Social Security offsets: Policies public employees love to hate and don't understand

By Thomas Margenau, ©2007 International Foundation of Employee Benefit Plans

Do you administer a public pension for employees not covered by Social Security? If so, you may be aware of two laws that can offset, or perhaps eliminate, Social Security benefits employees may have earned on the side or may be due from a spouse. Questions are understandable, given the complexity of these laws: the windfall elimination provision and the government pension offset. This article intends to clarify these government offsets.

"I've heard through the grapevine that my Social Security will be cut in half because of our pension plan. What's the deal?"

"A co-worker just told me that I won't get a nickel of my wife's Social Security because of our pension. That isn't fair!"

"I understand an offset will prevent me from getting any Social Security. But surely I'll be covered by Medicare, right?"

The above questions and comments may be heard from those who work in the benefits or payroll department of a public agency not covered by Social Security. Conventional wisdom usually places the blame for these perceived Social Security benefit inequities on a law vaguely referred to as a government offset.

In fact, there are two provisions in Social Security law that may potentially impact employees due to receive a pension from a job not covered by Social Security. The first is the windfall elimination provision, which generally reduces a public employee's own Social Security retirement benefit. The second is the government pension offset, which impacts any Social Security spousal benefits employees might be due from a wife or husband's Social Security record. Employees may be affected by one or both of these laws.

Two provisions

Most local and state government employees, as well as a growing share of federal employees, pay into Social Security just as everyone else does. In fact, approximately 70% of all state and local government jobs (including teachers in most states) are covered by Social Security.

However, for those representing a portion of the 30% of public employees not covered by Social Security (including teachers in some states such as California and Texas), these laws will play a major role in pension and retirement planning.

If employees receive a pension from a job not covered by Social Security, but they have paid enough Social Security taxes in other jobs to qualify for a Social Security retirement benefit, that benefit will likely be reduced due to their government pension. The law requiring this reduction is the windfall elimination provision.

That same government pension will offset, and usually eliminate, any Social Security benefits employees may be due on a spouse's Social Security record. The law requiring this reduction is the government pension offset.

Why are most jobs covered by Social Security While others are not?

When the Social Security Act was passed in the mid-1930s, most workers in commerce and industry did not have any type of retirement pension plan. Because they were expected to directly benefit from Social Security, they were covered by the new law. Over the next several decades, other large employee groups, such as farm workers and military personnel, were also covered under the Social Security umbrella. In the mid-1950s, the self-employed were added to the Social Security rosters.

Certain large employee groups, such as federal government employees and railroad workers, had already established pension plans before Social Security was added. Therefore, Congress decided to exclude them from Social Security. Also, at the time of Social

Security's enactment, Congress felt it could not mandate a federal pension plan (Social Security) on state and local government entities, so employees of these agencies were given the choice of participating in Social Security. Of course, many of these entities established their own pension plans intended to operate independently of Social Security.

While many small and large government agencies did not accept Social Security coverage, over the years a high percentage of all state and local public employees opted to join the Social Security system. In 1983, sweeping changes altered the Social Security landscape following the recommendations of a presidential commission. All federal employees hired after December 31, 1983 were included in Social Security as were members of Congress, the president and vice president. State and local government employees were forbidden to terminate Social Security coverage after April 20, 1983. So today, railroad workers, a diminishing number of older federal government employees and about 30% of state and local public employees are the only large groups of workers in the United States not covered by Social Security.

That same presidential commission recognized that certain inequities in Social Security benefit payments were the direct result of these Social Security coverage issues. Public employees who worked for a relatively short time under Social Security received a windfall in Social Security retirement benefits that was intended only for long-term lower income workers. Many public employees were receiving spousal benefits from a husband's or wife's Social Security record although they did not meet the legal definition of dependency associated with those benefits. The result was, the commission recommended the passage of the two laws that became known as the windfall elimination provision and the government pension offset to deal with these inequities.

