

The Case for Simplifying the Social Security Benefit Formula



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Why simplify?



- Make benefits more predictable
- Improve social insurance value of program

Predictability



- Value of Defined Benefit (DB) plan over Defined Contribution (DC) plan lies in predictability of future benefit
 - E.g., AARP calls Social Security a “predictable, stable retirement income.”
- Predictability makes other saving and retirement decisions easier
- But how well can people predict their future Social Security benefits?

What a typical DB benefit formula looks like



- Replacement factor, times
- Final year salary, times
- Years of employment
- Equals: benefit

What the Social Security formula looks like



- Index past earnings to economy-wide wage growth, through age 60. Earnings post 60 un-indexed;
- Average highest 35 years of earnings; divide by 12 to produce average indexed monthly earnings (AIME)
- Run AIME through PIA formula
 - 90 percent of the first \$744; 32 percent of \$745 to \$4,483; 15 percent of earnings above \$4,483
- Repeat process for spouse to determine auxiliary benefit eligibility;
 - If own PIA < 50% of spouse PIA, receive 50% of spouse PIA
- Adjust for claiming age
- Don't forget the earnings test!

How much do people know about their benefits?



- Data source: Health and Retirement Study, 2000-06 waves
- If respondent hasn't claimed, asked:
 - What age do you think you will claim benefits?
 - If you claim at that age, what will your benefit be?
- If respondent *has* claimed, asked:
 - What is your Social Security benefit?
- Respondents interviewed in multiple HRS waves allow for comparison of predicted/realized benefits

