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Chapter 2
Basic Principles and Present Provisions of the OASDI System

The Old-Age, Survivors, and Disability Insurance (OASDI) system can best be understood by considering the basic principles underlying it before describing its provisions. The latter can be considered under three broad headings: coverage, benefit provisions, and financing. Each of these is taken up in turn, including explanations of why the provisions were adopted. Appendix D shows various reporting dates applicable to promulgations and reports under OASDI. Appendix E presents, in tabular form, the elements of the several fund ratios (measuring trust-fund balances against annual outgo) which are used to trigger certain features of the program (such as benefit COLAs).

This chapter deals with the major principles. The appendixes at the end of the chapter, as well as the copious footnotes, give complete details on the less important, often complicated, provisions of OASDI, and these can well be ignored by the reader who wants only a general overview of the program. It is also important to bear in mind that the public assistance programs serve as a "backstop" to OASDI benefits for those for whom such benefits are not adequate to meet their needs (see Chapter 11).

Before proceeding, it would be well to define several terms. By *workers* is meant both wage and salaried employees and self-employed individuals. By *wages* is meant both the wages of nonsalaried employees and the salaries of salaried employees in covered employment. By *earnings* is meant both wages and net self-employment income in covered employment. The terms *contributions* and *taxes* are here used interchangeably, because both are so used in the Social Security Act.

Reference will frequently be made to benefits *for* a month. This

denotes the month with respect to which the benefit accrues rather than the month in which it is actually paid (which is usually at the beginning of the next month). Furthermore, according to rules of the federal government, a person attains a particular age on the day before her or his birthday.

Also, it may be well to differentiate among *eligible*, *entitled*, and *receiving* as they relate to monthly benefits. A person is eligible for a benefit if all conditions for insured status, age, and so forth are met. Persons are entitled to benefits if they are eligible and a claim has been filed. A person is receiving a benefit if entitled and if no condition prevents payment (such as the retirement earnings test, the workers' compensation offset, and the public-pension offset).

Frequently, the term *dependents* is used (and will, at times, be used here) to connote the spouse and children of retired and disabled workers. Actually, this is not precise terminology, because there is no requirement of dependency for spouse's benefits, but rather only legal status.

As will be seen, the provisions of the OASDI system are quite complex, and the law itself is detailed and lengthy (about 225 pages for the OASDI benefits and another 400 pages for the Medicare benefits). The benefit provisions are contained in Title II of the Social Security Act (Title 42 of the U.S. Code) for OASDI (and in Title XVIII for Medicare), while the tax provisions (50 pages) are in the Internal Revenue Code.

One reason for the complexity of the law has been the desire of Congress over the years to put as much explicitly in the law as possible, and thus to leave as little discretion of interpretation as possible to the administrators. Nonetheless, it is frequently said that OASDI is so complicated that few covered persons really understand it. But this is also the case for many other things in our economy—private pension plans and insurance, among others (for that matter, many who use automobiles and television sets have no more than a vague idea as to what makes them operate).

In all cases, the same benefit rights and amounts accrue to women as to men. A description of how equal treatment by sex was achieved over the years is given in Appendix 3-2.

Basic Principles of the OASDI System

There are a number of what might be termed "basic principles" of the OASDI program. These principles have not changed greatly in somewhat more than 50 years of operation. Among them are the

following: (1) the benefits are based on presumptive need; (2) the benefits should provide a floor of protection; (3) there should be a balance between social adequacy and individual equity; (4) the benefits should be related to earnings; and (5) financing should be on a self-supporting contributory basis. There is not universal agreement on all these principles by students of social security, however, as mentioned in the following discussion.

Benefits Based on Presumptive Need

Certain categories of social risk are established by the law, and benefits are, in general, paid when these risks eventuate. Thus, for example, old-age benefits are not payable automatically on attainment of a stated minimum retirement age, such as 62, but rather only on retirement (although, as a political compromise, they are payable automatically without regard to retirement after an age beyond when most individuals retire—currently, age 70). Likewise, benefits for eligible aged widows, widowers, and dependent parents are generally payable for their full lifetime, subject to their not being substantially gainfully employed.

The retirement condition for receipt of benefits is frequently misunderstood as being a means test or a needs test. When the condition is considered in that light, some critics believe that the retirement (or earnings) test is unfair because only earned income is used as a criterion for paying benefits, while investment or pension income is disregarded. This procedure, however, is essential if there is to be a system paying *retirement* benefits, and not a charity or welfare program based on individual needs as determined by social workers. The latter would be an inimical basis insofar as the nation is concerned, because individual and group thrift would be discouraged (for the reason that any income resulting therefrom would be considered—i.e., deducted—in determining the amount of the public assistance payment).

It is sometimes said that social security benefits are intended to be a *replacement* of earnings when certain risks take place, but this is not entirely correct. In many instances, retirement benefits are paid, and quite properly so, even though the individual had not been substantially gainfully employed for some years before the minimum retirement age, so that no recent earnings are being "replaced." Under such circumstances it can be argued that the benefits are logically payable because the individual, by working in his or her younger years, was accumulating certain deferred retirement benefits.

"Floor-of-Protection" Concept

It is generally agreed that OASDI benefits should provide only a minimum floor of protection against risks. There is, however, a great diversity of opinion as to how far apart the floor and the ceiling should be. At one extreme are those who believe that the floor should be so low as to be virtually nonexistent. At the other extreme, some believe that the floor should be high enough to provide a comfortable standard of living, completely disregarding any economic security that private or group methods might provide. This viewpoint really implies that a floor-of-protection concept is not valid.

The middle viewpoint is that the benefits under a social insurance system should, along with other income and assets, be sufficient to yield a reasonably satisfactory minimum standard of living for the great majority of individuals. Then, any individuals still in need should receive additional payments from a supplementary social assistance program. This viewpoint was well expressed by President Franklin D. Roosevelt when he signed the original Social Security Act in 1935 and stated, "We can never insure 100 percent of the population against 100 percent of the hazards and vicissitudes of life." (See Appendix C for this historic statement, which so well expresses the moderate philosophy of the social security program in the United States.)

In considering the level of OASDI benefits, it should be kept in mind that they are only partially subject to personal income tax (not at all for the vast majority of beneficiaries at present), whereas preretirement earnings are subject to such taxes (and others, too). However, this partial exemption from income tax is a valuable feature only for persons with high OASDI benefits and for persons with other income. Those with small or moderate OASDI benefits and little other would not have to pay income tax even if such benefits were partially taxable, because of the personal exemption and the standard deduction.

A possible quantitative measure of whether OASDI meets the floor-of-protection standard might be the proportion of beneficiaries aged 65 or over who also are receiving public assistance. For many years, this proportion has been less than 10 percent (only 6 percent in recent years). This seems sufficiently low so that the standard can be said to be met.

It may also be noted that the floor-of-protection concept means that the vast majority of the people will have to supplement OASDI benefits with economic-security measures in the private sector to have full replacement of their take-home pay immediately prior to retirement. Nonetheless, those with low incomes can—due to the weighted bene-

fit formula under OASDI—properly have benefits that do provide such full replacement (or reasonably close thereto).

Relationship between Individual Equity and Social Adequacy

The OASDI system emphasizes social adequacy in the benefit structure more than individual equity, although some elements of the latter are present. In general, the higher the average earnings of the individual, the larger will be the benefits. Also, the longer a person is actually in covered employment in proportion to the period of potential coverage, the larger will be the benefits. The increase in benefits for higher earnings or for higher proportions of covered participation are by no means proportionate, but they are present. The social-adequacy basis is also evident in the imposition of maximum benefit provisions.

Over the years the OASDI benefit structure has shown a trend away from individual-equity principles and toward more social adequacy. The provisions of the original act emphasized social adequacy, although they did place considerable emphasis on individual equity through the provision "guaranteeing" that total benefits payable with respect to a covered worker would always at least equal the employee taxes paid plus an allowance for interest.[1]

A widespread misconception of the nature of OASDI as it was originally established is that the benefits were then on a completely "actuarial" or individual-equity basis. That this was not so can be clearly seen from the numerical examples presented in the next section.

Even today, many people incorrectly believe that complete individual equity prevails under OASDI and that their taxes are accumulating at interest in the headquarters of the Social Security Administration (SSA) in Baltimore. To some extent, this view is encouraged by the many references of the SSA to people's Social Security accounts that it maintains. Actually, these accounts record only the creditable earnings of each covered worker, and not the taxes paid or interest thereon.

This misconception prevails in some high places, too. For ex-

1. This guarantee was an amount of 3½ percent of total lifetime covered wages, as against the maximum ultimate tax rate being 3 percent, although the rate started at 1 percent. For example, an individual who had maximum covered earnings in 1937–84 and died at the beginning of 1985, before receiving any retirement benefits and leaving no eligible dependents, would have had a lump-sum death payment of $15,127 under the original provision, compared with no benefit at all under present law. The 1939 Act eliminated this provision and instead substituted monthly survivor benefits, payable only in those cases where eligible dependents are left. This is one of the few instances where the program was deliberalized over the years.

ample, Senator Barry Goldwater, in an article in *Reader's Digest* for August 1974, stated that OASDI benefits "are a repayment of our own earnings, which we have deposited in trust as a regular contribution deducted from our salaries and from our employers on our behalf." This statement was made to support the view that OASDI benefits should be paid at age 65 regardless of retirement from substantial employment.

Earnings-Related Benefits

Because of social adequacy and the floor-of-protection concept, it seems desirable that benefits should be relatively larger for those with low earnings than for those with high earnings. Accordingly, the benefit formula under the OASDI system has always been heavily "weighted," so that a higher benefit rate applies to the lower portion of average earnings than to the higher portion. However, since contributions are related to earnings up to the maximum earnings base, there is some appeal to the public in the fact that the higher an individual's earnings the higher the benefits will be.

Because of a conflict between the two principles, social adequacy and earnings-related benefits, an anomaly (some would say gross inequity or injustice) arose under OASDI in the first few decades of its operation.[2] If benefits are to be related to earnings, and if reasonably sizable benefits are to be paid in the early years of operation, the *absolute* actuarial bargain under individual-equity considerations will go to the highest-paid persons, even with a heavily weighted benefit formula. Under such circumstances, the *relative* actuarial bargain will be larger for low-paid persons in the short run. However, over the long run, low-paid persons will make out much better than high-paid ones when the values of benefits and taxes are compared, both relatively and absolutely.

As an illustration of this, consider the situation for individuals retiring at age 65 in January 1940. The monthly benefit for an unmarried individual with maximum creditable earnings was $41.20, and this had an actuarial present value then of about $4,940. The corresponding benefit for earnings of $1,200 per year (approximately the average earnings of a full-time worker then) was $25.75, with a present value of about $3,190. The total employee taxes paid were $90 for the maximum case and $36 for the average case. Thus, the average

2. For a more complete and critical discussion of this matter as it applies to both the Canadian social insurance system and OASDI, see James L. Clare, "Financing Social Security," *Proceedings*, 60th Annual Conference, National Tax Association, Tax Institute of America, 1973.

individual had a benefit value that was 89 times the taxes paid, compared with a ratio of 55 times for the maximum case. But the absolute "actuarial bargain" was $4,850 for the maximum case versus only $3,154 for the average case. More computations along these lines are presented in Appendix 5-3.

