives and reduce work disincentives. One approach would be to have a two-tiered Social Security system for providing benefits to individuals. The first tier would provide a basic benefit to every older American, and these benefits would be financed out of general revenues. The second tier would provide an additional earnings-related benefit based on payroll tax contributions made to individual accounts. Although tinkering with the current Social Security retirement system could certainly reduce its work disincentives, this more comprehensive approach could solve all of the current system's work disincentive problems. In short, the two-tiered system described here would make Social Security work.

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I. INTRODUCTION

Social Security is the largest social welfare program in the United States. In 2000, for example, Social Security's Old-Age and Survivor's Insurance (OASI) program alone collected some $421 billion in payroll taxes and distributed more than $352 billion in benefits to elderly Americans and their dependents.[1] These Social Security benefits are incredibly important for the population aged sixty-five and older. In fact, Social Security provides 100% of income for 20% of elderly households and more than half of the income for another 44% of elderly households.[2] Of particular note, Social Security has been especially successful in reducing the level of poverty among

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[1] SOCIAL SECURITY ADMINISTRATION, ANNUAL STATISTICAL SUPPLEMENT TO THE SOCIAL SECURITY BULLETIN: 2001, 151 (2002) [hereinafter ANNUAL STATISTICAL SUPPLEMENT], *available at* http://www.ssa.gov/policy/docs/statcomps/supplement/2001/supp01.pdf.

[2] *Id.* at 18.

the elderly. With Social Security, only 9% of beneficiaries in the year 2000 were poor; without it, 48% would have been poor.[3]

Three aspects of Social Security benefits are of critical importance. First, benefits are paid in the form of an annuity that lasts for the rest of a retiree's life. Second, benefits are adjusted for inflation so that the real benefits do not decline as the retiree grows older. As a result, Social Security benefits are designed to provide real benefits for as long as the retiree lives. Third, additional spousal and dependent benefits help support the retiree's family during life and even after the death of the retiree.

Unfortunately, however, many features of the current Social Security system tend to discourage individuals from working, just when the system should, instead, encourage people to stay in the work force longer so that they can accumulate the additional economic resources that they will need to support themselves over ever longer lives and ever longer retirements.

The current Social Security system discourages work in two principal ways. First, because the current Social Security system redistributes economic resources from some workers to other workers and their families, the system acts like a tax on some workers and like a welfare program for the other workers and their families. Such taxes and transfers inevitably influence individual decisions about work and retirement, and, as it turns out, both the net taxes and the net transfers tend to discourage work effort. Second, particular features of the way that Social Security benefits are financed, accrue, and are paid out tend to compound these work disincentives.

The purpose of this Article is to discuss how the Social Security system could be redesigned to make it more work friendly. This Article asks how Social Security should be structured in order to encourage work and to counter the trend toward early retirement. In short, this is an Article about making Social Security work.

At the outset, Part II of this Article provides an overview of the current Social Security system. Part III of this Article explains the need for reform. Finally, Part IV of this Article discusses how to restructure the current Social Security system in order to increase work incentives and reduce work disincentives.

II. AN OVERVIEW OF THE CURRENT SOCIAL SECURITY SYSTEM

The current 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 monthly cash benefits to retired workers and their dependents and to survivors of insured workers, and the Disability Insurance (DI) program provides monthly cash benefits for disabled workers under full retirement age and their dependents.[4] A worker builds protection under these programs by

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[3] *Id.* at 19.

[4] *See* STAFF OF HOUSE COMM. ON WAYS AND MEANS, 106TH CONG., 2000 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE

working in employment that is covered by Social Security and paying the applicable payroll taxes. At present, about 96% of workers are working in covered employment.[5] At retirement, disability, or death, monthly Social Security benefits are paid to insured workers and to their eligible dependents and survivors.

The Old-Age and Survivors Insurance (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 2000, for example, the OASI program paid more than $352 billion in benefits to more than 38 million retired workers and their families.[6] The average benefit paid to a retired worker was about $845 per month.[7] Consequently, for the remainder of this article, the term "Social Security retirement taxes" will refer to OASI taxes, and the term "Social Security retirement benefits" will refer to OASI benefits.

In addition, a separate Supplemental Security Income (SSI) program provides monthly cash benefits to certain low-income elderly, disabled or blind Americans.[8] In 2000, for example, almost 1.3 million elderly Americans received SSI benefits from the federal government, and the average benefit was about $258 a month.[9]

A. Social Security Taxes

Social Security 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 2003, employees and employers each pay a tax of 5.3% on up to $87,000 of wages earned in covered employment, for a combined OASI rate of 10.6% (the lion's share of the total rate of 15.3% that is collected for OASI, DI, and Medicare).[10] Employees are not allowed to deduct their portion of Social Security taxes for income tax purposes.[11] On the other hand, the employer's portion of Social Security taxes is excluded from the employee's income for income tax purposes.[12]

ON WAYS AND MEANS 1–96 (Comm. Print 2000) [hereinafter 2000 GREEN BOOK]; *see generally* Social Security Act, 42 U.S.C. §§ 301-1397(jj) (2000)).

[5] 2000 GREEN BOOK, *supra* note 4, at 4.

[6] ANNUAL STATISTICAL SUPPLEMENT, *supra* note 1, at 151, 174.

[7] *Id.* at 174.

[8] *See* 2000 GREEN BOOK, *supra* note 4, at 211–78. In 2003, for example, the maximum federal benefit for an individual is $552 per month, and the maximum federal benefit for a married couple is $829 per month. *See also* Cost-of-Living Increase and Other Determinations for 2003, 67 Fed. Reg. 65,620 (Oct. 25, 2002). Some states provide small additional supplements. *See, e.g.*, 2000 GREEN BOOK, *supra* note 4, at 232–39.

[9] ANNUAL STATISTICAL SUPPLEMENT, *supra* note 1, at 276, 278.

[10] Cost-of-Living Increase and Other Determinations for 2003, 67 Fed. Reg. 65,620, 65,622 (Oct. 25, 2002); 2000 GREEN BOOK, *supra* note 4, at 42.

[11] I.R.C. §§ 275(a)(1)(A), 3502(a) (2000); Treas. Reg. § 1.164-2(a) (as amended in 1981).

[12] H.R. REP. NO. 47, at 125–26 (1983), *reprinted in* 1983 U.S.C.C.A.N. 404, 414–15.

Self-employed workers pay an equivalent OASI tax of 10.6% on up to $87,000 of net earnings.[13] In order to put self-employed individuals in an approximately equivalent position as employees, self-employed individuals can deduct half of these taxes for both Social Security and income tax purposes.[14]

Of note, however, the earned income tax credit in the individual income tax system offsets a large portion of the Social Security payroll taxes paid by low-income workers. In 2003, for example, the earned income tax credit provides taxpayers with two or more children with a credit of up to $4,204.[15] For married couples, the credit phases in as earned income rises from zero to $10,510, and it begins to phase out once income exceeds $14,730. A taxpayer with one child can claim an earned income tax credit of up to $2,547, and a taxpayer with no children can claim a credit of up to $382. In effect, through the mechanism of the earned income tax credit, the Treasury makes the Social Security payroll tax contributions for many low-income workers, with the Treasury's payments coming out of such other general revenues as the individual income tax and the corporate income tax.

Finally, as much as 85% of a taxpayer's Social Security benefits are subject to income taxation.[16] 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% of their Social Security benefits in income. For the year 2000, an estimated 12.5 million OASI and DI beneficiaries paid tax on at least some of their benefits (32% of all beneficiaries).[17] All in all, the federal government collected about $17.3 billion in taxes from those beneficiaries.[18]

B. *Social Security Benefits*

1. *Worker Benefits*

Workers over the age of sixty-two are generally entitled to Social Security retirement benefits if they have worked in covered employment for at least ten years.[19] Benefits are based on a measure of the worker's earnings history in covered

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[13] Cost-of-Living Increase and Other Determinations for 2003, 67 Fed. Reg. 65,620, 65,622 (Oct. 25, 2002); GREEN BOOK, *supra* note 4, at 43.

[14] I.R.C. §§ 164(f), 1402(a)(12) (2000).

[15] Rev. Proc. 2002-70, 2002-2 C.B. 845.

[16] I.R.C. § 86(a)(2)(B) (2000).

[17] 2000 GREEN BOOK, *supra* note 4, at 65.

[18] *Id.*

[19] 42 U.S.C. §§ 402(a), 414(a)(2) (2000); 2000 GREEN BOOK, *supra* note 4, at 16 (ten years is

employment known as the average indexed monthly earnings (AIME).[20] 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 $87,000 of 2003 earnings could count toward a Social Security retirement benefit.[21]

The starting point for determining the worker's AIME is to determine how much the worker earned each year through age sixty. Once these so-called "benefit computation years" and covered earnings for those years have been identified, the worker's earnings for years prior to age sixty 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 sixty 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. [22] Earnings in and after age sixty are not indexed, but can enter into the benefit computation formula.

The highest thirty-five years of earnings are then selected, and the rest of the years are dropped out.[23] The AIME is then computed as the average earnings for the remaining thirty-five years. More specifically, the sum of the indexed earnings in the worker's highest thirty-five years is divided by the 420 months in that thirty-five year computation period (420 months = 35 years x 12 months per year).

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).[24] Historically, "full retirement age" was age sixty-five, but it is gradually increasing to age sixty-seven for workers reaching age sixty-two in or after 2022 (sixty-seven in or after 2027).[25] For a worker turning sixty-two in 2003, the PIA is equal to 90% of the first $606 of the worker's AIME, plus 32% of the AIME over $606 and through $3,653 (if any), and plus 15% of the AIME over $3,653 (if any).[26]

Most importantly, it is worth noting that, on its face, the benefit formula is highly progressive; that is, the benefit formula is designed to favor workers with relatively

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the equivalent of forty quarters of coverage).

[20] 42 U.S.C. § 415(b) (2000).

[21] *Id.* §§ 415(e), 430. For comparison, note that the earnings cap was $3,000 from 1937 to 1950 and only reached $7,800 in 1970. 2000 GREEN BOOK, *supra* note 4, at 42.

[22] For example, the maximum nominal covered earnings for 1960 was approximately $4,800, but indexing those earnings up to 1999 yields indexed earnings for 1998 equal to $34,572. The indexing year is the second year before the year in which the workers attains age sixty-two, becomes disabled, or dies. Earnings after the indexing year are counted at their nominal value. 2000 GREEN BOOK, *supra* note 4, at 19–20, 54.

[23] 42 U.S.C. §§ 415(b)(2)(i), 415(b); 2000 GREEN BOOK, *supra* note 4, at 20.

[24] 42 U.S.C. §§ 415(a), 416(l).

[25] *Id.* §416(l); 2000 GREEN BOOK, *supra* note 4, at 22–23.