Results



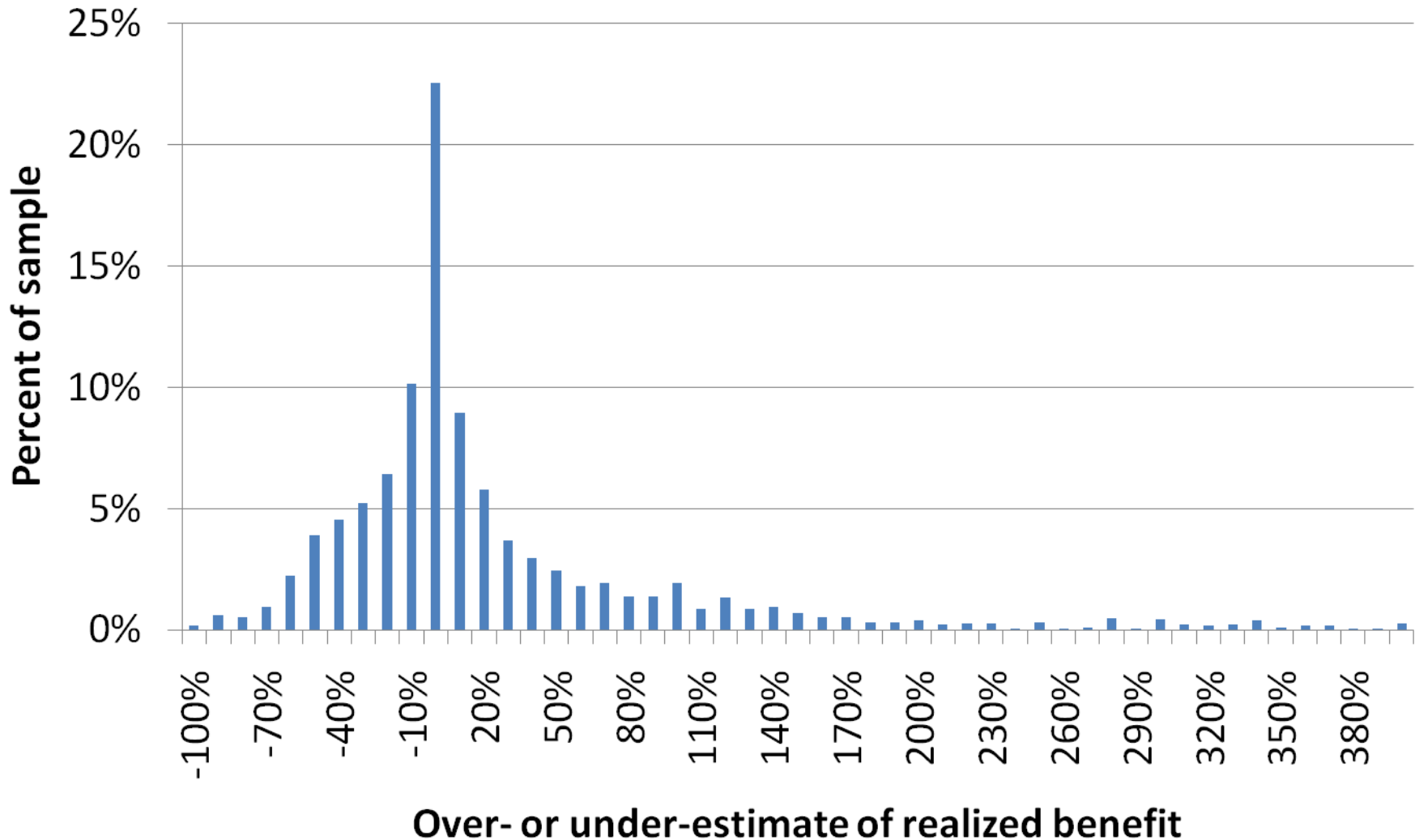
TABLE 1
DISTRIBUTION OF PROJECTED
VERSUS REALIZED RETIREMENT BENEFITS

Percentage of sample	Difference between projected and actual benefit (percent)
5	-58
10	-46
25	-19
50	-3
75	28
90	107
95	168

SOURCE: University of Michigan, Institute for Social Research, Health and Retirement Study, 2000–2006 waves.

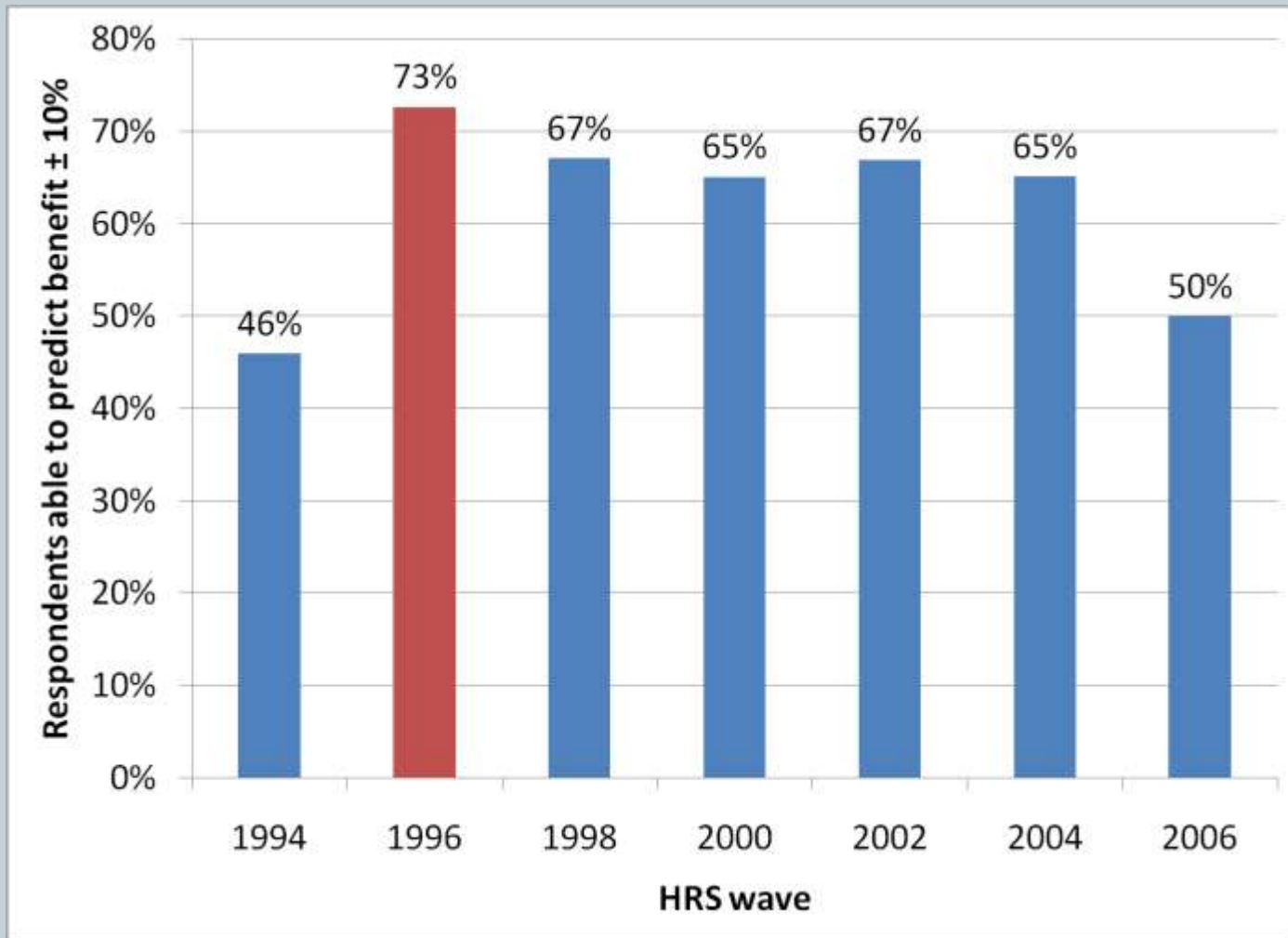
NOTE: N=1,901; negative numbers denote underestimates.