Some would call this situation "upside-down welfare" and therefore consider it indefensible. But it should be noted that the only way to avoid this result if there is to be a social insurance plan is to have flat benefits—or to have only a public assistance plan. Those who believe in the desirability or necessity of an earnings-related social insurance system argue that the long-range advantages of this approach offset the disadvantages associated with the short-term anomaly discussed above.

Self-Supporting Contributory Basis

In brief, the principle of self-support means that no general-revenue appropriations or subsidies will, over the long run, be needed to finance the benefit payments and the administrative expenses. The contributions (taxes) from workers and employers will be available for such purposes, as will be the interest earned by the trust funds. Such funds invest the excess of income over outgo of the system, by law, in only U.S. government securities (or securities guaranteed by the government). Such interest does not represent "contributions" or "financial support" from either the General Treasury or the general taxpayer, because the interest on these investments would have to be paid regardless of whether the securities were held by the trust fund or by private investors.

In regard to this subject, President Franklin D. Roosevelt stated, "If I have anything to say about it, it will always be contributed, both on the part of the employer and the employee, on a sound actuarial basis. It means no money out of the Treasury."[3]

Contributory Basis for Employers and Employees

The basic financing principle adopted by Congress in 1950, and maintained for OASDI until the enactment of the 1983 Amendments, was that the program should be completely self-supporting from the taxes of workers and employers. Self-support can be achieved by any number of different tax schedules—ranging, at one extreme, from a

3. As quoted in Arthur M. Schlesinger, Jr., *The Coming of the New Deal* (Boston: Houghton Mifflin, 1959).

schedule higher in the early years than in the later ones, thus tending to produce a "fully funded reserve," to the other extreme of a schedule so slowly graded up that "pay-as-you-go" or current-cost financing would, in effect, result. The actual basis adopted initially for OASDI was between pay-as-you-go and fully funded—probably nearer the former—again, despite the statements of some persons that the original funding basis was "full actuarial reserves."[4]

It should, however, be noted that this long-standing (some would say time-proven) principle of complete self-support from contributions of workers and employers was partially—although not necessarily completely—breached by the 1983 Amendments (as will be described later). Some persons believe that a much larger and more direct government subsidy (or more euphemistically, government contribution) is desirable because the heavy, and readily apparent, burden of payroll taxes is a strong deterrent to the benefit liberalizations they espouse. For example, the Carter administration proposed this as a partial solution to the financing problems of OASDI in connection with the 1977 Act, but Congress rejected it. Support for general-revenue financing is not new; it has been urged from time to time, for various reasons, ever since the program was enacted in 1935 (and even in the deliberations underlying the legislation). This subject is discussed in more detail later, especially in Chapter 5.

Efforts to destroy the self-supporting principle of financing OASDI were given impetus by the change in the Railroad Retirement system in 1974, whereby a significant amount of its financing will come from the General Fund of the Treasury. This is discussed in detail in Chapter 12. It could be argued that such action is not really a precedent for the OASDI system, because there is a significant difference between a small group being subsidized by the whole nation and the entire citizenry being subsidized by itself.

Over the years, various amendments have moved the system closer toward current-cost financing, especially insofar as the next few years after the legislative change are concerned, but still with considerable buildup of the trust-fund balance in the long run. As a result, the actual experience showed close to current-cost financing, with the actual trust-fund balances in 1965–75 being about one year's outgo in size—and, in the next few years, considerably less.

The amendments in 1972 recognized this principle of current-cost financing for the OASDI system by establishing a tax schedule that

4. For example, see the statements of Maurice Stans, a former director of the Bureau of Budget and later Secretary of Commerce, in an interview in *U.S. News & World Report*, January 16, 1967.

would accomplish this general result for all future periods. The principle is not stated explicitly in the law, although it is brought out clearly in the House and Senate committee reports, which have considerable influence in expressing congressional intent.

The 1977 Act, however, moved somewhat in the opposite direction—and the 1983 Act did not change the situation. The relative size of the trust-fund balances will increase significantly beginning in about 1990, according to the intermediate-cost estimate. Shortly after the turn of the century, the size of the fund will be far in excess of one year's outgo (in fact, of a magnitude of about five years' outgo). No discussion of this situation occurred during the congressional considerations. It is quite likely that such large fund buildups will not be allowed to occur (by reducing the scheduled increases in the tax rates). More detailed discussion of this matter is given later, particularly in Chapter 5.

In carrying out this principle of self-support in the past, the basis has been adopted that the employer and employee should share the cost equally, each paying a percentage tax rate on earnings up to a certain specified maximum amount. This equal-sharing basis was adopted on purely arbitrary grounds, and not for actuarial reasons. From a logical standpoint, it seemed reasonable, since both parties have an interest in the matter—the employee because of his or her self-concern and the employer because of the desire to replace a superannuated staff in a humanitarian way.

In connection with the legislation leading up to the 1977 Act, the Carter administration proposed that, although the employer and employee should pay the same tax rate, the maximum taxable earnings base should be higher for the employer than for the employee. Although the Senate bill followed this recommendation, it was deleted from the final version of the bill.

Contributory Basis for the Self-Employed

When self-employed individuals were first covered by the system, their tax rate was set at 75 percent of the combined employer-employee rate. This was a "political" and "practical" compromise between the position of paying only the employee rate and that of paying the combined employer-employee rate. This 75-percent basis was also "supported" by several other arguments.

One was that self-employed persons report income that is partly the result of presumed interest earnings on the invested assets in the business, and this might average 25 percent of their total income. There-

fore they should not pay tax on this amount. The fallacy here, however, is that then this 25 percent should not be included as a benefit credit, but actually it is included.

Another argument for the 75-percent basis for the self-employed was that this category has a lower cost than does the category of employees, largely because they are likely to defer retirement longer. This may be true, but again the argument is of doubtful relevance, because experience rating does not, and should not, play a role in OASDI with regard to other low-cost or high-cost categories. For a long-range risk like OASDI, it would be virtually impossible to develop any reasonably valid experience-rating system.

Actually, from the standpoint of logic, and considering the financing of the system, the self-employed should pay the same rate as the employer and employee combined. The trust funds should receive the same amount of taxes for a particular amount of earnings credits no matter who earns them. And this is what was done in the 1983 Act! (Interestingly, Canada follows this approach in its Canada/Quebec Pension Plan.)

The 75-percent basis seemed politically necessary because the tax burden on the self-employed would otherwise seem too high, and many in this category are considered to be politically potent. Moreover, initially the self-employed paid the tax in one lump sum annually, when they filed their income tax, so that the tax amount was very apparent, compared with employees who pay by the less painful way of periodic payroll deduction. Currently, the self-employed generally pay the social security tax in advance, along with the quarterly estimated income tax.

Even the 75-percent basis for the self-employed seemed onerous to them, so a 7-percent ceiling on the OASDI rate was inaugurated for the self-employed in the 1965 Act. As it happened, this ceiling first became effective in 1973. Likewise, to satisfy the complaints of the self-employed when the Hospital Insurance (HI) portion of Medicare was established in 1965, it was decided that the self-employed should pay only the employee tax rate (i.e., 50 percent of the combined employer-employee rate). As one way of dealing with the financing problems of OASDI, the 1977 Act essentially restored the 75-percent basis for OASDI for the self-employed, effective in 1981.

When the system receives lesser amounts from the self-employed than from other covered categories, someone must make up the difference. Therefore it can be said that all the tax concessions made to self-employed persons under OASDI and HI in the past meant that the employers and employees paid somewhat more than they otherwise would. Specifically, if the self-employed paid the full employer-

employee rate, the 13.4-percent rate applicable for 1983 for OASDI and HI combined could have been reduced to 13.1 percent—a not insignificant decrease!

Coverage Provisions of the OASDI System

Virtually all gainfully employed persons are covered under the program or could be covered by election. The major exceptions are police officers with their own retirement systems in most states, federal government employees under the Civil Service Retirement or Foreign Service Retirement systems who have, in general, been continuously employed since before 1984, low-income self-employed persons, and farm and domestic workers with irregular employment. Railroad workers are, in essence, covered under the OASDI program as a result of: (1) the provision in the Railroad Retirement Act for transfer of the wage credits of employees with less than 10 years of service, (2) the two-tier basis for the Railroad Retirement system with respect to service after 1974 (the first tier being, by and large, an OASDI benefit), and (3) the financial-interchange provisions between the two systems. The temporary employment of nonresident aliens who are students, scholars, or teachers is not covered if such employment is for the purposes for which they were admitted to the U.S.

The numbers of covered workers and total workers, classified according to their major job, who were employed at any time during 1986 are shown in Table 2.1. About 92 percent of all workers were in covered employment then. These figures are on the basis of actual

TABLE 2.1. Estimated OASDI Coverage in Effect among Persons in Paid Employment, 1986 (number of persons in millions)

Employment Category	*Total Workers*	*Covered Workers*	*Percent Covered*
Employees in industry and commerce	86.5	86.3*	99.8
Employees of nonprofit organizations	7.2	7.1	98.6
Employees of state and local governments	15.0	10.7	71.3
Employees of federal government, civilians	3.8	1.5	39.5
Employees of federal government, military	2.2	2.2	100.0
Farm employees	1.3	1.1	84.6
Domestic employees	1.4	0.5	35.7
Railroad employees	0.4	0.4	100.0
Self-employed persons	9.5	7.2	75.8
Total employed persons	127.3	117.0	91.9

*Difference consists of newspaper carriers under age 18.
Source: Social Security Administration.

coverage in effect, not what is legally required (i.e., taking into account any noncompliance). Thus the figures for coverage of domestic and farm workers are significantly lower than what they would be if there were full compliance, and the figure for the covered self-employed persons is likewise somewhat low. The corresponding proportion for 1990, when 134 million persons had some covered employment, is estimated to be 92½ percent, and it will slowly rise over the years—to about 94 percent as more and more federal civilian employees become covered (by being new hires after 1983, as discussed later). It is interesting to note that this proportion was only 56 percent when the system first began operations (and covered only workers in industry and commerce).

It is significant that in recent years the wages and salaries of persons covered by OASDI (including Railroad Retirement) have represented 90 percent of all wages and salaries in the country. Furthermore, the wages and salaries of persons covered under other government retirement systems (Civil Service Retirement and state and local government retirement systems) but not under OASDI represented another 7½ percent. Thus, the wages and salaries of persons with government retirement plan protection were as much as 97½ percent of all wages and salaries in the country.

Nonfarm Self-Employed

All nonfarm self-employed persons are compulsorily covered—both nonprofessional (such as store owners) and professional (such as lawyers and physicians).[5] They report their net earnings annually on the income-tax return, with no coverage when such earnings are less than $400. This latter provision was introduced for administrative reasons, because coverage enforcement would be extremely difficult for persons with very low earnings. It should be noted, however, that many persons are required to file income-tax returns for Social Security purposes even though they have no income tax to pay (because the personal exemptions exceed their net income, despite the latter being

5. A problem has always existed with regard to income "earned" by persons who had a financial interest in an unincorporated business but did not render personal services in connection therewith. Such "silent partners" must count this income as self-employment earnings for Social Security purposes. However, in the 1970s, there was abuse of this feature. A growing number of businesses advertised limited partnerships as a means of acquiring Social Security coverage solely through what was really the investment income from such partnerships (e.g., by government employees not under the program who sought to obtain windfall benefits in this manner). The 1977 Act closed this loophole, effective 1978. Also, any windfall benefits of persons who are in noncovered employment during most of their working career have been reduced greatly by a provision in the 1983 Act (discussed later).