[26] Cost-of-Living Increase and Other Determinations for 2003, 67 Fed. Reg. 65,620, 65,623 (Oct. 25, 2002).

low career-average earnings. In addition, for workers with very low AIMEs, there is a special minimum benefit that is structured to provide an even larger benefit to those who worked in covered employment for many years but had low earnings.[27]

A worker's benefits may be increased or decreased for several reasons. Most important, benefits are indexed each year for inflation as measured by the increase in the Consumer Price Index.[28]

Also of critical importance, workers who retire before their full retirement age have their benefits actuarially reduced.[29] For example, a worker who turned sixty-two in 1999 and had yearly earnings throughout her career equal to the average wage would be entitled to a worker benefit starting at age sixty-five of $1,049.60 a month.[30] If, instead, she started drawing her benefit at age sixty-two, that benefit would be actuarially reduced by 20%, to about $839 per month.[31] As full retirement age increases to age sixty-seven, the actuarial reduction will also increase to 30%.[32]

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.[33] The delayed retirement credit increases the monthly benefit to be paid to a worker who delays receipt of benefits until after full retirement age because the worker has not filed an application for benefits or was working. The delayed retirement credit is 7.5% per year for workers age sixty-two in 2003 and will increase by one-half of 1% in 2005 to reach an actuarially-fair 8%.[34]

Finally, the so-called "retirement earnings test" can reduce 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.[35] For example, in 2003, workers who have not yet reached full retirement age lose $1 of benefits for every $2 of annual earnings over $11,520.[36]

2. *Family Benefits*

Spouses, dependents, and survivors of the worker may also receive additional monthly benefits.[37] These family benefits are also based on the worker's primary

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[27] 2000 GREEN BOOK, *supra* note 4, at 21.

[28] 42 U.S.C. § 415(i) (2000).

[29] 42 U.S.C. § 402(q); 2000 GREEN BOOK, *supra* note 4, at 22–23.

[30] 2000 GREEN BOOK, *supra* note 4, at 56.

[31] *Id.* at 22–23, 60 ($1,049.60 × .80 = $839).

[32] 2000 GREEN BOOK, *supra* note 4, at 23, 60.

[33] 42 U.S.C. § 402(w).

[34] 2000 GREEN BOOK, *supra* note 4, at 23, 60.

[35] 42 U.S.C. § 403(f)(2000).

[36] Cost-of-Living Increase and Other Determinations for 2003, 67 Fed. Reg. 65,620, 65,622–23 (Oct. 25, 2002).

[37] 42 U.S.C. §§ 402(b) (wife), (c) (husband), (d) (child), (e) (widow), (f) (widower), (g)

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% of the worker's PIA.[38] Consequently, a retired worker and spouse generally can claim a monthly benefit equal to 150% of what the retired worker alone could claim. In December of 2000, for example, almost 2.8 million spouses of retired workers were collecting benefits averaging $430 per month.[39] Also, a retirement-age widow or widower of the worker is entitled to a monthly surviving spouse benefit equal to 100% of the worker's PIA.[40]

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.[41]

C. Social Security Funding

The Social Security system operates largely on a pay-as-you-go basis (PAYGO).[42] 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 year or two of benefits. For example, in 2000, the Old-Age and Survivors Insurance Trust Fund received $421 billion in payroll tax contributions, paid out $353 billion in benefits, and had $931 billion on hand at the close of the year.[43] Similarly, in 2000, the Disability Insurance Trust Fund received $71 billion in payroll tax contributions, paid out $55 billion in benefits, and had $118 billion on hand at the close of the year.[44] As of January 1, 2003, the unfunded liability of the Social Security system was estimated to be $12.6 trillion.[45]

(mother and father), and (h) (parents).

[38] 42 U.S.C. § 402(b)(2).

[39] ANNUAL STATISTICAL SUPPLEMENT, *supra* note 1, at 178.

[40] 42 U.S.C. §§ 402(e), (f).

[41] 42 U.S.C. § 402(k) (2000).

[42] *See generally* LAWRENCE THOMPSON, OLDER & WISER: THE ECONOMICS OF PUBLIC PENSIONS (1998); Laurence S. Seidman, *Funding Social Security*, 81 TAX NOTES 241, 242–43. (1998).

[43] ANNUAL STATISTICAL SUPPLEMENT, *supra* note 1, at 151.

[44] *Id.* at 152.

[45] *See generally* OFFICE OF THE CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION, UNFUNDED OBLIGATIONS AND SELECTED TRANSITION COSTS FOR THE COMBINED OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE (OASDI) PROGRAM (Mar. 17, 2003) [hereinafter SOCIAL SECURITY UNFUNDED OBLIGATION] (copy on file with the author). The $12.6 trillion figure is an estimate of the maximum transition cost as of January 1, 2003, in connection with replacing the current form of Social Security benefits with a new form of benefits. Thus, the maximum transition cost represents the cost for terminating the current Social Security program, but continuing to pay benefits that have already been earned. This maximum transition cost is computed as the difference between (a) the present value of all future benefits payable after the

D. *Supplemental Security Income*

Supplemental Security Income (SSI) is a means-tested, federally administered program that provides monthly cash benefits to certain low-income elderly, disabled or blind Americans.[46] Benefits are indexed for inflation, and in 2003, the maximum federal benefit for an individual is $552 per month, and the maximum federal benefit for a married couple is $829 per month.[47] Some states provide small additional supplements.[48] Unlike Social Security, the SSI program is financed by general revenues—individual income taxes, corporate income taxes, and other taxes.

The total number of recipients on SSI has increased from nearly 4 million in 1974 to nearly 6.8 million in September of 2002.[49] Most are under age sixty-five and disabled. Still, in 2000, almost 1.2 million elderly Americans received SSI benefits from the federal government, and the average benefit was about $258 a month.[50]

Eligible recipients do not have to be totally without income to receive SSI benefits. Eligible recipients receive the maximum benefits if they have no other "countable" income in that particular month. If an individual or couple has "countable" income, however, there is a dollar-for-dollar reduction against the maximum payment. Just over half of SSI beneficiaries have another source of income, and the largest fraction of these received modest Social Security benefits.[51] In 1999, for example, 36.3% of SSI beneficiaries also received Social Security benefits, and the average amount of those Social Security benefits was almost $384 per month.[52]

As currently structured, SSI benefits alone are insufficient to pull recipients out of poverty. In 1999, for example, the maximum federal benefit for an individual was just 75% of the poverty level, and the maximum federal benefit for couples was just 89.3% of the poverty level.[53]

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valuation date based on earnings prior to the valuation date (earnings credited under the old form), and (b) the value of the assets on the valuation date plus the present value of revenue from taxation of future benefits payable on the old form. Future benefits payable on the old form for workers who have not reached benefit eligibility age (sixty-two) are calculated on a proportional past service credit basis. *See also* Stephen C. Goss, *Measuring Solvency in the Social Security System*, *in* PROSPECTS FOR SOCIAL SECURITY REFORM 16, 34 (Olivia S. Mitchell et al. eds., Pension Research Council 1999) (explaining the methodology and estimating Social Security's unfunded liability at about $9 trillion as of October 1, 1997).

[46] *See* 2000 GREEN BOOK, *supra* note 4, at 212.

[47] Cost-of-Living Increase and Other Determinations for 2003, 67 Fed. Reg. 65,620 (Oct. 25, 2002).

[48] *See, e.g.*, 2000 GREEN BOOK, *supra* note 4, at 232–39.

[49] *Id.* at 213; 64 SOC. SECURITY BULL., inside back cover (No. 3 2001/2002).

[50] ANNUAL STATISTICAL SUPPLEMENT, *supra* note 1, at 276, 278.

[51] 2000 GREEN BOOK, *supra* note 4, at 214–15.

[52] *Id.*

[53] *Id.*

By long-standing administrative policy, public assistance payments such as SSI are not subject to income taxation.[54]

III. THE NEED FOR REFORM

Social Security needs to be reformed for two principal reasons. First, Social Security is in financial trouble and will not be able to meet its future benefit commitments. Second, Social Security discourages people from working, just when it should instead encourage people to stay in the work force longer so that they can accumulate the additional economic resources that they will need to support themselves over ever longer lives and ever longer retirements.

A. *The Social Security System Is Vastly Underfunded*

Perhaps the most obvious problem with Social Security is that it is in financial trouble. The Trustees of the Social Security Trust Funds estimate that Social Security retirement and disability benefits will exceed trust fund income starting around 2018, and the Social Security system will be unable to pay full benefits after about 2042.[55] In fact, the Trustees estimate that the deficit over the traditional seventy-five-year projection period is about 1.92% of payroll,[56] and the unfunded liability of the Social Security system exceeds $12.6 trillion.[57]

The primary reason that Social Security is in financial trouble is that people are living longer and retiring earlier.[58] As a result, there are a lot of Social Security

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[54] INTERNAL REVENUE SERVICE, U.S. DEP'T OF TREASURY, TAXABLE AND NONTAXABLE INCOME 24 (Pub. No. 525, 2002); I.T. 3447, 1941-1 C.B. 191, *superseded by* Rev. Rul. 70-217, 1970-1 C.B. 12; *see also* 2000 GREEN BOOK, *supra* note 4, at 780–81, 812–13; Rev. Rul. 76-395, 1976-2 C.B. 16 (Home Rehabilitation Housing and Community Act; grants to low-income recipients primarily for correction of critical code violations); Rev. Rul. 78-170, 1978-1 C.B. 24 (Ohio payments to reduce energy costs for low-income elderly or disabled heads of households); Rev. Rul. 76-144, 1976-1 C.B. 17 (Disaster Relief Act; grants to persons who as a result of a major disaster are unable to meet necessary expenses and needs); *see generally* Jonathan Barry Forman, *The Income Tax Treatment of Social Welfare Benefits*, 26 U. MICH. J.L. REFORM 785 (1993).

[55] Social Security and Medicare Boards of Trustees, *Status of the Social Security and Medicare Programs: A Summary of the 2003 Annual Reports*, at http://www.ssa.gov/ OACT/TRSUM/trsummary.html (last visited Oct. 23, 2003).

[56] *Id.*

[57] SOCIAL SECURITY UNFUNDED OBLIGATION, *supra* note 45.

[58] For example, the life expectancy for a male born in 1940 was just 61.4 years; in the year 2000, it was 73.9 years. 2000 GREEN BOOK, *supra* note 4, at 993. Also, a man reaching age 65 in 1940 could expect to live another 11.9 years, but a man who reached 65 in the year 2000 could expect to live another 15.9 years. *Id.* Moreover, as the years go by, an increasing percentage of Americans will survive to old age. While just 54% of men born in 1875 survived from age 21 to age 65 in 1940, some 83% of men born in 1985 are expected to survive from age 21 to age 65 in 2050. C. EUGENE STEUERLE & JON M. BAKIJA, RETOOLING SOCIAL SECURITY FOR THE 21ST

beneficiaries, and there are fewer workers to support them.[59] That is not necessarily bad. After all, it is great that we are living longer, and it is great 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.

