

The Distributional Effects of the Social Security Windfall Elimination Provision

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About one-fourth of all public employees in the U.S. do not pay Social Security taxes on the earnings from their government job. This includes about 5.25 million state and local workers, and about 1 million federal employees hired before 1984. Many of these public employees still qualify for Social Security benefits, either because they were in covered employment at some point in their career or because they simultaneously work two or more jobs that span both covered and uncovered employment.

If Social Security benefits were calculated as a simple linear function of lifetime earnings, it would be possible to calculate the retirement benefit for a worker with partial coverage by simply applying the standard benefit formula only to those earnings covered by Social Security. But Social Security benefits are not linear; they provide a higher income replacement rate to those with lower earnings. Thus under the standard formula, workers who have only part of their lifetime earnings covered by Social Security would look like lower earners than they really are, and they would receive a higher replacement rate than would be awarded if their entire lifetime earnings were considered. The Windfall Elimination Provision (WEP) was enacted in 1983 to address this inequity, downward adjusting the benefit of affected workers.

The WEP is extremely controversial. Indeed, bills to eliminate or alter the WEP are regularly proposed in Congress. Among the reasons for the intense opposition are that: (a) the rationale is not widely understood, (b) SSA publications frame the WEP as a benefit cut, rather than a correction, and (c) the WEP is perceived as being unfair to lower income individuals. This paper discusses all three concerns, but with a primary focus on the distributional implications of the WEP in comparison to alternative formulations.

We find that the WEP does indeed reduce benefits disproportionately for lower earning households as compared with higher earning households. Because the WEP changes the marginal Social Security benefit only on the first \$711 (in 2008) of average indexed monthly earnings, the WEP reduces benefits by a larger percentage for households with lower covered earnings. In addition, because the WEP provision is phased out for individuals with 20 to 30 years of sufficient covered earnings, it can in some cases lead to large changes in Social Security replacement rates based on small changes in covered earnings.

Are there alternative formulations of the WEP that would come closer to the intended redistribution in the system? For example, if SSA had access to complete records on uncovered earnings, the conceptually simple way to make such an adjustment would be to calculate an individual's benefit using total (covered plus uncovered) earnings, and then multiply this by the ratio of covered-to-total lifetime earnings. This approach is not currently plausible, because the SSA does not have access to reliable

earnings histories prior to the 1980s. Even without these data, however, we show how it is possible to construct alternative approaches that come closer to preserving the intended progressivity of the benefit structure, and that can be implemented with existing data and no budgetary impact.

Even without a change in the benefit formula, we speculate that SSA may be able to reduce some of the public discontent with the WEP if its rationale were presented more clearly, and if it were framed differently. Throughout the SSA literature, the WEP is described as a “benefit reduction.” This framing would appear to suggest to affected participants that the provision involves a “loss.” One might reframe the presentation of the WEP as “Getting your benefit right” instead of “your benefit may be reduced” and thereby, at least potentially, moderate some of the discontent.

The full working paper is available on our website, www.nber.org/programs/ag/rrc/books&papers.html as paper NB08-05.

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This research was supported by the U.S. Social Security Administration through grant #10-P-98363-5 to the National Bureau of Economic Research as part of the SSA Retirement Research Consortium. The findings and conclusions expressed are solely those of the author(s) and do not represent the views of SSA, any agency of the Federal Government, or the NBER.