$400 or more). Undoubtedly, much such "required" coverage is not actually effectuated.

There has been a gradual "hidden" extension of coverage over the years in this area of employment. The $400 limit on earnings is now *relatively* much lower than when it was adopted initially for 1951, due to the significant increase in the general earnings level since then. Accordingly, a rising proportion of the self-employed has been required to be covered.

Certain groups who are really employees are covered as though they were self-employed (as will be discussed in more detail later)—ministers, American citizens who are working in the United States for a foreign government or an international organization, and licensed real estate agents and direct home-to-home sellers. The latter category is deemed, by law, to be self-employed regardless of common-law rules.

Directors of corporations are deemed by law to be self-employed persons. Their fees are thus taxable (and creditable for benefit purposes) when received. However, for the purposes of the retirement earnings test, their earnings are considered on a when-earned basis so as to prevent manipulation and abuse (as discussed later).

A special limited simplified reporting procedure applies to the nonfarm self-employed when they have low net earnings compared with gross earnings.[6]

About 10 percent of the nonfarm self-employed persons are not covered in such employment because of the minimum earnings requirement for coverage. Another 5 percent could have elected coverage under the simplified reporting procedure but did not do so. Most of these low-income individuals were not dependent on such employment for their livelihood.

Farm Operators

Farmers are covered on the same general basis as other self-employed persons, except for a simplified reporting option for those with low incomes.[7] This option is available for low-income farmers because

6. The procedure for the simplified reporting method for nonfarm self-employed persons is similar to that for farmers (see footnote 7), but it is more restrictive in that it can be used in only five reporting years, and then only in years when net earnings were less than both $1,600 and two thirds of gross income, and also only if net earnings were at least $400 in two of the preceding three years. These simplified reporting procedures are becoming increasingly less utilizable, because the dollar amounts involved have remained unchanged since 1956, while earnings levels have increased greatly.

7. A farmer with a gross income of not more than $2,400 a year may, instead of itemizing income and expenses, use two thirds of gross income as earnings for OASDI

they frequently do not maintain good financial records, and they do not need to do so for income-tax purposes because no such tax liability exists.

About 20 percent of the farmers are not compulsorily covered in such employment even though they have gross earnings of at least $600; they could then "elect out" by using the net-earnings alternative if net earnings were less than $400. Some 90 percent of this category could have elected coverage under the simplified reporting option based on gross income.

Ministers

Ministers, unlike other occupational groups, may opt out of coverage on the ground of being opposed to public insurance of the OASDI type on account of conscience or religious principles, with such action being taken within approximately two years after ordination.[8] No specific proof of such grounds is necessary. The statement of the minister that such is the case is sufficient. Ministers' earnings are considered self-employment income even if their compensation is in the form of regular salary.[9]

Members of religious orders who have taken a vow of poverty are eligible for coverage on an employer-employee basis if their order agrees irrevocably to cover them. Their "earnings" are based on the subsistence provided them, with a minimum of $100 per month.

The special coverage basis for ministers resulted from the strong feeling of some denominations that ministers are not employees and from the belief of some ministers that participation in a government insurance program violates the principle of separation of church and state.[10] On the other hand, some denominations are quite willing to

purposes (even though this is less than actual net earnings). Consistent with this, a farmer with gross income of over $2,400, but net earnings of less than $1,600, may report earnings of $1,600, instead of actual net income.

8. The 1977 Act permitted those who had previously opted out to rescind such action if this was done before April 16, 1979.

9. Ministers serving abroad who are U.S. citizens are covered in the same manner as in the United States, regardless of their employer and regardless of whether they have maintained a U.S. residence—for example, a U.S. citizen who has served a Canadian congregation for many years.

10. In passing, it is interesting to note a special exemption for members of certain religious faiths, which applies primarily to certain Amish and Mennonite groups. Exemption from coverage as a self-employed person or as an employee of such a person may be granted to any individual who is a member of a sect that is conscientiously opposed to public or private insurance of the form of OASDI benefits. Under such circumstances, the individual must waive all future OASDI benefit rights based on his or her own wages and self-employment income.

have their ministers covered on a compulsory basis. The present basis prevails because of the "least common denominator" element.

About 90 percent of the ministers who are eligible for coverage are actually covered, with a higher proportion covered among those at the older ages than at the younger ages.

Employees of Nonfarm Private Employers

All employees in private industry and commerce, including mining, transportation other than railroads, and service industries, are compulsorily covered, with no minimum restrictions on the amount of earnings or length of employment.[11] Full-time life insurance agents and certain other types of salespersons are defined by law to be "employees," regardless of their common-law status.[12] (Because many readers of this book are interested in the insurance business, Appendix 2-1 gives more details on the coverage of life insurance agents.) On the other hand, licensed real estate agents and direct sellers (home-to-home sales) are covered as self-employed persons even if they are employees under common-law rules (as a result of legislation in 1982).

Employees of Nonprofit Organizations

Coverage for almost all employees of nonprofit organizations of a charitable, educational, or religious nature, such as churches, private hospitals, and private schools and colleges, is on a mandatory basis, beginning in 1984. Before then, it was at the option of each employing unit.[13] The employees in service at the time of election of coverage

11. A minor exclusion from coverage is newspaper carriers under age 18; this was done because of the administrative problems involved and the great likelihood that the earnings credits would be of little value from a benefit standpoint. Another minor exclusion is the employment of children under age 18 in an unincorporated business. Until 1988, the spouse of such an employer was excluded; this was done originally to prevent abuse (at a time when auxiliary benefits were not provided and the qualifying period was short). Yet another exclusion is employment not in the course of the employer's trade or business.

12. These categories are: agent-drivers and commission drivers distributing meat or meat products, vegetables or vegetable products, fruit or fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services; full-time traveling or city salespersons; and homeworkers (who work in accordance with the employer's specifications on material furnished by the employer and return the finished product to the employer).

13. Certain categories, such as students employed by their colleges, student nurses, and persons paid less than $100 in a calendar year (before 1978, $50 in a calendar quarter), are not eligible to be covered.

had an individual choice of whether to be covered. Once coverage was established, however, it was compulsory for new employees.

The original voluntary-coverage basis was adopted because of the traditional tax-exempt status of this type of organization. The requirement for compulsory coverage of new entrants and the stringent limitations on canceling the agreements prevented antiselection against the program.[14] In 1981, about 79 percent of those eligible for coverage by election were actually covered.

Legislation in 1984 permits religious organizations who oppose paying OASDI-HI taxes on the basis of religious principles (and which did not have a waiver-of-exemption agreement in effect at the end of 1980) to elect irrevocably not to be covered. Under such circumstances, the employees will be considered as being self-employed persons with regard to their wages. In these cases, coverage does apply to the individual employee if earnings in the year are at least $100 (rather than the usual $400 floor for self-employed persons) and, further, no expense-deductions from pay are considered. Still further, some such employees can opt out individually, under the circumstances described in footnote 10.

Employees of State and Local Governments

Employees of state and local governments under a retirement system can be covered under OASDI at the option of the state and of the employing unit. In addition, a majority of the employees therein must vote in favor of coverage. However, police officers under an existing retirement system cannot be covered under any circumstances, except in specified states.[15] In addition, there are a number of special provisions for designated states that facilitate coverage extension to employees under existing retirement systems by making subdivision thereof, with those electing to remain under the previously existing retirement system doing so and with the remainder (and all future employees as well) coming under OASDI and also having the protection of a new supplementary retirement sys-

14. The agreement could be canceled by the organization after it had been in effect for at least 10 years (with advance notice of 2 years, which could be withdrawn in the 2-year period). The covered employees were not legally entitled to any voice in this matter. Relatively few such terminations had occurred, but there was some tendency in this direction in the early 1980s.

15. These states are Alabama, California, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Maine, Maryland, Mississippi, Montana, New York, North Carolina, North Dakota, Oregon, South Carolina, South Dakota, Tennessee, Texas, Vermont, Virginia, and Washington (and also Puerto Rico).

tem.[16] Coverage cannot be provided for certain small categories, such as persons hired temporarily on an emergency basis because of a natural disaster (such as a flood) or for relief of unemployment and certain services performed by penal inmates, patients in hospitals and other institutions, student nurses, and by election workers who are paid less than $100 in a calendar year.

Employees of state and local governments (other than students employed by their college or university, who can be covered at the option of the employer) who are not actually under a retirement system are compulsorily covered under OASDI, beginning July 2, 1991. Formerly, they could have been covered at the option of the employer. The Internal Revenue Service has issued regulations to prevent pseudo-retirement plans (with severe vesting requirements and low benefits, with resultant very low cost) being established so as to avoid OASDI coverage. For example, in order to meet the requirement of being considered as a "retirement system," a defined-contribution plan must have a total contribution rate of at least 7.5 percent, while a defined-benefit plan with the benefit based on the average salary in the last three years must have a benefit factor of at least 1.5 percent per year of service.

The voluntary-coverage basis was adopted originally because of constitutional necessity. It was believed that the federal government is not allowed to tax state and local governments, although it can tax the employees (see the later discussion of how employees of international organizations and foreign governments are covered). Currently, the view is that such taxation is constitutionally possible, and this has been done for the Hospital Insurance portion of the tax for all new hires after March 1986 (and, more recently, for those not under a retirement system). The many complex provisions and alternatives for this coverage result from congressional courtesy. If one state wishes special treatment that is not disadvantageous to other states, it is readily granted. The requirement for compulsory coverage of new entrants and, beginning in 1983, the prohibition against canceling the agreements tend to prevent antiselection against the program. Before 1983, the agreements could be canceled, under stringent limitations.[17]

16. These states are Alaska, California, Connecticut, Florida, Georgia, Hawaii, Illinois, Massachusetts, Minnesota, Nevada, New Jersey, New Mexico, New York, North Dakota, Pennsylvania, Rhode Island, Tennessee, Texas, Vermont, Washington, and Wisconsin.

17. The agreement could be canceled by the government entity after it had been in effect at least seven years (with advance notice of two years, which could be withdrawn in the two-year period). Even though the covered employees may have had the right to

Currently, about 71 percent of all state and local employees are covered. This proportion is 73 percent of all employees who were eligible for such elective coverage. About 70 percent of this covered group also had coverage under a state or local retirement system.

Employees of Federal Government

Prior to 1984, virtually all federal civilian employees not under the Civil Service Retirement system or some other government-employee retirement system established by law—mostly temporary employees[18]—and all members of the uniformed services were covered on a regular contributory basis. Beginning in 1984, coverage is applicable to all new civilian employees of the federal government (including persons who had previously been federal employees and who had a break in service of at least 365 days). Coverage was also made applicable to certain persons in service at the end of 1983—the President, the Vice President, members of Congress, legislative employees who were not under CSR on December 31, 1983, federal judges, and high-level political appointees.[19] Members of the military are covered in

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vote on the initiation of the coverage, they did not have the right to vote about its withdrawal. Under the pre-1983 law, once an entity had withdrawn it could not again elect coverage. The 1983 Act permits any entities which withdrew in the past to reenter. In the late 1970s and early 1980s, a number of government entities, mostly small, terminated coverage. In the late 1970s, New York and Alaska served notice to terminate coverage but rescinded it before it became effective. However, Alaska later submitted another termination notice, and it took effect at the end of 1979. The general experience as to such terminations is discussed in Appendix 3-1.