B. *The Social Security System Discourages People from Working*

A second major problem with the current Social Security system is that it tends to discourage people from working. Social Security discourages work in two principal ways. First, because the current Social Security system redistributes economic resources from some workers to other workers and their families, the system acts like a tax on some workers and like a welfare transfer program for the other workers and their families. Such taxes and transfers inevitably distort individual decisions about work and retirement, and, as it turns out, both the net taxes and the net transfers tend to discourage work effort. Second, particular features of the way that Social Security retirement benefits are financed, accrue, and are paid out also tend to compound these work disincentives. These are discussed in turn.

1. *Redistribution in the Social Security Retirement Program Discourages Work Effort*

a. *How Social Security Redistributes Economic Resources*

A casual observer of the current Social Security retirement system would see that it is a pay-as-you-go (PAYGO) social welfare system that takes payroll taxes from current workers and redistributes those funds to current retirees and their families. On closer inspection, however, most experts agree that the best way to understand Social Security's distributional features is to evaluate the program's impact over the course

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CENTURY: RIGHT AND WRONG APPROACHES TO REFORM 41 (1994).

[59] The ratio of workers-to-beneficiaries has been declining for years. In 1950, there were 16.5 covered workers for each beneficiary; in 1975, there were about three workers per beneficiary; and by 2015, there will be about 2.7 workers per beneficiary. *See, e.g.*, Lawrence H. Thompson, *Overview of Social Security Issues, in* 2 REPORT OF THE 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY 279 (1997) [hereinafter SOCIAL SECURITY ADVISORY COUNCIL].

of a worker's lifetime.[60] This lifetime perspective leads to a comparison between the Social Security taxes paid by a worker and the expected benefits.[61]

Numerous studies have made just such comparisons.[62] Their results clearly show that the linkage between the Social Security taxes paid by a worker and her expected benefits is quite loose and can vary dramatically depending on such factors as family status, income, and age. In effect, the current Social Security system takes money from some workers and gives it to other workers and their families.

In fact, the current Social Security system is wildly redistributive, and not everyone gets his or her "money's worth." In particular, the current Social Security system favors early generations of retirees over later generations, workers with low career-average earnings over workers with high career-average earnings, married couples over single individuals, one-earner couples over two-earner couples, larger families over smaller families, and elderly retirees over elderly workers. These are discussed in turn.

i. *Early Generations vs. Later Generations*

Early generations of Social Security beneficiaries receive disproportionately greater benefits than their meager tax contributions might otherwise justify. Their rich rewards are the inevitable consequences of two facts: (1) early participants paid relatively low taxes over relatively short coverage periods, yet (2) they received relatively generous benefits over relatively long benefit periods. Thus, Social Security favors early generations of beneficiaries over later generations.

This redistribution in favor of early generations of retirees can be most easily understood by considering the very first Social Security beneficiary, Ida May Fuller of

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[60] *See, e.g.*, Dean R. Leimer, *Lifetime Redistribution Under the Social Security Program: A Literature Synopsis*, 62 SOC. SECURITY BULL. 43 (No. 2 1999); Jonathan Barry Forman, *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples*, 45 TAX LAW. 915, 948–57 (1992); Jonathan Barry Forman, *The Social Security Cash Machine, in* ESTATE PLANNING STRATEGIES: A LAWYER'S GUIDE TO RETIREMENT AND LIFETIME PLANNING 3, 3–9 (Jay A. Soled ed., 2002).

[61] For example, one might compare the expected value at age sixty-five of the OASI taxes that a worker paid over a career, together with interest at a market rate on those tax payments, with the expected value at age sixty-five of the stream of OASI benefits that the worker could expect to receive for life. The worker will receive her "money's worth" if the expected value of benefits to be received equals the expected value of all taxes paid. If the expected value of taxes paid exceeds the expected value of benefits, then the worker would, in effect, be paying other program participants. But, if the expected value of benefits exceeds the expected value of the taxes paid, then the worker would be receiving extra benefits from other participants.

[62] *See, e.g.*, sources cited in Leimer, *supra* note 60; *see also* sources cited in *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples*, *supra* note 60, at 937–48.

Ludlow, Vermont.[63] Miss Fuller was a legal secretary who retired in November 1939. She started collecting benefits in January 1940 at age sixty-five and eventually lived to be one hundred years old, dying in 1975. Miss Fuller worked for just three years under the Social Security retirement program. The accumulated payroll taxes on her salary during those three years totaled $24.75. Her initial monthly check was $22.54. During her lifetime she collected a total of $22,888.92 in Social Security benefits.[64]

Fortunately, Social Security is close to maturity, with most workers having been in covered employment or self-employment throughout their careers. Additionally, both the Social Security tax rate and tax base have been increased. Accordingly, studies project that by the time the baby boomers retire (starting around 2010), the value of the Social Security benefits the boomer generation will receive should roughly equal the value of the Social Security taxes that they paid.[65] Generations retiring prior to 2010 will continue to receive more favorable treatment, but the size of these intergenerational transfers will diminish over time.

ii. *Low Earners vs. High Earners*

Because of the progressive formula used to compute Social Security benefits, workers with low earnings over their careers tend to receive disproportionately greater benefits than workers with high earnings. Of note, however, this redistribution occurs only within the limited range of covered earnings (*i.e.*, up to $87,000 in 2003); above this cap, earnings are not redistributed. For example, a worker earning $1,000,000 a year pays no more Social Security retirement taxes than a worker earning $87,000 a year.[66] Also, the progressive redistribution (from high-earners to low-earners) may be somewhat offset by the longer life expectancies of high-income workers and their spouses and by the greater likelihood that spousal and surviving spouse benefits will be paid to spouses of high earners.[67]

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[63] Larry DeWitt, *Details of Ida May Fuller's Payroll Tax Contributions*, Social Security Administration Historian's Office Research Note No. 3, *at* http://www.ssa.gov/history/idapayroll.html (prepared July 3, 1996); *see also* Social Security Administration, *The First Social Security Beneficiary*, *at* http://www.ssa.gov/history/imf.html (last visited Oct. 23, 2003).

[64] *Id.*

[65] *See, e.g., Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples*, *supra* note 60, at 937–43.

[66] *See, e.g.*, Jonathan B. Forman, *Bill Gates and I Pay Equally—and This Is Supposed to Be a Fair System?*, L.A. TIMES, Dec. 25, 1998, at B13.

[67] *See generally* WILLIAM W. BEACH & GARETH G. DAVIS, SOCIAL SECURITY'S RATE OF RETURN: A REPORT OF THE HERITAGE CENTER FOR DATA ANALYSIS, No. CDA98-01 (Jan. 15, 1998); JAMES E. DUGGAN ET AL., PROGRESSIVE RETURNS TO SOCIAL SECURITY? AN ANSWER FROM SOCIAL SECURITY RECORDS (Office of the Assistant Secretary for Economic Policy, U.S. Treasury Department, Research Paper No. 9501, Nov. 21, 1995); CONSTANTIJN W.A. PANIS & LEE A.

iii. *Married Couples vs. Single Individuals; Larger Families vs. Smaller Families*

Because of spousal and surviving spouse benefits, married couples tend to receive relatively more benefits than single individuals.[68] To illustrate this inequity, consider the fact that a single worker with no dependents will receive a benefit at full retirement age of just 100% of the worker's PIA, while a worker with a spouse will receive 150% of the worker's PIA, and a surviving spouse can receive 100% of a worker's benefit long after that worker's death.

The redistribution that results from spousal benefits can be most easily understood when one considers how long surviving spouse benefits can last. For example, consider Gertrude Janeway, the last widow of a Union veteran from the Civil War.[69] Ms. Janeway married her husband in 1927, and when she died in January of 2003 at the age of ninety-three, she was still collecting a $70-a-month pension from the Veterans Administration.[70]

Furthermore, providing family benefits for other dependents favors larger families over smaller families and single individuals. In that regard, a worker with a spouse and additional dependents could receive a monthly benefit of as high as 188% of the worker's PIA,[71] yet a worker with a spouse and no other dependents would receive a monthly benefit of just 150% of the worker's PIA. Again, in contrast, a single worker would receive a monthly benefit of just 100% of her PIA.

LILLARD, SOCIOECONOMIC DIFFERENTIALS IN THE RETURNS TO SOCIAL SECURITY (RAND Labor and Population Program, Working Paper Series 96-05, No. DRU-1327-NIA, Feb. 1996).

In that regard, in 2001, 79.9% of households in the highest quintile of household income were married-couple families, but only 19.6% of households in the lowest quintile were married-couple families. CARMEN DENAVAS-WALT & ROBERT W. CLEVELAND, MONEY INCOME IN THE UNITED STATES: 2001, at 10 tbl. 3 (U.S. Census Bureau, Current Population Reports, series P60-218, 2002), *available at* http://www.census.gov/prod/2002pubs/p60-218.pdf.

[68] *See generally* Jonathan Barry Forman, *Making Social Security Work for Women and Men*, 16(1) N.Y.L. SCH. J. HUM. RTS. 359 (1999); Jonathan Barry Forman, *Whose Pension Is It Anyway? Protecting Spousal Rights in a Privatized Social Security System*, 76 N.C. L. REV. 1653 (1998); Jonathan Barry Forman, *Social Security: What Can Be Done About Marriage Penalties?*, 75 TAX NOTES 270 (1997) and 6 S. CAL. REV. L. & WOMEN'S STUD. 553 (1997).

[69] *See* Duncan Mansfield, *Civil War Widow Gertrude Janeway dies at age 93*, Tennessean.com (Jan. 20, 2003) *at* http://www.tennessean.com/obits/archives/03/01/27889583.shtml?Element_ID=27889583 (last visited Jan. 11, 2004).

[70] The Civil War's last widow is still alive. She is Alberta Martin, age 96. In 1927, she married William Jasper Martin, then an 81-year-old former private in the Confederate army. Although he is long gone, she continues to draw a substantial, Alabama-financed, Confederate pension. David Lamb, *Civil War's Last Widow Shares Her Memories*, LOS ANGELES TIMES, Feb. 3, 2003, at A14.

[71] 2000 GREEN BOOK, *supra* note 4, at 23.

iv. *One-earner vs. Two-earner Couples*

Two additional problems result from providing spousal and surviving spouse benefits based on the earnings of a retired worker. First, two-earner couples generally receive lower total benefits than one-earner couples with the same earnings. Second, because married women with earnings usually earn less and work a shorter time than their husbands, they often receive little or no additional Social Security retirement benefits from their Social Security tax payments.

The following example helps illustrate the penalty on two-earner couples:

> The Greens and the Whites each earn twice the average wage. But, while Tom Green is the sole breadwinner, Ted and Becky White each earn the same amount. When Tom Green retires in 2032, the couple receives a Social Security benefit of $37,769—Tom's retired worker benefit of $25,179 plus Beth Green's spousal benefit of half that amount, $12,590. When Ted and Becky White retire in 2032, each spouse gets a retired worker benefit of $17,358, a family total of only $34,716. That's $3,053 less than Tom and Beth's benefit.