Windfall elimination provision

The windfall elimination provision reduces an employee's Social Security benefit, generally by about one-half. In other words, if the computerized estimate an employee impacted by this provision receives from the Social Security Administration indicates he or she is due $400 per month in a retirement pension upon reaching Social Security's full retirement age, that person can likely expect to receive about $200.

This is a very important point because if the Social Security Administration does not know if a potential retiree is impacted by the windfall elimination provision, it does not use the modified retirement benefit formula when sending annual benefit estimate statements. Therefore, retirement estimates in the Social Security statements sent to employees impacted by the windfall elimination provision are most likely wrong.

The key to understanding this provision is to realize that the word "social" in Social Security means something. Unlike private and other public sector pension plans, there are social goals built into the Social Security program. One of those goals is to raise the standard of living of lower income workers in retirement. This is accomplished through a benefit formula designed to give lower-paid workers a better deal than their more highly paid counterparts. Very low-paid workers could get a Social Security retirement benefit that represents up to 90% of their average lifetime earnings. This percentage is known as a replacement rate. In other words, Social Security benefits paid to the lowest-paid workers in our society are intended to replace 90% of their pre-retirement earnings. Those with average incomes (the middle class) generally get a 40% replacement rate. Those with higher incomes get a rate of approximately 30%.

The actual benefit formula the Social Security Administration uses to figure Social Security retirement benefits is updated annually and is further complicated by variables that are different for each year of birth. For example, a worker who turns 62 in 2007 would take the first $680 of average monthly earnings and multiply it by 90%; the next $3,420 by 32%; and the remainder by 15%. The Social Security Administration publishes a fact sheet, "Your Retirement Benefit-How It Is Figured," that explains the benefit computation formula. It is available on the Social Security Administration's Web site at www.socialsecurity.gov/pubs/10070.html.

In the author's opinion, the problem is that government employees and others who spend the bulk of their working lives not paying into Social Security are automatically treated as low-income workers by the Social Security Administration's computers. This is due to zeros on their Social Security earnings record for every year they spent in a non-Social Security job. Social Security's records don't show that they were actually working at another job and earning another pension. Instead, their Social Security earnings record simply shows gaps in their work history. So, when figuring their Social Security retirement benefit, the Social Security Administration's computers automatically use the formula intended to compensate a lower-income person. However, government employees can generally be classified as having average incomes, so they should get the same Social Security replacement rate paid to all middle-class workers. This is why a modified formula is used to refigure their benefits and give them the proper, and fair, replacement rate. For public employees impacted by this law, this modified formula replaces the 90% benchmark in the first step of the Social Security retirement formula with a smaller rate of usually 40%. The desired effect is to eliminate the windfall paid to middle-class public employees usually intended for lower-class workers (thus the name windfall elimination provision). Or, in other words, the windfall elimination provision takes a public employee from the 90% (low-class) replacement rate to a 40% (middle-class) replacement rate.

What does that mean in real money?

If an employee is affected by the windfall elimination provision, there is a simple formula that can be used to refigure his or her benefit. For example, if the retirement estimate in his or her Social Security statement is $612 or more, subtract $340 (or half of the public pension, whichever is less). If the retirement estimate in his or her Social Security statement is $611 or less, multiply the estimate by four and divide by nine.

The Social Security Administration has an online calculator for those impacted by the windfall elimination provision. It can be found at
www.socialsecurity.gov/retire2/ anyPiaWepjs04.htm.

An exception to the windfall elimination provision

The modified windfall elimination provision formula shown above applies only to people who have 20 or fewer years of substantial Social Security earnings.

If an employee has 30 or more years of substantial Social Security earnings, the windfall provision won't apply and the employee's Social Security benefit will not be reduced. If an employee has between 20 and 29 years of substantial earnings, his or her Social Security benefit will be only partially reduced. Instead of being cut roughly in half, it will be reduced by about 5% to 45%, depending on the number of years of substantial earnings on the person's record. The more years of earnings, the less the reduction will be. The online windfall elimination provision calculator on the Social Security Administration's Web site will figure the reduction that applies.