18. The minor exceptions to coverage of those not under a government-employee retirement system included such small categories as temporary employees hired on an emergency basis because of a natural disaster, such as a flood, and certain services performed by penal inmates, patients in hospitals and other institutions, persons employed for relief of unemployment, and student nurses; these categories continue to be excluded. OASDI coverage on a coordinated basis is provided for two small retirement systems for federal employees (Tennessee Valley Authority and Board of Governors of the Federal Reserve Board) and for certain quasi-federal employees, such as those in military post exchanges, who also have supplementary pension plans. The President has a noncontributory pension under a special law. The Vice President, members of Congress, and congressional employees can elect to be covered under Civil Service Retirement (CSR), but they were not, in either event, covered under OASDI with respect to their government employment before 1984. It is significant to note, however, that many members of Congress did have current OASDI coverage as a result of their income from speeches, articles, and the like being compulsorily covered as self-employment income. Also, President Carter was similarly covered under OASDI (as shown by the income tax returns that he made public) as a result of the earnings from his peanut industry, which were considered self-employment income, and so too was President Reagan, but on the basis of his previous work experience as an actor.

19. These individuals (other than the legislative employees) had three options as to their coverage (if any) under the Civil Service Retirement system. First, they could drop out of CSR and receive a refund of their employee contributions and pay only the

this manner only on their cash base pay (and have noncontributory wage credits in addition, to recognize other remuneration—as discussed later).

This significant exclusion of most federal civilian government employees before 1984 (including, ironically, those of the Social Security Administration) from OASDI coverage resulted from the pressure of government-employee unions. The unions apparently preferred to have a separate, noncoordinated pension plan. This would give the unions more influence over the nature and development of their pension plan. It also permitted the development of dual benefit protection by concurrent or subsequent OASDI employment, which may be very advantageous financially to the individuals involved, because they will receive relatively high benefits in relation to the taxes they pay (so-called windfalls or double-dipping).[20] By the same token, this antiselection is costly to OASDI. The 1983 Act contained a provision to reduce such effect.

On the other hand, short-service federal employees were at a disadvantage by not receiving any benefits under CSR (other than a refund of their own contributions) and having a blank period in their OASDI earnings record. The unions, which opposed coordination of the two programs, appeared not to be so much concerned with this category as with career workers. It is noteworthy that the government requires private employers with pension plans to coordinate them with OASDI (rather than permit contracting out or exemption for those with suitable plans), but did not do so itself! This anomaly was, of course, rectified by the 1983 Act.

At the same time that coverage has been extended to federal civilian employees hired after 1983, the Civil Service Retirement System that was (and still is) applicable to those hired before 1984—a defined-benefit plan—was replaced by the Federal Employees' Retirement System. The new plan was enacted in 1986, but it was retroactive to January 1, 1984.

FERS consists of a defined-benefit plan (at a much lower level than

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6.7 percent OASDI-HI rate. Second, they could stay fully under CSR and contribute 7 percent to CSR and 6.7 percent to OASDI-HI (versus the 7 percent for CSR and the 1.3 percent for HI in 1983). Third, they could be in the yet-to-be-developed modified CSR system for new hires after 1983 and contribute 1.3 percent to CSR and 6.7 percent to OASDI-HI. It should be noted that CSR contributions apply to all earnings, whereas OASDI-HI taxes apply only to earnings up to the earnings base.

20. For example, a career federal worker who retired at age 57 in 1970 and then, for the first time, entered employment covered by OASDI and had maximum covered earnings in 1970–77 had a primary benefit on attaining age 65 at the beginning of 1978 that was only 30 percent lower than if he or she had been in covered employment at maximum earnings for the 41 years since the system began.

CSR, but with virtually as low retirement ages) and a voluntary thrift (or savings) plan. Under the latter, the federal government, as employer, contributes 1 percent of pay regardless of whether the employee contributes and then matches on a 1-for-1 basis any employee contributions up to 3 percent and on a 1-for-2 basis on the next 2 percent (so that for an employee contribution of 5 percent, the government contributes at the same rate).[21]

Employees of Foreign Governments and International Organizations

U.S. citizens employed in the United States by foreign governments and international organizations are compulsorily covered. Their earnings are considered self-employment income, despite the fact that they are really salaried employees. This was done because of the diplomatic immunity from taxes for the employers involved.

Farm Workers

Farm employment (other than that by a foreign worker admitted on a temporary basis) is covered if cash wages in a year from a particular employer amount to at least $150.[22] Currently, about 20 percent of the farm workers who are employed are not covered because of the earnings and other rules.

Domestic Workers

Domestic servants are covered in their employment for a particular employer if cash wages are $50 or more in a quarter from that employer.[23] When this limit was established in the 1950 Act, it represented about 10 days of employment by a day-worker, but currently it is only about 2 days. There is a considerable problem of coverage compliance in this area.

The dollar limits of coverage for both agricultural and domestic

21. For more details about both FERS and CSRS, see Richard G. Schreitmueller, "The Federal Employees' Retirement System Act of 1986," *Transactions*, Society of Actuaries, Vol. XL, 1988.

22. As an alternative, coverage is applicable, other than to certain hand-harvest workers, if the employer pays at least $2,500 in wages in a year. Agricultural work performed by foreign workers lawfully admitted on a temporary basis is not covered. Also not covered are certain family workers (see footnote 11).

23. Domestic workers on a farm operated for profit are considered to be farm workers. Also not covered are certain family workers (see footnote 11) and, in some cases, the parent of the employer (the exception being when the employee has no spouse [or has a spouse who is disabled] and has a child under age 18 [or disabled] in the home).

workers have been unchanged for four decades, despite the significant increases in general earnings levels. As a result, a gradual "hidden" extension of coverage has occurred over the years for these employment categories.

Tips

Tips to employees by the patrons of the employer are covered if they amount to at least $20 a month. Under such circumstances, the employee must report the tips to the employer, and the latter must then include them in the Social Security tax returns as employee earnings. Before 1988, only the employee tax was paid on them.[24] This unusual approach was taken because of the opposition of the employers involved, who protested that they had no control over the remuneration received as tips and therefore should not be taxed on it.[25] Currently, the matching employer tax must always be paid on reportable tips. The Internal Revenue Service has testified that about two thirds of reportable tips are not reported.

Employment Abroad

The preceding discussion of coverage conditions relates to employment in the United States (including American Samoa, Guam,[26] Northern Mariana Islands,[27] Puerto Rico, and the Virgin Islands) and on

24. If the employee does not report the tips to the employer and is later discovered to have done this, payment of the combined employer-employee tax is required. Beginning in 1978 and until 1988, the employer tax was only payable under the relatively rare circumstance where the actual cash wages paid for a month were *less* than what would be payable according to the federal minimum wage. Then the employer would pay the employer tax on such tips as make up this difference. If tips are not counted for coverage purposes, neither will they be used for purposes of the earnings test (not even as being noncovered earnings!). When the employer imposes a flat (or other) service charge on its customers and distributes the proceeds to its employees, these are considered wages, not tips. Food or beverage establishments with at least 10 employees must allocate to employees as tips the excess of 8 percent of gross receipts over tips reported; the Internal Revenue Service can, upon request and proof that tipping is minimal, reduce the 8 percent to as little as 2 percent.

25. From an actuarial standpoint, it was argued, the system suffers no loss because the wage credits arising from tips are in addition to the normal (but low) wages paid by the employer and so produce additional benefits in the upper, less heavily weighted, portion of the benefit formula. This, however, was not really a valid argument—the system should, in logic, receive the same amount of taxes per dollar of earnings credits, regardless of the type of employment.

26. Work in Guam by a resident of the Republic of the Philippines under contract to work on a temporary basis as a nonimmigrant alien is not covered.

27. Work in the Northern Mariana Islands was first covered in 1987 (at the same time, employment covered by the Trust Territory Social Security system during July 1968 through December 1986 was made creditable for OASDI-HI benefit purposes.)

American vessels and airplanes. In addition, U.S. citizens and alien residents working for American employers abroad are covered; also, such persons working for foreign subsidiaries of an American employer can be covered if such employer so elects and guarantees payment of the taxes.[28] A self-employed person working abroad is covered if he or she is a resident of the United States.[29]

International Social Security Agreements

The 1977 Act authorized the President to enter into bilateral totalization agreements with other nations for limited coordination of OASDI (but not Medicare) with their corresponding programs.[30] The earnings records of persons who work in the countries with which agreements have been made will be combined for purposes of determining benefit eligibility (there must be at least six quarters of coverage under OASDI) and benefit amounts, if advantageous to the individual. Currently, in such agreements, the combination of earnings records is done only for eligibility purposes; when eligibility is obtained only because of such totalization, the benefit amount is computed in a unique manner (see Appendix 2-14).

Another feature of these agreements is that dual simultaneous coverage (and thus payment of contributions) will be eliminated. In other words, a citizen of the United States who is employed in another country by a U.S. employer (and whose coverage under OASDI thus continues) would not be covered under the social insurance system of a nation with which an agreement had been made (as would otherwise have been the case). The same situation, of course, prevails for for-

28. Beginning in 1984, alien residents of the United States who are employed abroad are covered in the same manner as citizens. The American employer must own at least a 10-percent interest in the foreign business entity (in the voting stock, if a corporation; in the profits, for other entities). The 1983 Act made it possible for unincorporated business entities to qualify as either parent company or subsidiary. All eligible persons must be covered at the time that the agreement becomes effective, as must all future hires. Formerly, the agreement could be canceled unilaterally by the American employer, but it must have been in effect for at least 10 years (with a 2-year advance notice of termination being required). Few such terminations occurred (other than by cessation of business activity), but now they are prohibited.

29. Self-employed persons are subject to the OASDI-HI taxes on their worldwide self-employment income even if it is subject to the foreign-earned-income exemption for income-tax purposes. (Before the 1983 Act, there were several complex exemptions insofar as OASDI-HI taxes were concerned.) This applies to both U.S. citizens and alien residents.

30. Congress will review each agreement. Prior to a contrary ruling by the Supreme Court in 1983, either the House or the Senate could disapprove an agreement before it entered into force. The statutory review period was reduced by the 1983 Act to 60 session days of either house. Now, legislation would apparently be necessary to prevent an agreement from becoming effective.

eigners working in the United States for an employer of their own country.

Agreements with Austria, Belgium, Canada, Finland, France, Germany, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom are in effect. Agreements with Ireland and Luxembourg are in various stages of negotiation.

Military Service Wage Credits

"Gratuitous" wage credits of $160 a month were provided for military service after September 15, 1940.[31] These terminated at the end of 1956, and regular contributory coverage began. Similar wage credits—in general at the rate of $1,200 per year of military service—are given for service after 1956 as an allowance for remuneration furnished in kind.[32] Until the 1983 Act, the OASDI system and the Hospital Insurance program were reimbursed by the General Fund of the Treasury for the cost of any additional benefits paid as a result of these wage credits (not for the taxes that would have been applicable to such wage credits); such reimbursement was made at the time (approximately) the benefits were paid insofar as the post-1956 ones were concerned and by equal annual installments (subject to periodic reevaluation and recomputation) during 1966 through 2015 for the pre-1957 ones.