> Tom Green dies. Beth Green moves up from spousal benefit to survivor benefit and receives $25,179. But, when Ted White dies, Becky White continues to get only her retired worker benefit of $17,358. Taking into account life expectancy, Tom and Beth can anticipate lifetime benefits of $549,694, while Ted and Becky are likely to receive $100,103 less—only $449,561.[72]

In fact, the inequity really falls on the secondary workers themselves—those married individuals who earn less than their spouses. When a secondary worker is entitled to Social Security benefits both as a retired worker and as a spouse (or surviving spouse) of a primary worker, the dual entitlement rule prevents the secondary worker from receiving both the full worker's benefit and the full spousal (or surviving spouse) benefit. Instead, only the larger of the two benefits is paid. The effect is that the secondary worker gets no return on the Social Security retirement taxes she paid unless her worker benefit exceeds the spousal (or surviving spouse) benefit she is entitled to based on the primary worker's earnings record.

Consider another example:

> Jorge Rodriguez earns $40,000 a year, entitling him to a retired worker's benefit of $14,758 when he retires in 2000. His wife Inez, earns $15,000 a year, which yields a retired worker's benefit of $7,967. Granted, that's more than the spousal benefit of $7,379—but not much more, only $588 a year. In fact, if instead of Inez working at all, Jorge earned that $15,000 on top of his current salary, he would be entitled to $17,008 a year at retirement and Inez would get $8,504 in spousal benefits. Thus, if Jorge earns the additional $15,000, their total benefit

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[72] Corinna Nicolaou & Rochelle Stanfield, *Social Security: Out of Step with the Modern Family* 9 (Apr. 1, 2000), http://www.urban.org/UploadedPDF/out_of_step.pdf.

would be $2,787 higher than if Inez earned the $15,000. When either Jorge or Inez dies, the survivor gets $2,250 more if Jorge, rather than Inez, had earned the extra $15,000. [73]

Indeed, for many secondary workers in two-earner couples, the additional Social Security retirement taxes they paid will produce absolutely no more retirement benefits than if they had not worked at all and paid no retirement taxes. With respect to spousal benefits, this inequity will occur any time the worker benefit earned by the primary worker is more than twice the worker benefit earned by the secondary worker. The secondary worker would then receive a greater Social Security retirement benefit as a spouse than as a retired worker.[74]

All in all, there are substantial penalties on two-earner couples, in general, and on secondary workers, in particular.

v. *Elderly Retirees vs. Elderly Workers*

The current Social Security retirement program also favors elderly retirees over elderly workers.[75] Monthly Social Security retirement benefits are paid as a matter of right to a qualified individual who retires at age sixty-two or older. If the individual continues to work, however, she must continue to pay Social Security and income taxes on her subsequent earnings, and she may well die before she collects any benefits. To be sure, the benefits to which she is entitled will be actuarially adjusted to account for her postponing her retirement, but if she dies before retiring, she will get nothing. And if she dies without a surviving spouse or other dependents, her heirs will get nothing.

Continuing to work can also subject certain elderly individuals to confiscatory tax rates. For example, a self-employed worker who faces the 28% income tax rate, the inclusion of 85% of her Social Security benefits in income, and the 15.3% Social Security tax rate can face an effective marginal tax rate of more than 60%. Worse still, elderly workers who are also subject to the Social Security retirement earnings test can face even higher effective marginal tax rates.

In short, the current Social Security system takes money from elderly workers and redistributes it to elderly retirees.

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[73] *Id.* at 11.

[74] With respect to survivor benefits, a surviving secondary worker will receive no additional benefits any time the worker benefit earned by the primary worker is more than the worker benefit earned by the secondary worker.

[75] *See, e.g.*, Jonathan Barry Forman, *Reforming Social Security to Encourage the Elderly to Work*, 9 STAN. L. & POL'Y REV. 289, 289 (1998).

b. *How Redistribution in the Social Security System Discourages Work and Encourages Early Retirement*

The net effect of redistribution within the Social Security retirement program is that the program operates like a net tax on some workers and a net transfer in favor of other workers and their families. These net taxes and transfers inevitably distort individual decisions about work and retirement, and, as it turns out, both tend to discourage work effort.

i. *The Standard Economic Model of Labor Supply*

The starting point for understanding how individuals change their work effort in response to Social Security taxes and benefits is the standard economic model of labor supply.[76] In the standard model, individuals are assumed to be able to work as many hours as they like at wages that are determined by the market.[77] Individual decisions about how hard to work depend on each individual weighing the relative benefits of work and leisure, and each worker then seeks a combination of income and leisure that maximizes her satisfaction.[78]

Redistribution within the Social Security system results in some workers receiving net transfers from other workers and other workers paying net taxes. In one sense, it is as if the Social Security system raises the wages of some workers and lowers the wages of other workers.

The standard economic model can help us understand how people will respond to such changes in the wage rate. According to the model, an individual's response to a wage change will depend upon the individual's relative preferences for leisure and other goods.

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[76] Within the discipline of economics, labor economics is the branch that concerns itself with issues involving the economics of work and pay. Labor economics deals with such topics as the supply of labor, the allocation of labor among uses, the incidence of unemployment, the determination of wages, and choices about education and training. Pertinent here, labor economics offers powerful explanations about how individuals respond to market forces and how they are likely to respond to government interventions. *See generally* DANIEL S. HAMERMESH & ALBERT REES, THE ECONOMICS OF WORK AND PAY (4th ed. 1988).

[77] Pay is assumed to be proportionate to output.

[78] The model assumes that each individual enjoys consuming goods and leisure activities. In order to be able to buy goods, however, the individual must work, but working cuts into leisure time which is also a "good." The more you work, the more you make, but the less leisure time you have. In short, there is a trade-off between labor and leisure.

Each individual chooses a level of work that results in a level of income and remaining free time that makes her as happy as possible. In the language of economics, individuals are said to be utility-maximizers, and each individual chooses a level of work (and so leisure) that maximizes her overall utility.

For example, in response to a wage increase, some individuals will end up working more, but some individuals may end up working less. On the one hand, a higher wage rate will attract more people to the work force. For example, someone who would not even get out of bed for a job that pays $5 an hour might be thrilled to have a job that pays $10 an hour.[79] On the other hand, some workers who were working seventy hours a week for $5 an hour might choose to spend more time with their families if they suddenly got a raise to $10 an hour. Consequently, the overall effect of a wage increase can be hard to predict.

More specifically, economists note that the effect of a wage increase is hard to predict because an increase in the wage rate results in two separate but opposite effects on an individual's labor supply—a substitution effect and an income effect.

On the one hand, consider the substitution effect. An increase in the wage rate makes working more attractive, and this raises the relative cost of leisure time. Consequently, a higher wage will lead individuals to consume less leisure and spend more time working. This is the substitution effect: individuals will "substitute" work for leisure, and the wage increase will lead them to work more.

On the other hand, consider the income effect. Because a higher wage rate means that a worker will have more total income from the same amount of work effort, the worker will be able to consume more goods, including more leisure.[80] Consequently, a higher wage will lead individuals to consume more leisure and spend less time working. This is the income effect: the wage increase will increase the worker's "income" and she will purchase more leisure (*i.e.*, work less).

In response to a wage increase, these income and substitution effects work in opposite directions. Consequently, the net effect on work effort is ambiguous. An increase in the wage rate will result in an increase in the supply of labor if the substitution effect is larger than the income effect, and it will result in a decrease in the supply of labor if the income effect is larger than the substitution effect. The opposite effects will result from a cut in the wage rate.

There is a fair amount of empirical evidence about the effects of taxes and welfare transfers across the population, however.[81] That research shows that various segments of the population exhibit varying levels of responsiveness to taxes, transfers, and wage changes.[82] In particular, that research shows that low-income workers and secondary earners tend to be fairly responsive to taxes,

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[79] For example, every time General Motors advertises for new employees at high union wages, thousands line up to apply. *See, e.g.,* Laura Ouimette, *Life in the GM Job Lineup,* THE TORONTO SUN, Jan. 13, 1995, at 12.

[80] Leisure is considered a "normal" good. If you have more money, you will buy (consume) more of it.

[81] *See, e.g.,* Jerry A. Hausman, *Labor Supply, in* HOW TAXES AFFECT ECONOMIC BEHAVIOR 27 (Henry J. Aaron & Joseph A. Pechman eds., 1981).

[82] Economists call this responsiveness the "elasticity" of labor supply.

transfers, and wage changes.[83] On the other hand, high-income workers tend to be less responsive to those changes.[84]

ii. *How Net Transfers and Taxes within the Social Security Retirement System Tend to Reduce Work Effort*

Redistribution within the Social Security system provides disproportionate rewards to certain beneficiaries, especially those workers who end up with relatively low career-average earnings. These transfers tend to operate like any other welfare transfer. They tend to make it easier to live without working and so induce individuals to work less, for example, by retiring earlier than they might if there were no Social Security system.

Low-skilled workers. For example, consider how the Social Security retirement system might influence a low-skilled individual's decisions about work at various points in her career. In the early part of her career, Social Security's progressive benefit formula and minimum benefits should encourage the worker to qualify for Social Security benefits, as these features provide disproportionate rewards for workers with low career-average earnings.

Once a worker has completed the ten years of service needed to qualify for benefits, however, these subsidies become less valuable. Moreover, as a worker completes more years of service and achieves a higher Average Indexed Monthly Earnings (AIME), additional Social Security contributions will purchase less and less additional benefits. Moreover, once a worker has thirty-five years of covered earnings, each additional year of work simply replaces some earlier year of covered earnings in the benefit computation formula, and the rate of return on additional payroll taxes paid drops precipitously. In addition, once benefits become available at age sixty-two, the relatively higher benefits that are the result of the progressive benefit formula and minimum benefits will make retirement relatively more attractive than working, especially for low-income workers.

How do low-income individuals respond to such transfers? They reduce their work effort. In that regard, for example, this country's traditional welfare program, Aid to Families with Dependent Children, was estimated to result in "nontrivial work disincentives" for welfare recipients of around 5.4 hours per week, implying a 30% reduction in their work effort.[85]

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[83] *See, e.g.,* Stacy Dickert et al., *The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation, in* 9 TAX POLICY AND THE ECONOMY 1 (James Poterba ed., 1995).

[84] *See, e.g.,* Robert K. Triest, *Fundamental Tax Reform and Labor Supply, in* ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 247 (Henry J. Aaron & William G. Gale eds., 1996).

[85] *See, e.g.,* Robert Moffitt, *Incentive Effects of the U.S. Welfare System: A Review,* 30 J. ECON. LITERATURE 1, 15–16 (1992).

The same kind of effect results from the net transfers to low-skilled workers and their families under the Social Security retirement system. While more than half of the elderly retire as soon as they can—at age sixty-two, and 72% quit work by age sixty-five, low-skilled workers are more likely to leave the labor force than high-skilled workers.[86] Why work for the minimum wage, when Social Security pays almost as much?