Distribution of projected Social Security benefit errors relative to realized benefit



Source: Author's calculations, based on 2000-2006 HRS waves.

Has the Social Security Statement helped?

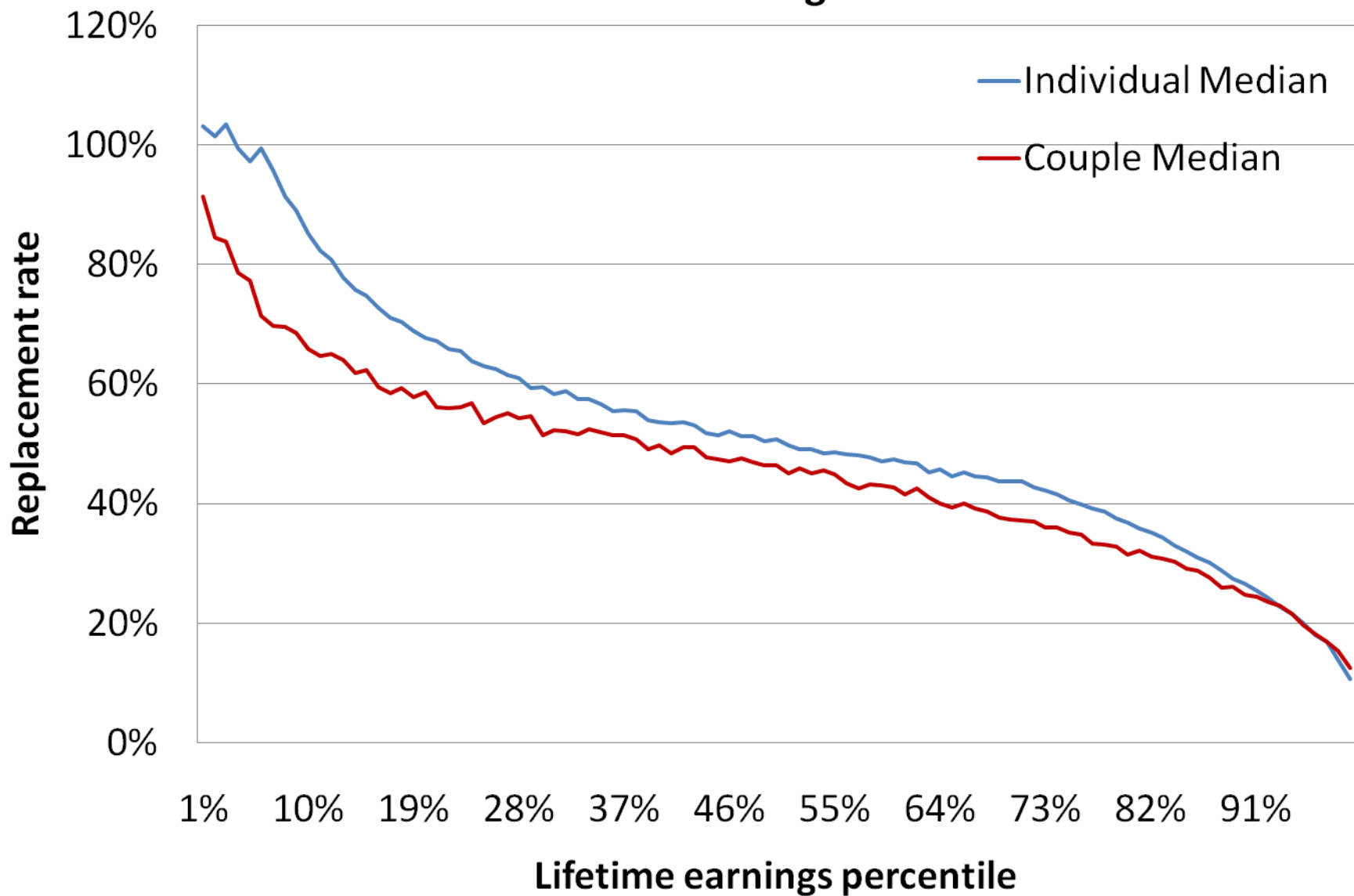


Benefit targeting

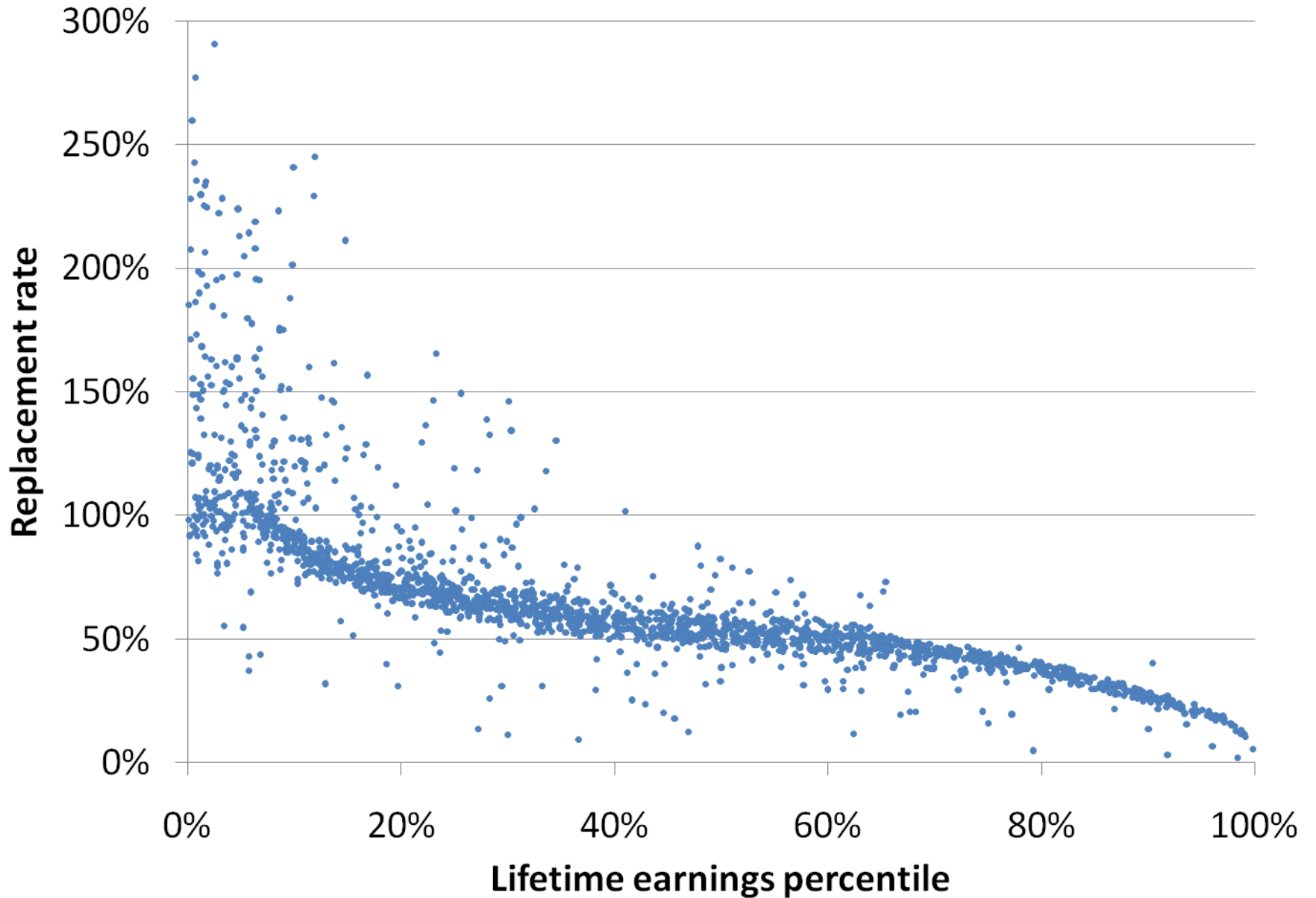


- Social Security designed to be “social insurance” program that, among other things, insures against low lifetime earnings
- Progressive benefit formula provides higher average replacement rates for low earners
- But to be effective insurance, this progressivity must be *consistent*