The 1983 Act provided that a lump sum should be transferred from the General Fund to the trust funds representing (1) the present value of the additional benefits estimated to be payable as a result of the pre-1957 wage credits and (2) the accumulated combined employer-employee taxes on the post-1956 wage credits for the period 1957–83 (in each case, with appropriate adjustment for past payments and for interest). The total appropriated was $25.8 billion (in May 1983 and June 1984)—for OASDI, $6.5 billion for the pre-1957

31. Such wage credits were also given for service during September 16, 1940, through July 24, 1947, by American citizens who served in the armed forces of allied countries (and entered such service before December 9, 1940, and met certain other conditions as to prior residence and type of discharge). In any event, these wage credits are given only if the individual was discharged from active service under conditions other than dishonorable (or died in service) after service of at least 90 days (or prior disability or death). However, such wage credits are disregarded if a monthly benefit is payable by another federal agency (other than the Veterans Administration) based on the same period of service—with the exception that persons in active service after 1956 may use such wage credits for 1951–56 regardless. In essence, the foregoing exclusion prevents retirees under the military retirement system from counting their military service before 1951 for OASDI purposes.

32. For 1957–77, the basis was $300 for each calendar quarter during which there was some military service. For 1978 and after, the basis is $100 for each full $300 of cash military wages paid in a year, up to a maximum of $1,200 of such credits.

credits and $15.6 billion for the post-1956 credits; for HI, $1.9 billion for the pre-1957 credits and $1.7 billion for the post-1956 credits. In the future, the General Fund will make payments to the trust funds equal to the combined employer-employee taxes on the $1,200 wage credits (other than those which, along with the actual cash military pay, would bring the total over the maximum taxable earnings base), on a current basis.

Somewhat similar gratuitous wage credits are given to U.S. citizens of Japanese ancestry who were interned during World War II. The amount of such wage credits is based on the minimum wage then applicable under general law or, if higher, on the actual past wage of the individual.[33] The cost of the additional benefits arising from these wage credits is reimbursed to the trust funds by the General Fund of the Treasury. Reimbursement was made in a lump sum of $2.7 million for OASDI in 1977 (plus $2.0 million for HI).

It is important to note that the gratuitous wage credits granted for periods before 1951 have relatively little cost effect, because the vast majority of benefit computations are based on earnings after 1950.

Definition of Earnings

In general, OASDI taxes are payable on all remuneration (up to the maximum taxable earnings base) whether payable in cash or in kind, and similarly benefit credit is given on such basis. Wages of employees for such purposes are determined on the basis of when paid (or constructively paid) rather than when actually earned, and include vacation pay, bonuses, Christmas gifts, dismissal pay, and other such items. Self-employment income, however, is determined on the same basis that the individual uses for income-tax purposes, usually on a cash basis (i.e., when actually received), although an accrual basis can alternatively be used (i.e., when actually earned).

Wages earned before the death of the employee but not paid prior thereto are covered if paid in the year of death, but not if paid afterward. For example, in the case of an employee life insurance agent, all the continuing renewal commissions paid in the year of death are covered, but not those paid to the heirs thereafter.

Certain important exceptions occur. As mentioned earlier, only the cash wages are used for farm and domestic workers (for administrative simplicity for the employer). Fringe-benefit costs payable by the

33. The credit for each week involved is the larger of (1) 40 times the highest hourly rate of pay that the individual had had in covered employment or (2) $12 for weeks in 1941–44 and $16 for weeks in 1945–46.

employer are generally excluded from being taxable wages. These special exceptions are considered in more detail in Appendix 2-13.

Benefit Provisions of the OASDI System

The term *benefit provisions* includes such elements as (1) eligibility conditions that determine the extent of coverage required for benefits, or "insured status"; (2) beneficiary categories, which identify the types of persons to whom payments are made; (3) benefit amounts, including how payments are calculated and the offsets to benefits that are made in certain cases where benefits are also payable under Workers' Compensation programs (or other governmental disability programs) or under retirement systems for employees of federal, state, and local governments; (4) an earnings test to establish the level of earnings permitted if benefit payments are to be made; and (5) payment of benefits abroad.

Whenever the general benefit level is considered, it is important to keep in mind that, for most persons, OASDI benefits are not subject to federal or state income taxes (as will be discussed in more detail in a subsequent section). It is also important to keep in mind that if OASDI benefits are insufficient, along with other income and assets, to provide adequate financial support for an individual, public assistance payments are available under the Supplemental Security Income program. At present, the benefit conditions apply equally to females and males, although this was not always the case. (See Appendix 3-2 for a detailed discussion of this subject.)

Insured-Status Conditions

There are three kinds of insured status: "fully," "currently," and "disability." The first yields eligibility for all types of old-age and survivor benefits. The second gives eligibility for certain survivor benefits. The third is part of the requirement for the "disability freeze" and for monthly disability benefits, except for blind persons.

Quarters of Coverage

Insured status is defined in terms of quarters of coverage (QC).[34] In 1978, 1 QC was given for each full $250 of earnings (up to a maxi-

34. Before 1978, the requirements for a QC were quite complicated. The general rule was that a QC was given when $50 of wages was paid in a calendar quarter or for each full $100 of self-employment income earned in a year. With certain minor ex-

mum of 4 QC for earnings of $1,000 or more).[35] In years after 1978, the $250 unit is adjusted upward if average annual wages in the nation rise (in both covered and noncovered employment, as determined from income tax forms W-2 and 1040). For example, for 1979, the $250 was multiplied by the ratio of such average wage for 1977 to that for 1976 (see Table 2.18) and rounded to the nearest $10, which yielded $260. For subsequent years, the $250 is multiplied by the ratio of such average wage for the second preceding year to that for 1976, and rounded to the nearest $10. (See page 179 for a description of this wage-indexing series.) The unit requirement for a QC is not allowed to decrease from one year to the next if the wage level declines. The required earnings for obtaining 1 QC in various years are shown in the table below.

Year	*Requirements*	*Year*	*Requirements*
1978	$250	1986	$440
1979	260	1987	460
1980	290	1988	470
1981	310	1989	500
1982	340	1990	520
1983	370	1991	540
1984	390	1992	570
1985	410	1993	590

ceptions, such as death in the particular year, covered self-employed individuals were always credited with 4 QC each year, because they were not covered unless they had $400 of earnings in the year. This was also the case for persons with the maximum amount of taxable wages in a year. Special rules similar to those for self-employed individuals applied to farm workers, whose coverage depends on an annual, rather than a quarterly, earnings amount. Specifically, they received credit for 1 QC for each full $100 of farm wages earned in a year up to a maximum of 4 QC for a calendar year. Naturally, persons with several types of employment received credit for no more than 4 QC in a particular year. As was the case in connection with the coverage conditions based on dollar amounts, there was a gradual "hidden" liberalization of the requirements for QC, because under recent earnings conditions it was much easier to earn $50 a quarter than when this limit was set in the 1939 Act. The annual basis for allocating QC for the self-employed and for farm workers was necessary because the coverage provisions for these categories were on an annual reporting requirement. A special simplified method of determining QC is available for 1937–50, because for this period only total earnings are available on the computerized records. In general, for such earnings, one QC is given for each $400 of earnings (subject to a maximum of 56 QC for the 14-year period).

35. One restriction to this general rule is that QCs cannot be credited until the quarter has begun, and the individual is then living (e.g., a person who dies in September can be credited with no more than 3 QC). Another restriction is that QCs cannot be credited for quarters that are partially or entirely included in a period of disability (except the initial quarter and ending quarter of such period) despite credited earnings then (such as from trial work of a rehabilitative nature or from self-employment income from a business managed by another person).

Fully Insured Status

This is achieved if the individual's QC equals at least the number of years elapsing after 1950 or the year of attainment of age 21, if later, and before the year of attainment of age 62.[36] A person who becomes 65 in 1991, for example, must have at least 37 QC to qualify for old-age benefits (unless having had a prior "disability freeze," discussed hereafter). Persons who become 62 after 1990 (i.e., attain age 21 in 1950 or after) have a requirement of 40 QC to be fully insured at age 62.[37] In death and disability cases, the measuring period ends with the year before the year of death or disability. There is a minimum requirement of 6 QC. The required QC do not necessarily have to be obtained in the measuring period, but they can be acquired as well before 1951, before age 22, or in or after the year of becoming 62.

Currently Insured States

This is achieved by having 6 QC in the 13-quarter period ending with the quarter of death, disability, or attainment of age 62 (or actual retirement, if later). As seen from the subsequent discussion, currently insured status does not create entitlement to many types of benefits, or, in fact, to any that fully insured status does not also yield entitlement. Because the latter is so easy to acquire, there are only a small number of benefits that are actually payable only because currently insured status was present.[38]

36. Men who attained age 62 before 1975 have somewhat less liberal conditions for obtaining fully insured status. Before the 1972 Act, an age-65 computation point was applicable to men but not to women. Thus, men attaining age 62 in 1972 had to have 24 QC to be fully insured, rather than the 21 QC which would be required under the new computation method. This 24-quarter requirement was made applicable for men attaining age 62 in 1973–75. As a result, for attainments of age 62 in 1975, the requirement is the same for both sexes, and remains so thereafter as it increases 1 quarter for each elapsing year, to the maximum of 40 QC for those attaining age 62 after 1990. This discrimination against men attaining age 62 before 1975 is not very serious because most persons have far more QC than needed to obtain fully insured status. The parallel discrimination with regard to computation of benefit amounts, discussed later, is much more significant. A special, more lenient rule is applicable to individuals who, on December 31, 1983, were employees of nonprofit organizations which were not covered then but which were brought into coverage in 1984; such persons need only 20 QC (acquired from any employment after 1983) if age 55 or 56 on January 1, 1984, 16 QC if age 57, 12 QC if age 58, 8 QC if age 59, or 6 QC if age 60 or over.

37. This requirement is specified in the law as the maximum, but this is now really redundant, because such a result occurs under the regular definition. It had been applicable previously when the computation point was age 65.

38. Some years ago, currently insured status was *required* for some types of benefits (dependents and survivor benefits for married female workers and disability benefits). At present, currently insured status, when not fully insured, can give valuable protection under Medicare for both the insured worker and family members in the event of end-stage renal disease (see Chapter 6).

Disability Insured Status

This is achieved by having 20 QC in the 40-quarter period ending with the quarter of disablement. Persons under age 31, who may not have had much opportunity for coverage, have alternative, generally more liberal, rules.[39]

Years that are partially or entirely contained in a qualifying period of disability for individuals who have both fully insured status and disability insured status do not "count against" the individual in measuring the elapsed period for any of the insured-status categories. This results from the "disability freeze" provision, which is described later. For example, a person who qualifies for the disability freeze remains fully insured for life if recovery does not occur. In case of recovery before age 62, the number of QC otherwise required for fully insured status subsequently is then reduced by the number of calendar years of which any part was in a period of disability.