Moreover, the Supplemental Security Income (SSI) program creates additional work disincentives for its eligible beneficiaries. This occurs largely because SSI imposes a confiscatory benefit-reduction rate on earned income beyond some very small income disregards (*i.e.*, dollar-for-dollar).[87] There is also some evidence that features of the SSI and Social Security interact in a manner that creates incentives for prospective SSI recipients to take early retirement under Social Security as a means of maximizing their total lifetime benefits.[88]

Secondary workers. Similarly, consider how the presence of spousal and surviving spouse benefits tends to undermine the work effort of secondary earners (primarily women). First, the presence of spousal benefits makes it easier for elderly individuals to live without working and so induces them to retire when they can. Second, because of the dual-entitlement rule, Social Security retirement payroll taxes will operate like real taxes on many secondary workers. Both of these features discourage secondary workers from working.

First, the availability of generous spousal benefits means that at full retirement age, most secondary earners in two-earner couples can claim a benefit equal to half of the primary earner's worker benefit, and, after the primary worker's death, the secondary worker can claim a benefit equal to 100% of the primary earner's worker benefit. The availability of these generous benefits makes it easier for secondary workers to leave the work force at age sixty-five, or even earlier if the primary worker

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[86] *Report of the Technical Panel on Trends and Issues in Retirement Savings, in* 2 REPORT OF THE 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY, at 21 (1997); John R. Besl & Balkrishna D. Kale, *Older Workers in the 21st Century: Active and Educated, a Case Study,* 119 MONTHLY LAB. REV., No. 6, at 18, 20–24 (June 1996) (showing greater labor force participation by those with greater educational attainment); *see also, e.g.,* JAY STEWART, DO OLDER WORKERS RESPOND TO CHANGES IN SOCIAL SECURITY BENEFITS? A LOOK AT THE TIME SERIES EVIDENCE (Bureau of Lab. Stat., Working Paper No. 271), *available at* http://stats.bls.gov/ore/pdf/ec950140.pdf; Patrick J. Purcell, *Older Workers: Employment and Retirement Trends,* 123 MONTHLY LAB. REV., No. 10, at 19 (Oct. 2000).

[87] *See, e.g.,* David Neumark & Elizabeth Powers, *Means Testing Social Security, in* PROSPECTS FOR SOCIAL SECURITY REFORM 243 (Olivia S. Mitchell et al. eds., Pension Research Council 1999); David Neumark & Elizabeth Powers, *Welfare for the Elderly: The Effects of SSI on Pre-retirement Labor Supply,* 78 J. PUB. ECON. 51–52 (2000).

[88] *See, e.g.,* ELIZABETH T. POWERS & DAVID NEUMARK, THE SUPPLEMENTAL SECURITY INCOME PROGRAM AND INCENTIVES TO TAKE UP SOCIAL SECURITY EARLY RETIREMENT: EMPIRICAL EVIDENCE FROM MATCHED SIPP AND SOCIAL SECURITY ADMINISTRATIVE FILES (Nat'l Bureau of Econ. Research, Working Paper No. 8670, 2001).

becomes disabled or dies. Like other welfare transfers, the provision of these benefits is expected to reduce work effort. Moreover, if the secondary earner were to continue to work, she would have to continue to pay income taxes and payroll taxes on her earnings, and her spousal benefits could be reduced by operation of the retirement earnings test.

Second, because of the dual-entitlement rule, Social Security retirement taxes will operate like real taxes on many secondary workers, and these taxes will discourage them from working. For many secondary workers in two-earner couples, the additional Social Security taxes they pay will produce absolutely no additional retirement benefits than if they had not worked at all and had not paid retirement taxes.[89] In short, rather than buying additional benefits, the Social Security retirement taxes they pay operate like a real tax on their earned income.

All in all, the provisions of generous spousal benefits and payroll-tax financing discourage secondary earners from working. In that regard, there is a good deal of evidence that women—who make up the bulk of secondary workers—spend much less time in the work force than men. Of workers retiring in 1996, for example, the median woman had worked twenty-seven years over her lifetime, while the median man had worked thirty-nine years.[90] Similarly, while 32.2% of men age sixty-five through sixty-nine remained in the work force after age sixty-five in 2002, just 20.7% of women that age were still in the work force that year.[91]

Elderly workers. Consider also how the current Social Security system discourages elderly individuals, in general, from working. Here, the availability of reduced benefits at Social Security's early retirement age of sixty-two and full benefits at full retirement age are powerful inducements to retire. Moreover, once a worker has completed thirty-five years of covered service, she is unlikely to see much increase in benefits resulting from working more years and paying more Social Security retirement taxes. Indeed, few workers who have reached the Social Security early retirement age will see much increase in their benefits resulting from additional payroll taxes with respect to additional years of work. That is one of the reasons why more than half of new Social Security beneficiaries claim their benefits as soon as they can—at age sixty-two, and 72% of new beneficiaries claim them by age sixty-five.[92]

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[89] *See supra* Part III.B.iii.

[90] NATIONAL ECONOMIC COUNCIL INTERAGENCY WORKING GROUP ON SOCIAL SECURITY, WOMEN AND RETIREMENT SECURITY 9 (1998), *available at* http://www.ssa.gov/history/pdf/sswomen.pdf.

[91] BUREAU OF LABOR STATISTICS, TABLES FROM EMPLOYMENT AND EARNINGS: HOUSEHOLD DATA–ANNUAL AVERAGES: EMPLOYMENT STATUS OF THE CIVILIAN NONINSTITUTIONAL POPULATION BY AGE, SEX, AND RACE (2002), *available at* http://www.bls.gov/webapps/legacy/cpsatab2.htm.

[92] *Report of the Technical Panel on Trends and Issues in Retirement Savings, supra* note 86, at 21.

2. *How Particular Features of the Social Security System Tend to Discourage Work Effort*

The last Section showed how the current Social Security retirement program tends to discourage work effort, especially by low-skilled workers, secondary earners, and elderly individuals. At the risk of repetition, this Section briefly explains how the various features of the Social Security retirement program result in work disincentives. These features fall into three basic categories: financing, benefit accrual, and payout.

a. *Financing Features*

i. *Payroll Taxes*

To pay for retirement benefits, a source of revenue is needed. One approach would be to have a straight "forced savings" system in which individual workers are required to set aside a portion of their earnings in exchange for actuarially fair benefits paid to them at retirement. Social Security looks a little like that, but as this Article has shown, benefits are not directly proportional to Social Security retirement tax "contributions." Individuals pay a flat Social Security retirement payroll tax—for example, both employers and their employees pay 5.3% of the first $87,000 of wages in 2003, but the benefits paid out are not directly proportional to those payroll taxes paid.

Instead, taxes paid by some workers are redistributed to other workers and their families. The net effect is that Social Security payroll taxes operate like a real tax on the earned income of many workers.

In that regard, it is worth considering the economic effects of a direct tax on earned income. Because taxes reduce the ability to purchase goods, they may encourage individuals to work harder to make more money. That is how the so-called "income effect" works. On the other hand, because taxes on earnings make leisure relatively more attractive, they may encourage individuals to work less and consume more leisure. That is an example of the so-called "substitution effect." Because the income and substitution effects often work in opposite directions, the net effect on work effort is ambiguous and will depend heavily on individual preferences.

But for many workers—especially low-income workers and secondary workers—it seems likely that the net effect of a direct tax on earned income will be to reduce work effort. For example, Figure 1 shows how a worker might reduce her work effort in response to a 30% payroll tax. The worker in Figure 1 can earn $10 an hour, and, in the absence of tax, she would work 2000 hours a year and earn $20,000 a year. Faced with a 30% tax on her earnings, however, she would reduce her work effort to just 1,750 hours a year and take home just $12,500 a year after tax.

FIGURE 1. HOW A 30 PERCENT TAX ON EARNED INCOME CAN REDUCE WORK EFFORT
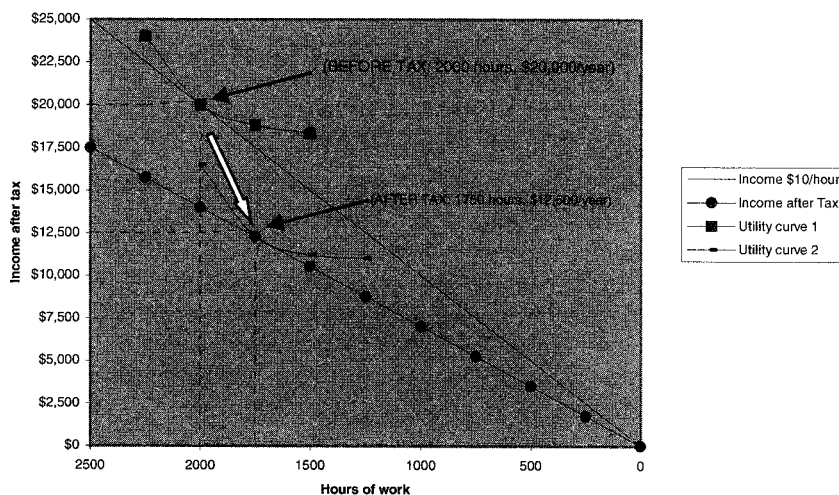
In short, for many workers, the Social Security retirement system will operate like a payroll tax, and faced with that tax, many workers will reduce their work effort.

Pertinent here, the government bears the burden of justifying its redistributive taxation. To be sure, it can make sense to redistribute economic resources from rich to poor—from those with a greater ability to pay tax to those with a lesser ability to pay tax. If redistribution is called for, however, the payroll tax seems to be a particularly poor choice for the redistributive mechanism.[93] Normally, one would look to an income tax or a wealth tax to measure the ability to pay.

Under the current system, someone earning $87,000 in salary will pay $4,611 in Social Security retirement taxes, and her employer will pay a matching amount. Under current law, a large portion of these taxes is redistributed to other workers and their families. On the other hand, some rich beach bum collecting $500,000 a year from her grandparent's trust fund will pay nothing at all to support those beneficiaries.

Admittedly, the earned income tax credit offsets the Social Security taxes paid by many low-income workers, particularly those with children. Consequently, the credit tempers the regressivity of the payroll tax and moves the Social Security retirement program closer to an ability-to-pay tax base. Still, if

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[93] *See, e.g.,* Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income,* 22 VA. TAX REV. 1, 3 (2002); Andrew Mitrusi & James Poterba, *The Distribution of Payroll and Income Tax Burdens, 1979–99,* 53 NAT'L TAX J. 765 (2000); *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples, supra* note 60; *Bill Gates and I Pay Equally—and This Is Supposed to Be a Fair System?, supra* note 66.

redistribution is called for, it would make more sense to use the income tax or, perhaps, a wealth tax, to pay for any redistribution through Social Security benefits.

ii. *Taxation of Benefits*

Additional revenue is also collected through taxation of Social Security benefits. Under current law, 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% of their Social Security benefits in income. Largely because of the interaction between these floors and the income and payroll taxes imposed on individuals who continue to work past age sixty-two, some workers can face confiscatory tax rates that will discourage them from working.[94]

There would be much smaller work disincentives if the floors were repealed, for example, if Social Security benefits were taxed the same way as private pensions.[95] In that regard, pension benefits are fully taxable, except to the extent that those benefits reflect previously-taxed employee contributions.

b. *Benefit Accrual Features*

i. *The Progressive Benefit Formula and Minimum Benefits*

Perhaps, most of the redistribution in the Social Security retirement system is accomplished by the progressive benefit formula and minimum benefits. For example, the primary insurance amount (PIA) for a worker turning sixty-two in 2003 is equal to 90% of the first $606 of the worker's average indexed monthly earnings (AIME), plus 32% of the next $3,057 of AIME (if any), and plus 15% of the AIME over $3,653 (if any). There is also a special minimum benefit for workers with low AIMEs. Reducing the progressivity of the benefit computation formula and getting rid of the special minimum benefits would reduce redistribution and the associated work disincentives.