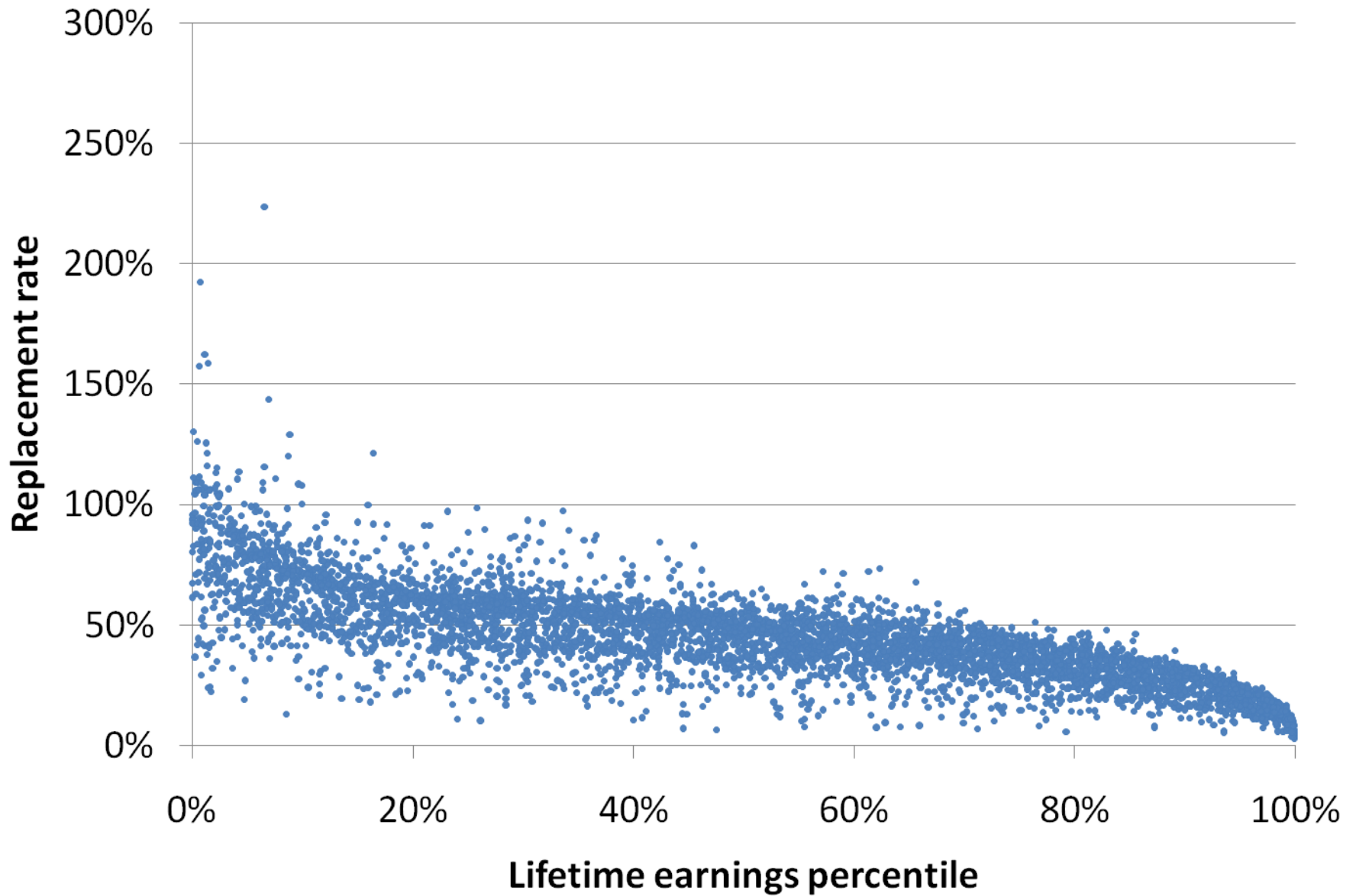
Individual and couple median replacement rates by lifetime earnings