Beneficiary Categories

Old-Age (Retirement) Benefits

An individual is eligible for a monthly old-age insurance benefit at age 62 or later if fully insured (see Appendix 2-4 for more details as to how age and initial month are determined and note therefrom that relatively few persons can actually receive benefits for the month they attain age 62, but rather must wait one month before benefits begin to accrue). The amount of this benefit is 100 percent of the primary insurance amount (PIA, defined later), except in the case of a worker

39. Those aged 24–31 (last birthday) at the time of disability must have QC *in* at least half of the quarters after the quarter of attaining age 21 up to and including the quarter of disablement (if such number of elapsed quarters is an odd number, it is reduced by 1 before determining half of it). Those under age 24 must have at least 6 QC *in* the 12-quarter period ending with the quarter of disablement. Note that anybody satisfying these rules will also satisfy the requirements for fully insured status. Also, note that these two rules for persons under age 31 have a smooth junction at age 24 (i.e., the requirement at that age is the same when determined by either one). Further, in a relatively few cases, a young disabled worker can meet the regular "20 out of 40" requirement and thus qualify, even though not being able to meet the special requirement. Further, a person who had a period of disability which began before age 31, and who recovered from the disability but became disabled again after age 30 has the determination of disability insured status based on the situation occurring as if such period of disability did not exist as it affects his or her attained age. For example, a person disabled on the date of attaining age 27 who recovers five years later, and who then becomes disabled again two years after the recovery, would have disability insured status measured as though first disabled at age 29 (with the first period of disability thus being "blanked out" for most purposes).

TABLE 2.2. Normal Retirement Ages for Various Years of Birth

*Year of Birth**	*NRA for Old-Age and Spouse's Benefits*	*Year of Birth*	*NRA for Widow's and Widower's Benefits*
Before 1938	65	Before 1940	65
1938	65 and 2 months	1940	65 and 2 months
1939	65 and 4 months	1941	65 and 4 months
1940	65 and 6 months	1942	65 and 6 months
1941	65 and 8 months	1943	65 and 8 months
1942	65 and 10 months	1944	65 and 10 months
1943–54	66	1945–56	66
1955	66 and 2 months	1957	66 and 2 months
1956	66 and 4 months	1958	66 and 4 months
1957	66 and 6 months	1959	66 and 6 months
1958	66 and 8 months	1960	66 and 8 months
1959	66 and 10 months	1961	66 and 10 months
1960 and after	67	1962 and after	67

*A person born January 1 is considered as born in the previous year.

first claiming benefits before the Normal Retirement Age and except for deferment of retirement beyond the NRA.

The NRA for retired workers (the first age when unreduced benefits are available) is based on the year of attainment of age 62. Such age is 65 for all persons who reach age 62 before 2000. It increases by two months for each later year-of-birth cohort, reaching age 66 for those who attain age 62 in 2005 (i.e., reach age 66 in 2009). The NRA remains at age 66 for those who attain such age in 2010–20. Then, for later year-of-birth cohorts, it increases by two months for each cohort, reaching age 67 for those who attain age 62 in 2022 and after (i.e., attain age 67 in 2027 and after). Table 2.2 gives more details on this matter.

It could be argued that the concept of NRA is subject to various interpretations. For example, persons currently reaching age 65, who can receive a benefit of 100 percent of the PIA then, could also have had a benefit of 80 percent of the PIA at age 62 or one of 115 percent of the PIA at age 70. So, it could be said that a full benefit could be had at age 62 and increased benefits at age 65 (125 percent of the age-62 benefit) and at age 70 (143.75 percent of the age-62 benefit). Or, it could be said that the full benefit is payable at age 70, and reduced benefits are available at age 62 (69.57 percent of the age-70 benefit) and at age 65 (86.96 percent of the age-70 benefit). Nonetheless, it seems reasonable and useful to use the concept of NRA described in the previous paragraph.

In the case of retirement before the NRA, the benefit is reduced by $\frac{5}{9}$ percent for each of the first 36 months and by $\frac{5}{12}$ percent for ad-

ditional months below the NRA at the time of retirement.[40] Thus, a person currently retiring at exactly age 62 receives a 20-percent lifetime reduction, and one so retiring in 2027 or after receives a 30-percent lifetime reduction, both of which closely approximate an "actuarial-equivalent" basis, so that no additional cost to the system arises on account of early retirement. Although the measurement of actuarial equivalence in an inflationary period is fraught with difficulties, there is the offsetting element that the benefits are automatically adjusted for changes in the Consumer Price Index (CPI), so that what is really involved is only the determination of the appropriate "real" interest rate. In the case of retirement after the NRA, the benefit is the PIA increased by delayed-retirement credits (discussed on page 98).

When a general benefit increase is legislated or occurs under the automatic-adjustment provisions (described subsequently), the amount of the increase for those who retired before age 65 with reduced benefits is merely the applicable percentage of the reduced benefit amount previously payable. Before the 1977 Act, a more generous procedure was followed.[41]

A different method of computing the PIA is applicable for certain persons who receive pensions based in whole or in part on earnings from noncovered employment, in the past or in the future (employ-

40. If an individual retires before the NRA but does not remain retired and instead returns to substantial employment, thereby losing some benefits under the earnings test (to be described later), a "roundup" or upward adjustment is made in the benefit when the NRA is attained. Specifically, the reduction factors are then applied only to the number of months before the NRA in which the full benefit was received, without reduction under the earnings test. Thus, a person first claiming benefits at age 62 when the NRA is 65, but who returns to substantial employment between ages 62 and 65 and does not receive benefits for 18 of those months, would have a 10-percent lifetime reduction after age 65; however, the 20 percent would have applied for all months before age 65.

The resulting reduction factors (i.e., the amount for early retirement as a percentage of the unreduced amount available at the NRA) are thus determined geometrically from two straight lines. These lines closely approximate the slightly upward concave curve which precisely portrays the factors computed by individual months of age below the NRA. When, before the 1983 Act, only a three-year difference existed between the NRA and age 62, the refinement of using two straight lines (instead of only one) did not seem necessary.

41. Then, the amount of the increase was based on the full PIA, reduced on the basis of the then-attained age. This is the actuarially equitable approach if the benefit increase is a "real" one (i.e., in excess of what would be justified by price rises), even though somewhat burdensome from an administrative standpoint, but is not correct when the benefit increase is solely due to price rises. As an example of the former procedure, consider an individual with a PIA of $200 per month who retired at age 62, and thus received a benefit of $160. If 1½ years later a 5-percent benefit increase became effective, the PIA was increased by $10, and the actual benefit was then raised by $9 (i.e., a 10-percent reduction factor was applied). Then, if three or more years later, a 10-percent benefit increase occurred, the actual benefit rose by $21 (i.e., 10 percent of the sum of $200 and $10).

ment covered by the Railroad Retirement Act is not considered, for these purposes, as noncovered employment). The specific method of computation is described later. Exempt from this provision are the following categories: (1) persons who attain age 62 before 1986; (2) disabled-worker beneficiaries who became disabled before 1986 (and were entitled to such benefits in at least one month in the year before attaining age 62); (3) persons who have at least 30 years of coverage (as defined later); (4) persons who were employed by the federal government on January 1, 1984, and were then brought into coverage by the 1983 Act (members of Congress, the President, the Vice President, judges, and high-ranking political appointees); and (5) persons who were employed on January 1, 1984, by a nonprofit organization which was not covered on December 31, 1983, and who had not been covered while working for this organization at any time in the past.

Payments are made only after an individual files a claim and is, in effect, substantially retired (retirement test provisions are described later). Retroactive payments for as long as 12 months before filing the claim may be made with respect to monthly disability benefits for workers (including auxiliary benefits) and for widow(er)s and 6 months for all other benefits, except that such filing cannot result in reduced benefits over what would be payable for the month of filing.[42]

42. The 1977 Act prohibited (other than for an exception described in the last sentence) retroactivity when *permanently reduced* benefits would result, with retroactivity of 12 months allowed for all types of benefits (changed in 1980 to 6 months for all except benefits for disabled workers and their dependents and for disabled widows and widowers). Previously, a person retiring at, say, age 65¼ could receive (if the earnings test permitted) a lump sum of 12 months' benefits, but would then have permanently reduced benefits (for the 9 months before age 65). Now, only three months' retroactive benefits would be payable. Of course, the individual could obtain the same results as under previous law by filing claim at age 64¼. This change was made to prevent individuals from filing retroactively and thus obtaining a lump-sum payment of several months' benefits despite having had substantial earnings (e.g., retiring at age 65 in April 1979 after having had $4,500 of wages, and then being eligible for benefits for January through March). Under such circumstances, reduced benefits would be payable for life. Such action would be poor retirement-income planning and could lead to pressures for benefit increases over the long run because of the lower level of "permanent" benefit income. This provision is also applicable to spouse's benefits claimed at ages 62–64 and to widow's and widower's benefits claimed at ages 60–64, except that the 1983 Amendments permit one-month retroactivity for the latter category (so as to recognize that, upon the death of the insured worker, the surviving spouse will generally not immediately file a claim, despite an earnings loss actually having occurred). Legislation in 1990 prohibited retroactivity to reduced benefits before the NRA even though the reduction in the benefits could be "worked off" by the retirement earnings test (see footnote 179). This legislation also prohibited the previously permitted retroactivity when reduced primary benefits are involved, but they would have made available unreduced auxiliary benefits retroactively (which was previously possible).

Disability Benefits

An individual is eligible for monthly disability insurance benefits in the amount of the PIA if he or she (1) is totally disabled and thus cannot engage in any substantial gainful activity, has been so disabled for at least five months, and can be expected to continue to be so disabled for at least 12 months in total, or until prior death, and (2) has both fully and disability insured status.[43] The PIA is computed, in essence, as though the individual had attained age 62 at the time of disablement. Persons who are blind need to satisfy only the fully insured status requirement. If the individual was disabled as a result of a work-connected accident or disease and is receiving workers' compensation benefits or is receiving certain other types of government disability benefits, the OASDI benefit may be reduced, as discussed later in connection with benefit amounts. An individual who elected early-retirement benefits and later (before NRA) became disabled can shift over to disability benefits.[44]

Total disability is defined as the "inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment." Blindness, statutorily defined as "central visual acuity of 20/200 or less in the better eye with the use of correcting lens" or limitation of vision such that "the widest diameter of the visual field subtends an angle no greater than 20 degrees," qualifies as a total disability.

43. Actually, the fully insured status must exist on the first day of the quarter of disablement—i.e., the actual QC that the individual has must have been acquired by earnings on or before such day. For example, consider an individual who, at the beginning of a year (after the requirement for fully insured status has increased by 1 QC), was short by 2 QC of being fully insured and who then earned sufficient wages in January to produce 2 QC. If such person became disabled in February, the date of disablement would be considered to be April 1, because not until then would fully insured status be obtained.

44. Under these circumstances, which could be caused by the gradual worsening of a condition that existed when early-retirement benefits were first claimed or by a sudden cause, the disability benefit is permanently reduced for the months for which old-age benefits had been received (at the applicable rates of 5/9 or 5/12 percent for each such month). A person becoming disabled between age 62 and the NRA can receive reduced old-age benefits during the waiting period for disability benefits and then shift over to disability benefits at a higher rate (even though somewhat reduced). For example, currently, if a person who attains age 62 on the first day of a particular month is disabled in that month, a reduced old-age benefit (80 percent of the PIA) can be obtained immediately. Then, for the sixth following month and thereafter, disability benefits can be received at a rate of 96⅔ percent of the PIA (a reduction of 3⅓ percent—5/9 percent for each of the six months of the receipt of old-age benefits). Disabled persons will often follow this procedure, both to have some benefit income during the waiting period and because of the possible delay in adjudication of the disability claim (or even its possible denial if the disability is not found to meet the required conditions).