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[94] *See, e.g., Reforming Social Security to Encourage the Elderly to Work, supra* note 75, at 289; *see also* JOSEPH F. QUINN, ET AL., PASSING THE TORCH: THE INFLUENCE OF ECONOMIC INCENTIVES ON WORK AND RETIREMENT 77–128 (1990); *Report of the Technical Panel on Trends and Issues in Retirement Savings, supra* note 86, at 15–20.

[95] *Report of the Technical Panel on Trends and Issues in Retirement Savings, supra* note 86, at 20–21; COMMITTEE FOR ECONOMIC DEVELOPMENT, FIXING SOCIAL SECURITY: A STATEMENT BY THE RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT 39–41 (1997) [hereinafter COMMITTEE FOR ECONOMIC DEVELOPMENT]; *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples, supra* note 60, at 965–66.

ii. *The Thirty-five Year Benefit Computation Period*

An individual worker's AIME and, consequently, her PIA, is based on her highest thirty-five years of indexed earnings. In effect, individuals who work more than thirty-five years get no return on the payroll taxes they paid for those extra years of work. Consequently, increasing the benefit computation period would reduce redistribution and the associated work disincentives.[96]

iii. *Spousal and Dependent Benefits*

Social Security also provides generous benefits to the spouses and dependents of covered workers. To come up with the money for these generous benefits, the benefits provided to individual workers must be less than actuarially fair. In short, the current Social Security system takes money from workers and gives it to spouses, surviving spouses, and other dependents.

To be sure, it can make sense to compel individual workers to share their retirement benefits with their own spouses and dependents, but it is quite another matter to take payroll tax contributions from one worker and use them to support some other worker's spouse and dependents.

Eliminating the current system's family benefits would reduce redistribution and work disincentives.

iv. *The Ten Year Minimum Service Rule*

Workers over age sixty-two generally are entitled to Social Security retirement benefits if they have worked in covered employment for at least ten years. This rule generally encourages individuals to work at least ten years in covered employment so that they can earn retirement benefits, perhaps even the disproportionately generous special minimum benefits. In particular, those government workers whose employment was not covered by Social Security often subsequently complete ten years of covered employment so that they can draw both a government pension and disproportionately large Social Security benefits.

On the other hand, the payroll tax contributions made by those who work less than ten years in covered employment yield no return. Those hurt by the rule include aliens who work in this country for only a few years and homemakers with only occasional participation in the paid labor force.

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[96] On the other hand, in order to increase worker benefits for women, some have suggested reducing the benefit computation period or, alternatively, giving individuals credit for years spent caring for their young children or elderly parents. *See, e.g.,* Mary E. O'Connell, *On the Fringe: Rethinking the Link Between Wages and Benefits,* 67 TUL. L. REV. 1421, 1494–95 (1993). Such changes, however, would make the Social Security system even more redistributive and so exacerbate the system's work disincentives.

All in all, it could make sense to tighten the relationship between benefits and contributions. For example, it could make sense to keep track of contributions and paying benefits to workers with even less than ten years of covered service, and it might make sense to reduce the minimum benefits available to those workers with just over ten years of service.

c. *Payout Features*

i. *The Early and Full Retirement Ages*

Under current law, individuals can begin drawing early retirement benefits at age sixty-two and full retirement benefits at full retirement age, which is gradually increasing to age sixty-seven. Raising the early or full retirement ages would almost certainly encourage workers to stay in the work force longer.[97]

ii. *Payment in the Form of an Annuity*

Another problem has to do with the fact that Social Security benefits are paid out in the form of an annuity. On reaching age sixty-two, people feel entitled to their benefits, but if they keep working, they may get nothing. In that regard, workers tend to make decisions about the timing of retirement a little bit myopically; that is, they tend to underestimate their life expectancies and overvalue in-hand benefits.[98] Consequently, changing the form and timing of benefit pay-outs could help encourage workers to stay in the work force longer.

iii. *The Retirement Earnings Test*

Along the same lines, the retirement earnings test reduces the benefits that certain individuals who work past age sixty-two receive. An actuarial adjustment restores any lost benefits to the worker's subsequent benefit stream, but the prospect of having current benefits reduced by the earnings test has long been thought to operate as a

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[97] *See generally* ALAN L. GUSTMAN & THOMAS L. STEINMEIER, THE SOCIAL SECURITY EARLY ENTITLEMENT AGE IN A STRUCTURAL MODEL OF RETIREMENT AND WEALTH (Nat'l Bureau of Econ. Research, Working Paper No. 9183, 2002).

[98] In that regard, economists sometimes say that individuals have "a relatively high time preference rate." For example, according to Gustman & Steinmeier:

> Individuals with a high time preference rate who are considering retiring at age 62 will see the loss of current benefits clearly, but they will devalue the increase in future benefits even though the increase is actuarially fair. The loss of current benefits will be perceived as a reduction in net compensation and will create an incentive to retire at age 62.

Id. at 2.

work disincentive.[99] In that regard, the Senior Citizens' Freedom to Work Act of 2000 recently repealed the limitation on the amount of outside income which Social Security beneficiaries who have attained full retirement age may earn without incurring a loss of benefits.[100] Repealing the retirement earnings limitation before full retirement age could also help encourage more elderly individuals to keep working.

IV. How To Make Social Security Work

The analysis so far suggests that there are a variety of improvements that could be made to make the current Social Security retirement system more work friendly. Subpart A of this Part offers a number of modest recommendations that could help reduce the system's work disincentives. Subpart B then takes a more comprehensive look at what we want the Social Security system to do and offers a more comprehensive solution to its work-disincentive problems.[101]

A. *Modest Changes that Could Improve the Work Incentives of the Current Social Security System*

1. *Move Away from Payroll Tax Financing*

As payroll taxes tend to reduce work effort among so many workers, reducing the Social Security retirement system's reliance on payroll taxes should promote work effort. When redistribution is called for, it just seems more appropriate to rely on general revenues, particularly those coming from the federal individual income tax.

In that regard, the earned income tax credit already operates to offset the payroll tax liabilities of millions of low-income workers, and it could make sense to expand the credit or otherwise further integrate the payroll and income taxes.[102] As a starting point, for example, the government could add a $10,000 per worker exemption to the Social Security system.[103] Eventually, the government might want to completely

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[99] *Id.* at 32.

[100] Pub. L. No. 106-182, 114 Stat. 198 (2000); *see also* Thomas P. Burke, *Social Security Earnings Limit Removed*, COMPENSATION AND WORKING CONDITIONS, Summer 2000, at 44, *available at* http://www.bls.gov/opub/cwc/archive/summer2000brief1.pdf.

[101] This Article makes no effort to resolve the Social Security system's financial troubles. *But see* Jonathan Barry Forman, *Saving Social Security With a Cash Balance Plan, in* NEW YORK UNIVERSITY 59TH INSTITUTE ON FEDERAL TAXATION—EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION, Ch. 3, at 3-1-3-29 (Alvin D. Lurie ed., 2001) (noting that the government has great flexibility about when to pay off the current Social Security system's unfunded liability).

[102] *See, e.g.*, *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples*, *supra* note 60; Geier, *supra* note 93, at 57–59; Jonathan Barry Forman, *Simplification for Low-Income Taxpayers: Some Options*, 57 OHIO ST. L. J. 145, 192–94 (1996).

[103] *See, e.g.*, *Simplification for Low-Income Taxpayers: Some Options*, *supra* note 102, at

replace the Social Security and income tax systems with a single, comprehensive income tax.[104]

For that matter, simply doing nothing about Social Security's impending financial problems is likely to result in greater reliance on general revenues and relatively less reliance on payroll-tax financing. The political power of the elderly and elderly lobbies like the AARP make it unlikely that future Social Security retirement benefits will actually ever be cut by much.[105] At the same time, however, it also seems unlikely that Congress will ever again find the political will to increase the Social Security payroll taxes to pay for retirement benefits. Consequently, once the Social Security trust funds are exhausted, the government will have to use general revenues to make up any shortfalls in promised benefits. Unless some new source of revenue is found, most of the increased burden will fall on the individual income tax, currently the largest source of federal revenue. Alternatively, the government might instead use a wealth tax, value-added tax, or national sales tax to meet those revenue needs.[106]

2. Reduce the Progressivity of the Social Security Benefit Formula, but Expand Supplemental Security Income (SSI)

An alternative way of reducing the work disincentives implicit in our payroll-tax-financed Social Security retirement system would be to make Social Security retirement benefits more proportional to taxes paid. This could be accomplished by reducing the progressivity of the benefit formula, or eliminating that progressivity altogether. In 2003, for example, instead of computing a worker's primary insurance amount (PIA) as 90% of her first $606 of average indexed monthly earnings (AIME),

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182–86; George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225 (1994); George K. Yin & Jonathan Barry Forman, *Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor*, 59 TAX NOTES 951 (1993).

[104] *See, e.g., Simplification for Low-Income Taxpayers: Some Options, supra* note 102, at 192–94.

[105] *Cf.* Alicia H. Munnell, *The Declining Role of Social Security*, JUST THE FACTS ON RETIREMENT ISSUES No. 6 (Center for Retirement Research at Boston College, Boston, Mass.), Feb. 2003, *available at* http://www.bc.edu/centers/crr/facts/jtf_6.pdf (assuming that half of the shortfall will be made up with benefit cuts and half with unspecified tax increases, and also expressing concern about he relatively lower value of future benefits as a percentage of pre-retirement earnings).

[106] Before adopting such an alternative tax, however, the government should consider how the new tax would affect work effort. In that regard, consumption taxes (i.e., a value-added tax or a national sales tax) tend to act a lot like wage taxes. Pertinent here, as most workers tend to spend nearly everything they earn, a consumption tax will tend to discourage work effort by reducing the returns from work and thereby making leisure relatively more attractive. Wealth taxes, on the other hand, are likely to have a less adverse impact on work effort.

plus 32% of the next $3,057 of AIME (if any), plus 15% of her AIME over $3,653 (if any), her PIA might be set at, say, a flat 50% of her AIME. That would make her benefits more directly proportional to her payroll tax contributions.

In order to protect workers with low career-average earnings, any reduction in benefits that resulted from decreasing the progressivity of the Social Security benefit formula could be offset by increasing Supplemental Security Income (SSI) benefits. Pertinent here, SSI benefits are funded out of general revenues, not out of regressive payroll taxes.