Individual replacement rate by lifetime earnings



Couple replacement rates by lifetime earnings

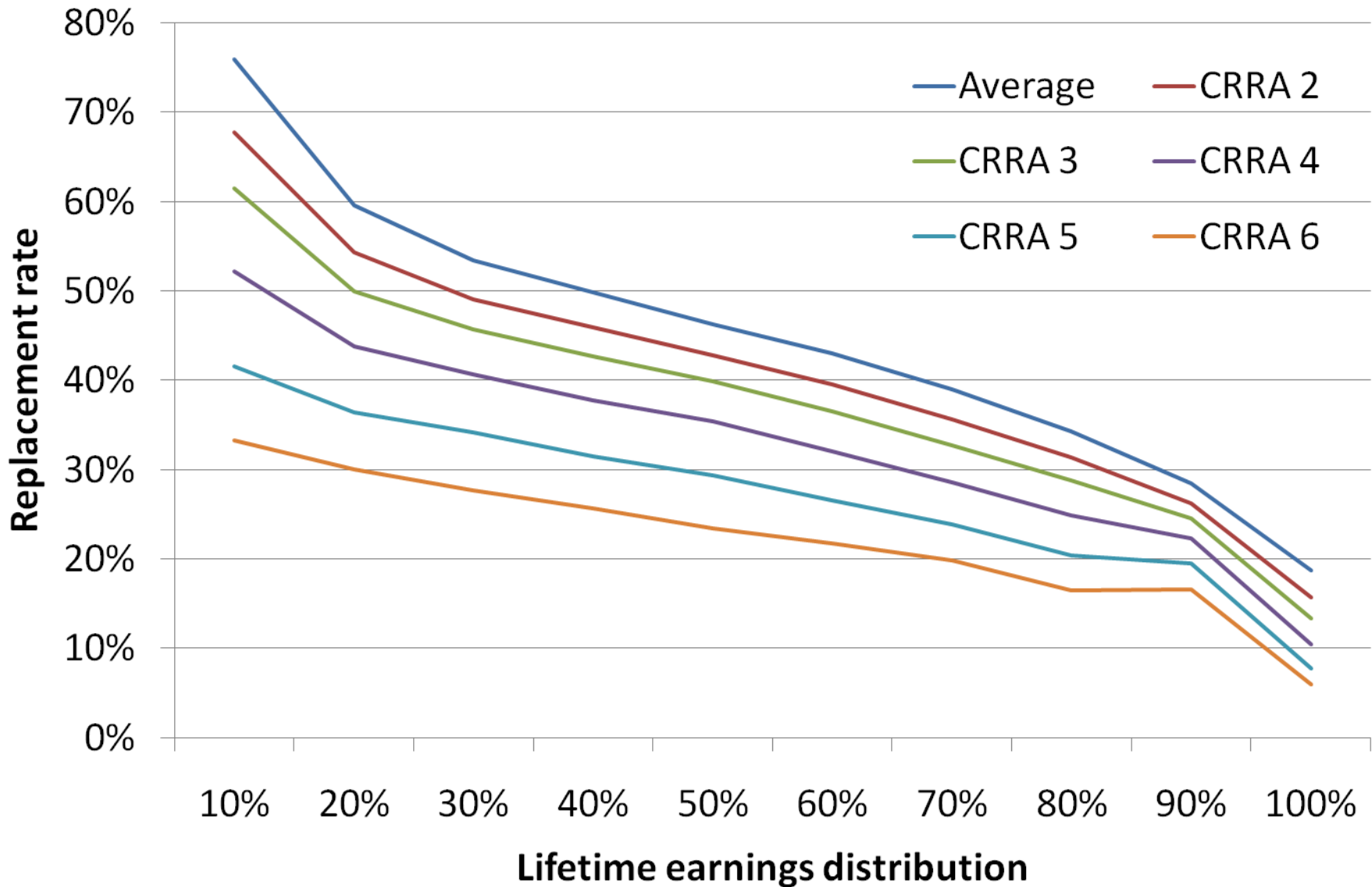


How can people with the same earnings get different benefits?



- Wage indexing of past earnings
- 40 quarter benefit eligibility
- 35 year AIME calculation
- 10-year marriage for divorced spouse benefits
- Maximum taxable wage
 - Generally small effects
- Claiming age
 - But claiming age controlled for in this analysis

Average and certainty-equivalent replacement rates, by lifetime earnings decile



Couple replacement rate by lifetime earnings; personal account plus flat dollar benefit, 1990 birth cohort