The determination of disability is, of course, much more difficult than the determination of retirement or death. There are many cases where qualifying disability is quite evidently present, but there is a wide "gray area" where its existence is questionable. Serious medical impairments (such as very serious heart conditions, terminal cancer, or loss of the use of limbs) constitute about 75–80 percent of all disability claims awarded.

The remainder of claims awarded involve a combination of medical impairment and vocational factors such as education, work experience, and age. For example, if a worker has a disability so severe that he or she can do only sedentary work, then disability is presumed in the case where the person is aged 55 or over, has less than a high-school education, and has worked in only unskilled jobs, but is not so presumed for a similar young worker. Clearly, borderline cases arise frequently and are difficult to adjudicate in an equitable manner!

In determining the ability to engage in any substantial gainful activity, the law specifies that the worker's age, education, and work experience must be considered. It is further stated that it is not relevant whether the work that could be done by an individual does not exist in the immediate area where he or she lives (as long as it does exist in the national economy), or whether a specific job vacancy exists, or whether he or she would be hired if work were applied for. (At times, the courts have failed to heed these provisos.)

The waiting period of five consecutive months of disability is not a presumptive period which, if satisfied, would "prove" the existence of a qualifying permanent disability.[45] If an individual recovers from disability and within five years becomes disabled a second time, this waiting period need not be satisfied again. Hereafter, when reference is made to the "year of becoming disabled," this means the year in which occurs the month when the disability began (rather than the month of the first benefit payment).

Initial determinations of disability are made by state agencies, generally the vocational rehabilitation unit. The Social Security Administration reviews many of these determinations and may reverse the finding of disability. As a result of legislation in 1980, it may also reverse a denial of the existence of disability.

The determination of continuance of disability is made by the state agencies. Individuals must, in general, undertake vocational rehabili-

45. The effective waiting period between the date of disablement and the date of the first benefit payment is 6½ months on the average, because the first payment is made at the end of the calendar month following 5 full months of disability, and then only if the individual is alive and disabled.

tation training. The costs of the rehabilitation services for disabled workers and other disabled beneficiaries may, under certain circumstances, be paid from the trust funds that pay their cash benefits; the Disability Insurance (DI) Trust Fund pays the cost of this service for disabled workers and disabled children of such beneficiaries, and the OASI Trust Fund pays for other disabled children (those of retired or deceased workers) and for disabled widows and widowers.

The Social Security Disability Amendments of 1980 provided, among other things, that the status of disabled beneficiaries be reviewed at least once every three years unless the disability had been found to be permanent. Such reviews had not been carried out routinely in the past. The Reagan administration enforced this procedure vigorously—many people believe much too vigorously and speedily. As a result, many beneficiaries who were terminated were later reinstated on appeal. A particular problem involved those with mental impairments.

Due to the unfavorable criticism and publicity (and after the turmoil resulting when some states refused to make disability reviews, and after SSA subsequently suspended the procedure), corrective legislation was enacted in late 1984. Among the many changes made to alleviate the situation were (1) placing limitations on benefit termination (such as requiring that medical improvement occur since the last favorable decision and that the person be able to engage in substantial gainful activity), (2) issuing a moratorium on reviews of mental-impairment cases until criteria for evaluation are "realistically" revised to reflect the person's ability to work in a competitive market, (3) giving advance notice to the beneficiary that a review is to be made, so that additional evidence can be provided, and (4) continuing benefit payment during the beneficiary's appeal of a termination (subject to repayment if the appeal is denied).

There are limitations on payments for rehabilitation services. They are available only if rehabilitation has actually occurred (as demonstrated by nine months of substantial gainful activity), and this as a result of the services. (Before October 1981, the total payments for these services for a fiscal year could not exceed 1½ percent of the benefit payments to beneficiaries in the preceding year. In fiscal year 1990, the costs of the payments for these services which were paid out of the trust funds—actually, only from DI—represented only 0.1 percent of the cash benefit payments with respect to disabled beneficiaries.)

Benefits are paid during the first 9 months (not necessarily consecutive) of a trial work period, regardless of the amount of earnings, if the individual has not recovered from the disability. Beginning in

1992 (as a result of legislation in 1990), this requirement is liberalized by making it applicable only if the 9 months occur within a 60-month period. Then, the beneficiary's work abilities are evaluated to determine whether he or she can engage in substantial gainful activity.[46] If so, benefits are terminated after an additional 3 months (such 3 months' payment is also made for beneficiaries who recover from their disability). Also, in the 36 months thereafter, if the individual has not recovered from the disability, benefits are paid for any month in which there is not substantial gainful activity (and Medicare coverage, if applicable, also continues then). During the next 60 months, if the individual again applies for disability benefits and is approved, no 5-month waiting period is required.

With the foregoing exceptions, there is no permitted amount of earnings, as there is for retired workers and for auxiliary and survivor beneficiaries under the earnings test. Rather, a disability beneficiary might have small earnings and still continue to receive benefits so long as he or she is considered unable to engage in any substantial gainful activity.

The disability benefits automatically terminate at the NRA, and the beneficiary then goes on the old-age benefit roll.

Auxiliary Benefits

If the retired or disabled individual has a spouse at the NRA or over at the time of the initial benefit payment, an additional benefit of 50 percent of the worker's PIA is payable (such amount is *not* increased if the retired worker had earned delayed-retirement credits). Such spouse is eligible for HI benefits under Medicare, even though, in the case of disabled workers, the worker might not be—because of being on the benefit roll less than 24 months.[47] If the spouse is under the NRA, but at least age 62, reduced spouse benefits are available (the amount of the reduction is described at the end of this section); of course, if the spouse chooses to delay filing claim until the NRA, no reduction occurs then. A spouse, regardless of age, also receives

46. The amount of earnings that is indicative of substantial gainful activity is promulgated by the Secretary of HHS ($500 per month as of 1992) except that, by law, for the blind this amount is the same as the monthly exempt amount in the earnings test for persons at the NRA ($10,200 in 1992). Also, see footnote 122.

47. Spouse's benefits in the case of a spouse who does not have a benefit based on own earnings record is actually paid in the same check as the primary benefit *unless* the spouse requests a separate check. If a person is eligible for both a benefit based on own earnings and a residual spouse's benefit (because the former is smaller than the full spouse's benefit), a separate check is *always* paid to such individual combining both such benefits.

such additional 50-percent benefit (without reduction) if he or she has care of a child under age 16[48] or a child of any age who was disabled before age 22 (using same definition of disability applicable for insured workers; no five-month waiting period; and same conditions as to termination of benefits). This benefit is payable for each eligible child, including children aged 16–18, even if an eligible spouse is not present. Under certain circumstances, the spouse's benefit is reduced if such spouse has a pension based on employment under a federal, state, or local government-employee retirement system that is not coordinated with or supplementary to OASDI (as discussed later). Although it was not the case some years ago, since 1983 there has been completely equal treatment of men and women as to auxiliary and survivor benefits. (See Appendix 3-2 for a more detailed discussion.)

A person aged 18 who is in full-time attendance at elementary or secondary school is also eligible for child's benefits.[49] Such a child does not make a parent eligible for spouse's benefits. Under such circumstances, the theory is that the parent is capable of employment, just as when he or she is under age 62 and has no eligible child under age 16. Prior to legislation enacted in 1981, benefits were payable to all children aged 18–21 who were in full-time school attendance (it was for this reason that children disabled before age 22 are eligible for benefits). Children on the roll in August 1981 who were post-secondary students prior to May 1982 could receive benefits through April 1985, but not during the months of May to August (with the amounts being reduced by 25 percent during each school year beginning September 1982 and with no automatic CPI adjustments). Children coming on the roll in September 1981–July 1982 could receive post-secondary benefits through July 1982. Full school-attendance benefits, not payable by the OASDI program, similar to those formerly payable under OASDI are available through the Veterans Administration in the case of persons who died in military service before August 13, 1981, or who die as a result of a service-connected cause incurred before then.

48. This limiting age was 18 until changed by legislation in 1981 (which had a savings clause that maintained age 18 for spouses on the roll in August 1981, for months through August 1983). If the only child is aged 16–17 and is disabled, the spouse is eligible for benefits (in that case, determination of disability is made, even though the child's benefits are not considered to be disabled-child's benefits—which is important insofar as Medicare benefits are concerned, as discussed in Chapter 6).

49. Benefit eligibility continues until the end of the semester or quarter during which the student attains age 19, or if the school is on a "course" basis rather than by semester or quarter, until the end of the course (although for not more than two months).

The term *child* includes not only natural children but also stepchildren and adopted children, although there are certain restrictions to prevent abuse. When there are two or more eligible auxiliary beneficiaries, the full 50-percent benefit for each will not be paid because of the maximum family benefit provision (described later).

In certain instances, child's benefits are payable on the earnings record of a grandparent or great-grandparent. Such a child's parents must be dead or disabled, and the child must have been living with and supported by the grandparent or great-grandparent for at least a year. Considering these stringent conditions and the great likelihood that the child would receive benefits from one of his or her parents, relatively few such child's benefits are payable.

A spouse between age 62 and the NRA (which is determined in exactly the same manner as for retired workers) without an eligible child can elect to receive reduced benefits. These are based on the 50-percent benefit, but with a reduction factor of $^{25}/_{36}$ percent for each of the first 36 months below the NRA and of $^{5}/_{12}$ percent for each additional month below the NRA at the time for which the benefit is first payable. This reduction continues during the joint lifetime of the couple.[50] Thus, such a spouse claiming benefits at exact age 62 has a 25-percent reduction when the NRA is 65[51] and a 35-percent reduction when the NRA is 67 (for persons who attain age 62 in 2022 and after).

A former spouse who was divorced after at least 10 years of marriage is also eligible for a spouse's benefit at age 62 or over, with such benefit being on a reduced basis if first claimed before the NRA.[52] Also, a divorced spouse under the NRA with a child under age 16 or disabled before age 22 receives unreduced benefits, regardless of age. Thus, more than one spouse's benefit can be paid on a particular earnings record.

50. A "roundup" similar to that for old-age benefits (see footnote 40) is also applicable for spouse's benefits when the beneficiary attains the NRA.

51. This is less than the approximately 30 percent needed on an actuarial-equivalent basis (a larger reduction than for workers claiming benefits before age 65 being required because it applies during the shorter joint lifetime with the spouse, as compared with the single lifetime of the worker). The 25-percent basis was adopted, despite some added cost to the program, because the 30-percent reduction actuarially called for "seemed too large" from a political viewpoint insofar as the sponsors of the change were concerned. However, the increased cost to the program was recognized, and was met by providing additional financing.

52. Before legislation in 1983, the divorced spouse could receive such benefits only if the worker had filed for old-age or disability benefits. Now, the divorced spouse can receive the benefits regardless of whether the worker has filed claim, as long as the divorce had lasted for at least two years, and the worker was aged 62 or over, or if the worker was entitled to benefits before the divorce even though not receiving them.