3. *Increase the Benefit Computation Period Beyond Thirty-five Years*

Another way to strengthen the relationship between a worker's payroll tax contributions and her resulting benefits—and so reduce work disincentives—would be to increase the benefit computation period beyond thirty-five years. Under current law, an individual worker's AIME and, consequently, her PIA, is based on her highest thirty-five years of indexed earnings. In effect, individuals who work more than thirty-five years get no return on the payroll taxes they paid in those additional years that they worked. Hence, this benefit computation rule operates to discourage elderly workers from continuing to work beyond thirty-five years. The rule also operates to subsidize the benefits of those who have the luxury of being able to take time out of the work force to go to college or to stay home to care for young children or elderly parents.

In order to understand the unfairness of this thirty-five-year benefit computation rule, consider two individuals, Alice and Beth. At age eighteen, Alice goes to work and pays payroll taxes continuously until age sixty-two (forty-three years). Beth goes to college and graduate school until she is age twenty-seven, when she, too, joins the work force and works and pays payroll taxes continuously until age sixty-two (thirty-five years). Both will compute their benefits based on their highest thirty-five years of earnings, but Alice will get absolutely nothing back for her additional eight years of payroll tax "contributions." [107]

Moreover, neither Alice nor Beth will have much incentive to keep working beyond age sixty-one. Only their thirty-five highest years of indexed earnings will enter into the computation of benefits. In all likelihood, that means that working another year will knock out an earlier year of relatively lower indexed earnings. Still, whether an earlier year or the additional year gets knocked out of the computation, the payroll taxes paid in that drop-out year will result in absolutely no additional retirement benefits for Alice or Beth.

In short, capping the benefit computation period at thirty-five years operates as a work disincentive and one that seems to have an especially powerful impact on elderly workers.

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[107] If she had been ambitious enough to have also worked while in high school, those earnings and the payroll taxes on those earnings, would also be ignored.

This high-thirty-five rule also operates to subsidize the benefits of workers who have even fewer than thirty-five years of covered earnings. For example, consider Carol, who from age eighteen through age sixty-one works in the labor force just thirty years and spends the remaining thirteen years caring for young children and elderly parents. In computing Carol's Social Security worker benefit, her career-average earnings are based on just thirty-five years, not all forty-three adult years from eighteen through sixty-one. The high-thirty-five benefit computation formula will require her to average in just five zero years, not the thirteen zero years she actually had; and the result is that she will get a relatively higher benefit than her career-average earnings should justify.

All in all, extending the benefit computation period would be a powerful work incentive. In that regard, for example, the 1994–1996 Social Security Advisory Council favored computing average indexed monthly earnings (AIME) on a worker's highest thirty-eight years of earnings.[108] For similar reasons, some analysts would compute the AIME on a worker's highest forty years of earnings.[109] From the standpoint of reducing work disincentives, it would probably make the most sense to change the AIME formula so that each and every year that a worker had earnings resulted in additional benefits.

4. *Raise the Early and Full Retirement Ages*

Another change that would encourage elderly workers to remain in the work force would be to raise the early and the full retirement ages. Under current law, the early retirement age is sixty-two, and the full retirement age is currently sixty-five but is slowly increasing to sixty-seven.

A majority of the members of the 1994–1996 Social Security Advisory Council favored accelerating the increase in the full retirement age to sixty-seven and favored continuing to increase the full retirement age thereafter to keep pace with increases in life expectancy.[110] Still other analysts have recommended raising the full retirement age to seventy.[111]

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[108] REPORT OF THE 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY, Vol. I, at 20 (1997) [hereinafter SOCIAL SECURITY ADVISORY COUNCIL].

[109] *See, e.g.*, COMMITTEE FOR ECONOMIC DEVELOPMENT, *supra* note 95, at 39.

[110] SOCIAL SECURITY ADVISORY COUNCIL, *supra* note 108, at 21. The Council wanted to raise the full retirement age to age sixty-seven by the year 2011, and thereafter the full retirement age would be indexed for increases in life expectancy at the rate of about one month every two years.

[111] *See, e.g.*, COMMITTEE FOR ECONOMIC DEVELOPMENT, *supra* note 95, at 39 (recommending gradually increasing the normal retirement age to seventy by the year 2030).

In addition, a number of the members of the Social Security Advisory Council recommended gradually increasing the early retirement age from sixty-two to sixty-five.[112]

These kinds of changes would almost certainly keep people in the work force longer, but the Social Security Disability Insurance (DI) and Supplemental Security Income (SSI) programs probably would need to be expanded to help those elderly Americans who could no longer work but were still too young to claim Social Security retirement benefits.

5. *Tax Social Security Benefits like Private Pensions*

Another change that could encourage at least some elderly individuals to remain in the work force would be to change the taxation of Social Security benefits. Under current law, 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% of their Social Security benefits in income. The interaction between these floors and the income and payroll taxes imposed on certain elderly individuals who continue to work can result in confiscatory tax rates that discourage them from working.

There would be much smaller work disincentives if the floors were repealed or if Social Security benefits were taxed like private pensions.[113]

6. *Replace Spousal Benefits with Earnings Sharing*

Another way to strengthen work incentives would be to replace Social Security spousal benefits with an earnings sharing system.[114] 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.

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[112] SOCIAL SECURITY ADVISORY COUNCIL, *supra* note 108, at 31. *But see* Kathryn L. Moore, *Raising the Social Security Retirement Ages: Weighing the Costs and Benefits*, 33 ARIZ. ST. L.J. 543 (2001) (weighing costs and benefits of raising Social Security retirement ages).

[113] *See, e.g.*, *Reforming Social Security to Encourage the Elderly to Work, supra* note 75; SOCIAL SECURITY ADVISORY COUNCIL, *supra* note 108, at 20–21; COMMITTEE FOR ECONOMIC DEVELOPMENT, *supra* note 95, at 39–41; *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples, supra* note 60, at 965–66.

[114] *See Making Social Security Work for Women and Men, supra* note 68, at 370–73 and sources cited therein, especially: STAFF OF HOUSE COMM. ON WAYS AND MEANS, 99TH CONG., REPORT ON EARNINGS SHARING IMPLEMENTATION STUDY (Comm. Print 1985); U.S. CONGRESSIONAL BUDGET OFFICE, EARNINGS SHARING OPTIONS FOR THE SOCIAL SECURITY SYSTEM (1986).

For example, consider a couple in which the primary worker earned $40,000 in a given year and the secondary worker earned $10,000. Under the current Social Security system, the primary worker is credited with $40,000 of earnings, and the secondary worker is credited with just $10,000 of earnings. Under earnings sharing, each would be credited with $25,000 of earnings for that year for purposes of computing benefits.

Replacing spousal benefits with an earnings sharing system would encourage work in two ways. First, by strengthening the relationship between payroll taxes paid by workers and their retirement benefits, this change would encourage greater work effort by current workers. A worker's payroll tax contributions would still be shared with her own spouse, but those taxes would no longer be redistributed to some other worker's spouse.

Second, replacing spousal benefits with earnings sharing would increase work incentives for secondary earners. No longer would so many secondary earners see absolutely no return from their payroll tax contributions. With the repeal of spousal benefits, the dual-entitlement rule would also disappear. Consequently, secondary earners would almost always see their payroll taxes lead to increased benefits. This greater proportionality between the payroll taxes they pay and the benefits they receive would encourage them to work harder and longer.

All in all, replacing spousal benefits with earnings sharing would get rid of the current system's marriage penalties and bonuses, both of which can discourage secondary workers from working. With earnings sharing, there would be no marriage penalties or bonuses.

Spousal benefits were added to the Social Security system in the 1930s when most families followed the traditional model of working husband and stay-at-home mom. Redistribution based on marital status may have appeared to make sense back then—as a proxy for need, but it makes little sense today.[115] In particular, spousal benefits are poorly targeted. The largest spousal benefits go to the spouses of those primary workers that have the highest career-average earnings. On the other hand, relatively low benefits go to the elderly who need them most: octogenarian widows, divorcees, and other unmarried women who had low lifetime earnings.

7. *Change the Way Benefits Accrue and Are Paid Out*

It could also make sense to change the way that benefits accrue and are paid out, especially once a worker becomes eligible for benefits. Under current law, an eligible worker can start drawing reduced benefits at age sixty-two. If that individual keeps

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[115] Frankly, it is not all that clear why taxes or benefits should ever vary based on marital status alone. *See, e.g.*, Jonathan Barry Forman, *What Can Be Done About Marriage Penalties?*, 30 FAM. L. Q. 1 (1996).

working, however, the retirement earnings test can take those benefits away, and if the individual doesn't live until full retirement age, she may never draw any benefits.

Workers tend to make decisions about the timing of retirement a little bit myopically; that is, they have a tendency to underestimate their life expectancies and overvalue in-hand benefits. The life expectancy tables may say that a sixty-two-year-old will live another twenty years, but many think they will only make it ten or fifteen years, so they want to get the full value of their benefits, and that means retiring early.

To the extent that the fear of losing benefits is driving people to retire early, there are a number of better approaches. One possibility would be to repeal the retirement earnings test, even for those who have not yet reached full retirement age. The Senior Citizens' Freedom to Work Act of 2000 recently repealed the limitation on the amount of outside income which Social Security beneficiaries who have attained full retirement age may earn without incurring a loss of benefits.[116] Consequently, workers can start taking benefits at full retirement age, and they will not lose benefits even if they keep working.[117] It could make sense to repeal the retirement earnings test altogether. Then, starting at age sixty-two, workers could start drawing benefits whether they worked or not.

A variation on this approach would be to allow workers who have reached age sixty-two to set up so-called "deferred retirement option plans" (DROPs), like those used with many state and local government pension plans.[118] Under a DROPs plan, once a worker reached age sixty-two, she could elect to have her benefit payments set aside in an individual retirement account until she actually retires.

Another approach would be to create individual Social Security retirement savings accounts for each worker at age sixty-two.[119] The starting balance in each worker's account would be an amount equal to the cost for an inflation-indexed annuity equal in value to the worker's Social Security benefit entitlement at that time. Thereafter, workers would earn investment income on the balance in their accounts, and they would see their subsequent Social Security retirement taxes contributed into their accounts. When the worker eventually retired, the balance in her account would be reconverted into a larger lifetime annuity. Alternatively, if she died before retiring, the balance in her account could be transferred to her heirs.

In general, Social Security reform plans that would create individual retirement accounts for workers tend to be much more neutral as to the timing of retirement than

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[116] Pub. L. No. 106-182, 114 Stat. 198 (2000).

[117] Up to 85% of those benefits may be subject to income taxation, however. *See supra* Part II.A.

[118] *See, e.g.,* Jonathan Barry Forman et al., *State, Local and Foreign Pensions: Implications for Social Security and Pension Reform: Proceedings of the 2002 Annual Meeting, Association of American Law Schools, Section on Employee Benefits,* 6(1) EMPLOYEE RIGHTS AND EMP. POL'Y J. 83, 92–100 (2002) (remarks of Glenda Chambers).