There are other exceptions that apply, such as for railroad workers, some employees of nonprofit organizations and those who worked in non-Social Security jobs prior to 1957. For a complete list of exceptions, see www.socialsecurity.gov/pubs/10070.html.

Why some employees may want a second job

Some employees may not be eligible for a Social Security retirement benefit (windfall elimination provision or not) if they do not have the 40 credits necessary to qualify for such benefits. However, employees who have close to 40 credits should consider taking a part-time job just to get over the threshold. With 39 or fewer credits, an employee won't collect a nickel from Social Security. With 40 or more credits, he or she will collect a benefit that will be subject to the windfall elimination provision and may be reduced to an amount less than $100 per month. And $100 in nickels is better than no nickels at all.

An employee can take a part-time job earning as little as $4,000 per year and receive four credits from Social Security. (That's the maximum payable in any one year.) Public employees significantly under the 40-credit threshold will have to decide if it is worth the effort to work at a Social Security-covered job for up to ten years to qualify for a very small monthly payoff from the system.

Government pension offset

The windfall elimination provision impacts an employee's Social Security retirement benefit. The government pension offset impacts Social Security spousal benefits and affects employees who will collect a pension from a job not covered by Social Security.

The government pension offset essentially states that a public pension paid to employees not covered by Social Security will offset (and generally eliminate) any benefits they may be due on a spouse's Social Security record.

The simple government pension offset formula

Unlike the complicated windfall elimination provision discussed above, the government pension offset formula is simple; the Social Security Administration must deduct an amount equal to two-thirds of an employee's government pension from any wife's, husband's, widow's or widower's benefits he or she might be due from Social Security. Because public pensions are often substantially higher than spousal benefits paid under Social Security, this rule generally means that an employee impacted by the government pension offset will not qualify for any benefits on a spouse's Social Security record.

Why the offset?

Benefits that Social Security pays to wives, husbands, widows and widowers are dependent's benefits. These benefits were established in the 1930s to compensate spouses who stayed home to raise a family and were financially dependent on the working spouse. However, as more and more couples became employed, they each earned their own Social Security retirement benefits. Social Security law has always required Social Security Administration to offset one retirement benefit against another. For example, if a woman worked and earned her own $800 monthly Social Security retirement benefit but she was also due a $500 wife's benefit on her husband's Social Security record, the Social Security Administration could not pay that wife's benefit because her own Social Security benefit offsets it. However, if that same woman was a government employee who did not pay into Social Security and earned an $800 public pension, there was no offset (prior to the government pension offset law) and the Social Security Administration was required to pay her a full wife's benefit in addition to her government pension. The government pension offset rule exists to ensure that employees who collect public pensions are treated the same way as those who collect Social Security retirement pensions.

Exceptions

There are a few exceptions to the government pension offset. They apply primarily to state and local government employees whose public pension was based on a job where they were paying Social Security taxes during the last five years of their employment, or to "civil service offset" employees. (A civil service offset employee is a federal employee with at least five years of prior civil service experience, rehired in 1984 or later following a break of more than one year in government service.) For a complete list of exceptions to the government pension offset rules, see the Social Security Administration's Web site, www.socialsecurity.gov/pubs/10007.html.

An example that explains the fairness of the government pension offset

Many public employees impacted by government pension offset think the law is unfair. They believe they are being cheated out of Social Security benefits that everyone else receives. For example, Bob and Carol-and their neighbors, Ted and Alice—live in a nice suburb of San Diego. Both Bob and Carol worked all of their lives at jobs covered by Social Security. In other words, Social Security taxes were deducted from both of their paychecks.

Ted also worked at a job covered by Social Security, however, his wife, Alice, was a teacher in San Diego. California teachers pay into the state teachers retirement system, but they do not pay into Social Security.