[119] *See Reforming Social Security to Encourage the Elderly to Work, supra* note 75, at 294–96.

the current system. Hence, proposals to privatize Social Security or replace Social Security with individual cash balance accounts should result in more elderly individuals remaining in the work force than does the current system.[120]

B. *A More Comprehensive Solution*

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. Once we know what we want from the Social Security system, it should be relatively easy to design a system that can achieve those results.

What do we want the Social Security retirement system to do? It would make sense for the Social Security system to satisfy three principal goals. First, the system should ensure that every elderly American has an adequate income throughout her retirement years. Second, the system should have a minimum of work disincentives. Finally, the system should have a minimum of marriage penalties and bonuses.

One way to achieve these goals would be to have a two-tiered Social Security system to provide benefits to individuals. The first tier would provide a basic Social Security benefit to every older American. These benefits would be financed out of general revenues. The second tier would provide an additional earnings-related benefit based on payroll tax contributions made to individual accounts. Finally, married couples would share their earnings.

These three components are discussed in turn.[121]

1. *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, at full retirement age, the government might guarantee every retiree a first-tier benefit equal to 100% of the

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[120] *See, e.g., Saving Social Security With a Cash Balance Plan, supra* note 101, and sources cited therein; *cf.* Jonathan Barry Forman, *How Federal Pension Laws Influence Individual Work and Retirement Decisions*, 54 TAX LAW. 143 (2000) (discussing how traditional defined benefit plans and defined contribution plans influence work behavior).

[121] To the same effect, see Yung-Ping Chen, *Social Security Reform: Assuring Solvency or Improving Benefits*, J. FIN. SERVICE PROFESSIONALS, July 2002, at 29, 39.

A good method would be to combine earnings sharing with a flat-rate benefit in a two-tiered benefit structure. The first tier would provide a flat-rate benefit payable to eligible persons for age or disability regardless of earnings. The second tier would be based on earnings—an individual's earnings when single plus half the couple's combined earnings while married.

The first-tier benefit should be integrated with the Supplemental Security Income program and funded with general revenue, not payroll taxes, because of its income redistributive and anti-poverty functions. The second-tier benefit should be financed by payroll taxes because contribution and benefit calculations are both based on earnings.

poverty level. In the year 2003, for example, the poverty level for a single individual is $8,980, yielding a monthly benefit of about $746.[122]

That benefit, $746 per month, would be the benefit payable to every individual at full retirement age. In that regard, there is every reason to think about raising the full retirement age to seventy, or at least to sixty-eight, but perhaps allowing individuals as young as sixty-five to receive actuarially reduced benefits. For example, if full benefits were payable at age seventy, the first-tier benefit at age sixty-five would be about 30% less, or $522 per month.[123]

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

This first-tier benefit 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, the first-tier benefits would be paid for out of general revenues.

Unlike SSI, however, these first-tier benefits would be universally available and would not be subject to any income or asset test.[124] Benefits would not phase out if the recipient has other income or wealth.

On the other hand, unlike current SSI benefits, these first-tier benefits would be taxable for income tax purposes. In that regard, however, the standard deductions and personal exemptions of the current income tax system are large enough to ensure that few individuals with income below the poverty level would pay any federal income tax.[125]

There would also be no retirement earnings test. Individuals could work and begin drawing actuarially reduced benefits at the early retirement age. Alternatively, they could wait and claim larger benefits. As there would be no retirement earnings test, it would probably make sense to just go ahead and pay full benefits starting at age seventy to those who had not claimed them before, rather than having some kind of delayed retirement credit for those who postpone claiming benefits.

Also, unlike SSI, there would be no marriage penalties or bonuses with respect to first-tier benefits. Each individual would be entitled to $8,980 a year at age seventy, regardless of marital status. Consequently, a married couple, both age seventy, could claim a combined family benefit equal to $17,960 per year (about $1,500 per month).[126]

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[122] Dep't of Health and Human Services, Annual Update of the HHS Poverty Guidelines, 68 Fed. Reg. 6,456, 6,457 (Feb. 7, 2003).

[123] $522.20 = 70% × $746.

[124] *Cf.* BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY 14–16, 129–54 (1999) (suggesting that each citizen get an entitlement to a basic retirement pension).

[125] *See, e.g.*, Jonathan Barry Forman & Hilary Nolan, *Poverty Levels and Federal Tax Thresholds: 2001*, TAX PRACT. & PROCED. August–September 2001, at 17–19.

[126] $1,496.67 = $17,960 ÷ 12.

If these first-tier benefit levels seem too generous, then an alternative approach might be to provide each individual with a first-tier Social Security benefit equal to one-half of the poverty level for a married couple. In the year 2003, for example, the poverty level for a married couple is $12,120.[127] That would suggest a first-tier benefit of $6,060 for each individual, starting at age seventy, or about $505 per month. With an actuarial reduction of 30%, that would yield a benefit of about $354 per month starting at age sixty-five.

2. *An Additional Earnings-Related Benefit*

In addition to the first-tier benefit, every worker would also earn additional retirement benefits 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, and the reduced payroll taxes they pay would be credited to those accounts, along with investment income on the balance in those accounts.

The accounts themselves could be funded, defined contribution accounts, or they could be hypothetical cash balance accounts.[128] The government would simply establish an individual account for each worker and keep track of the payroll tax and investment returns on those accounts.[129]

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[127] Dep't of Health and Human Services, Annual Update of the HHS Poverty Guidelines, 68 Fed. Reg. 6,456, 6,457 (Feb. 7, 2003).

[128] *See generally Saving Social Security With a Cash Balance Plan, supra* note 101. A cash balance plan is a defined benefit plan that looks like a defined contribution plan. The plan accumulates, with interest, a hypothetical account balance for each participant. The individual account balances are determined by the plan's benefit formula and consist of two components: an annual cash balance credit and an interest credit. For example, a simple cash balance plan might allocate 3% of salary to each participant's cash balance account each year, and credit the account with 7% interest on the balance in the account.

In the private pension world, cash balance account statements are issued to participants on a regular basis. Cash balance statements look like defined contribution plan statements and are generally easier for participants to understand than a traditional defined benefit plan formula. Cash balance plans may pay out account balances in the form of a lump-sum distribution or as an annuity, but some sponsors encourage the selection of an annuity by specifying a favorable actuarial basis to convert accounts to annuities. *See generally* Jonathan Barry Forman & Amy Nixon, *Cash Balance Pension Plan Conversions,* 25 OKLA. CITY U. L. REV. 379 (2000) and references cited therein; U.S. GEN. ACCT. OFFICE, CASH BALANCE PLANS: IMPLICATIONS FOR RETIREMENT INCOME (Rep. No. GAO/HEHS-00-207, Sept. 29, 2000); U.S. GEN. ACCT. OFFICE, PRIVATE PENSIONS IMPLICATIONS OF CONVERSIONS TO CASH BALANCE PLANS (Rep. No. GAO/HEHS-00-185, Sept. 29, 2000).

[129] To be sure, creating and managing individual accounts for millions of American workers would surely be a daunting task. *See Saving Social Security With a Cash Balance Plan, supra* note 101. In that regard, it would probably be easiest and cheapest to set up a system of hypothetical individual accounts within the Social Security system and let Social Security handle all of the investments.

In order to make the transition from the current system to this new two-tier system, participants in the current system could be given large starting balances in their section-tier individual accounts to reflect their already-accrued earnings-related benefit entitlements. From then on, each worker's Social Security retirement tax contributions would be added to her individual account, and each year the starting balance in the account would be credited with interest.

At retirement, the balance in a worker's account would typically be used to purchase an additional inflation-adjusted annuity over and above the individual's first-tier benefit, although in some cases workers with large accounts might be allowed to make larger withdrawals. In the case of a worker who died before withdrawing her benefit, the balance in her account would go to her spouse or other heirs.

For example, the government might want to require that individuals take monthly distributions that, together with their first-tier benefits, would provide them with the equivalent of an inflation-indexed annuity that is targeted to, say, 200% of the poverty level (i.e., $17,960 in 2003). If she waited until age seventy to retire, her first-tier benefit would provide her half of the required amount, and her second-tier individual account would be tapped to pay for a matching inflation-adjusted annuity for those with large enough account balances (and smaller annuities for those with smaller account balances). Beyond that 200%-of-the-poverty-level combined first- and second-tier annuity, however, more relaxed distribution rules might apply. Finally, at death, any remaining balance in her account would go to her spouse or other heirs.

Because first-tier benefits would be used to ensure that every elderly American has income sufficient to keep them out of poverty, the second-tier individual accounts would not have to be all that large, and payroll tax levels could be reduced. For example, the second-tier individual accounts might be funded by a combined payroll tax contribution by employers and employees of just 6 or 7% of compensation, as opposed to the current 10.6% level paid into the Social Security retirement system.

3. *Replace Spousal Benefits with Earnings Sharing*

These second-tier individual accounts of husbands and wives would be subject to earnings sharing on an annual basis according to the standard approach.[130] 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 each year of marriage. At retirement, each spouse's second-tier benefit would be based on one-half of the married couple's earnings credits during marriage plus whatever earnings credits each of them accrued before or after the marriage.

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[130] *See supra* note 121 and accompanying text.

4. *Evaluating the Comprehensive Solution*

Replacing the current Social Security retirement system and the current Supplemental Security Income (SSI) program with the proposed two-tier system would meet all three of the articulated goals. First, the system would ensure that every elderly American had an adequate income throughout her retirement years. Indeed, first-tier benefits should be designed to ensure that every American who works until full retirement age is entitled to a benefit at least equal to the poverty level

Second, the system would have a minimum of work disincentives. The new system would be much more neutral about the timing of retirement than the current system. In particular, redistributive taxation would shift away from regressive payroll taxes and toward income taxes and other general revenues. Payroll taxes would go down, as less money would be needed to pay for the earnings-related, second-tier benefits. On the other hand, income and other taxes would go up to pay for the more generous first-tier benefits.

Finally, the system would not have marriage penalties or bonuses. Replacing spousal benefits and surviving spouse benefits with earnings sharing would eliminate these distortions.

V. CONCLUSION

In the 21st Century, it would make sense for the Social Security retirement system to satisfy three principal goals. First, the system should ensure that every elderly American has an adequate income throughout her retirement years. Second, the system should have a minimum of work disincentives. Finally, the system should have a minimum of marriage penalties or bonuses.

One way to achieve these results would be to have a two-tiered Social Security system for providing benefits to individuals. The first tier would provide a basic Social Security benefit to every older American. These benefits would be financed out of general revenues. The second tier would provide an additional earnings-related Social Security benefit based on payroll tax contributions made to individual accounts. Finally, married couples would share their earnings.

Although tinkering with the current Social Security retirement system could certainly reduce its work disincentives, a more comprehensive approach could solve all of the current system's work disincentive problems. In short, the two-tiered system described here would make Social Security work.