Monthly Survivor Benefits

Widow's and widower's benefits are payable at age 60, or at age 50 if disabled, if the deceased spouse was fully insured (including death after retirement). Under certain circumstances, the benefit otherwise payable to a widowed spouse is reduced if such spouse also has a pension based on employment under a retirement system for federal, state, or local government employees which is not coordinated with or supplementary to OASDI, as discussed in detail later in this chapter. A divorced former husband or wife can qualify for widow's or widower's benefits if the marriage had lasted at least 10 years.

The definition of disability for widows and widowers was formerly stricter than that applicable to disability benefits for insured workers. It required the disability to be so severe as to prevent the individual from engaging in *any* gainful activity, not merely "any substantial gainful activity," which term is broadened by the law to take into account age, education, and work experience. However, beginning in 1992, the same definition applies. Further, the disability must occur no later than seven years after the death of the insured worker or, in the case of a widow or widower with eligible children, no later than seven years after termination of mother's or father's benefits. The reason for this seven-year "grace period" is that, by the end of that time, the widow or widower should, if not disabled before then, have been able to have worked and acquired disability insured status on her or his own earnings record. Just as for insured workers, a five-month duration of disability is required (which can be satisfied by being in existence before the death of the spouse), and the same conditions as to termination of benefits apply.

The widow's or widower's benefit is, in general, 100 percent of the PIA if the initial claim is made at the NRA and 71.5 percent at age 60 (or at ages 50–59 for disabled widows and widowers), with proportionate amounts at intermediate ages between 60 and the NRA at the time of the award.[53] Before the 1983 Act, the benefit percentages for disabled widows and widowers were smaller, being 50 percent at age 50 at award and proportionately higher amounts for older ages.

Further, if the deceased worker had claimed early-retirement bene-

53. These results are achieved, when the NRA is 65, by using a factor of 19/40 percent for each month below age 65 down to age 60 (which is somewhat smaller than the factor used for benefits for retired workers at ages 62–64 and is thus not quite on an approximate actuarial basis, so that some added cost to the program is involved. Just as in the case of old-age and spouse's benefits, a roundup is provided for widow's and widower's benefits to take into account any months for which benefits were not received before the NRA.

fits (i.e., before the NRA), the resulting widow's or widower's benefit cannot exceed the larger of (1) 82½ percent of the PIA[54] or (2) the reduced benefit which the worker had been receiving.[55] This restriction can result in very unfavorable treatment when a worker who retires well before the NRA has a spouse who is older, and the worker dies shortly after claiming benefits; under these circumstances, the latter's larger reduction applies during the surviving spouse's lifetime, whereas it would not have done so if claim for retired-worker benefits had not been made.[56] Finally, the resulting amount is increased by any delayed-retirement credits which the deceased worker had earned (see page 98).

The NRA for widow's and widower's benefits is determined in a slightly different manner than that for retired workers and spouses (because the early-retirement age for the former is lower than that for the latter categories). The NRA for widows and widowers is 65 for all who attain age 60 before 2000 and increases two months for each subsequent year-of-birth cohort, until reaching age 66 for those who attain age 60 in 2005 (i.e., attain age 66 in 2011). The NRA then remains at age 66 for those who attain that age in 2012–22, but thereafter it increases by two months for each subsequent year-of-birth group, until becoming 67 for those who attain that age in 2029 and after (as against reaching age 67 in 2027 for retired workers and spouses).

When a fully insured worker dies, parent's benefits are payable at age 62 or over to parents who have been dependent on such individual. The benefit is 82½ percent of the PIA if one parent receives benefits, and 75 percent each if two parents receive benefits. This is done so that two parents will not receive more than a retired worker and spouse both aged 65 or over.

When a fully or currently insured individual dies leaving an eligible child (including a child of a retired or disabled worker), benefits are payable to such child and to the widowed mother or father having

54. This odd figure of 82½ percent is present because, at one time, all widow's benefits were this proportion of the PIA, regardless of age at initial claim.

55. If the worker had died before attaining the NRA and had had benefits suspended for one or more months because of the retirement earnings test, the worker's early-retirement benefit used for this purpose is increased by a roundup (see footnote 40) to recognize this, in the month when the worker would have attained the NRA.

56. For example, if a male worker initially claims benefits at age 62 in 1993 and has a wife who is aged 65 or over, and he dies after a month or so, the widow will be limited for her lifetime to a benefit of 82½ percent of the PIA. On the other hand, if he had not filed for benefits, the widow's benefit would have been 100 percent of the PIA. So, a few months of retired-worker and spouse benefits would be far more than offset by the 17½ percent reduction in lifetime widow's benefits!

care of a child under 16 or disabled. A divorced former spouse is also eligible for father's and mother's benefits (except that the requirement of 10 years of marriage does not have to be met).

Just as in the case of retired and disabled workers, a non-disabled child aged 16 or over who is eligible for benefits does not make the widowed mother or father eligible for benefits. These child-survivor benefits are equally applicable with respect to the death of an insured female worker. Valuable permanent survivor protection is thus available for women who leave the labor market to take up the job of raising a family if they have worked in covered employment long enough to be fully insured at the time of potential death.

The benefits are 75 percent of the PIA, both for the widowed parent and for each child. If the widowed parent can receive a larger amount as a widow's or widower's benefit (generally if age 61 or over), such payment is made instead of a mother's or father's benefit. When there are three or more eligible survivors (not counting divorced former spouses), the full benefit rates described above will not be paid, because of the maximum family benefit provision (described later).

Decrease in Reduction Factors When NRA Increases

When the NRA increases from the present age 65, the reduction factor (i.e., the percentage that is applied to the full benefit in order to obtain the reduced benefit payable) for benefits for retired workers who first claim them at the earliest possible age (62), which is not changed over the years, becomes smaller. (Digressing a moment, it would have been more logical to increase the early-retirement age in tandem with the NRA, but politically it was more appealing to leave such age unchanged and to provide for actuarially consistent lower reduction factors.) Such reduction factor will drop from the present 80 percent for those with an NRA of 65 to 75 percent for those with an NRA of 66 and eventually to 70 percent for those with an NRA of 67, with gradual phasing in for fractional NRAs. In all instances, the factors for ages between the early-retirement age and the NRA are phased in smoothly, using the monthly percentage factors mentioned earlier.

The same procedure is followed for spouse's benefits when the NRA increases, except that in each case the reduction factor is 5 percentage points lower. However, the procedure is entirely different for widow's and widower's benefits, because the factor of 71½ percent for age 60 remains fixed, and the factors for ages at claim between 60 and the NRA are obtained by linear interpolation. For example, when the NRA is 65, the factor for exact age 62 is 82.9 percent (two fifths of

the way between 71.5 percent and 100 percent). Similarly, when the NRA is 67, the factor for age 62 is 79.64 percent (two sevenths of the way between 71.5 percent and 100 percent).

The following table gives the reduction factors for each of the three types of benefits for several illustrative NRAs. If the deceased insured worker had claimed a reduced old-age benefit before death, the widow or widower may receive a benefit less than the amount derived from these factors. Under such circumstances, the survivor benefit cannot exceed the larger of (1) the reduced old-age benefit or (2) 82½ percent of the PIA.[57] If the deceased insured worker had worked beyond the NRA and earned delayed-retirement credits (as discussed later), these are "inherited" by the widowed spouse, and the benefit amount resulting from the previously described procedure is increased thereby.

NRA	*Old-Age Benefits*	*Spouse's Benefits*	*Widow's and Widower's Benefits*
Initial claim at age 62			
65	80.00%	75.00%	82.90%
65½	77.50	72.50	81.86
66	75.00	70.00	81.00
66½	72.50	67.50	80.27
67	70.00	65.00	79.64
Initial claim at age 65			
65	100.00%	100.00%	100.00%
65½	96.67	95.83	97.41
66	93.33	91.67	95.25
66½	90.00	87.50	93.42
67	86.67	83.33	91.86

57. This complex provision resulted from the change in the 1972 Act providing for a 100-percent widow's benefit for widowhood at or after age 65, on the ground that a single survivor needed as much to live on as a single worker. Following this argument to its logical conclusion, then, a widow should not receive *more* than the retired worker on whose earnings the survivor pension is based. The 82½ percent reflects the fact that this was the benefit rate previously (before the 1972 Act) for widows aged 62 and over. This provision can result in considerable inequities and can make for difficult choices for persons who file claims for benefits. For example, consider a worker aged 62 currently with a wife aged 65. If he files a claim and becomes entitled to old-age benefits, his widow's benefit rate when he dies will be 82½ percent. But if he does not file, her rate will be 100 percent. It thus makes a tremendous financial difference if he files for early-retirement benefit and then dies within a few months after age 62 as compared with what would have happened if he had not filed. Another complexity occurs for the person who retires, then returns to work, and then dies (either before or after retiring again). If death occurs before age 65, the widowed spouse's benefit is determined as described in footnote 55. However, if death occurs after attaining age 65, the widowed

Dual Benefits

Certain complex situations are involved when an individual is eligible for more than one type of benefit (e.g., on his or her own earnings record and as a spouse of a living or deceased worker) and at least one of such benefits is subject to reduction due to claiming it before the NRA. This will be increasingly common in the future as more and more women engage in covered employment. Appendix 2-2 describes how such situations are handled.

Special Age-72 Benefits

Special flat-rate benefits payable at age 72 or after are available for two categories of persons who are not fully insured (no person born after 1899 can qualify for these benefits). These flat-rate benefits have been at a level of about 69 percent of the regular minimum benefit, as adjusted for increases in the CPI (which is no longer available for new eligibles after 1981, except for certain members of religious orders). The benefit rate for December 1991 through November 1992 was $173.60.

The size of such special age-72 benefits is automatically adjusted in the future in the same manner as other OASDI benefits. The persons eligible constitute an essentially closed group, which will gradually phase out in the future because it consists only of persons who attained age 72 in the past (although, if corrective legislation had not been enacted in 1990, it would have been "resurrected" for certain unusual cases of persons who attain age 72 after 1991). A detailed description of this beneficiary category is given in Appendix 2-3.

Lump-Sum Death Payments

In cases of death of a fully or currently insured individual, a lump-sum death payment of $255 is payable to the surviving spouse if living with the deceased worker. If the spouse is not living with the deceased worker, the lump sum is paid only if the surviving spouse is eligible for monthly benefits for the month of death (e.g., aged 60 or over, or with eligible children present) or, in the absence of such a spouse, to any children eligible for monthly benefits for the month of death.

spouse's benefit is based on the retirement benefit reduced only for the months for which the early-retirement benefit was actually received. An equitable solution to these anomalies would be merely to base the widowed spouse's benefit under this provision on the early-retirement benefit based on a reduction for only the number of months between ages 62 and the NRA when the earnings test did not affect the benefit payable.

The amount is less than $255 if the PIA is computed under a totalization agreement (see Appendix 2-14) and three times the PIA is smaller.

The amount originally was three times the PIA. The maximum amount available under the 1952 Act was $255, and it was frozen at this level and has not been increased by subsequent amendments. As a result of the 1973 Act, for deaths after February 1974, the lump sum was $255 in all cases because then, for the first time, 3 times the minimum PIA exceeded $255.[58]

The lump-sum death payment must be applied for within two years of the death of the insured worker. If the surviving spouse was entitled to spouse benefits for the month preceding the month of death, an application for the lump sum is deemed to have been filed (i.e., the payment is automatically made). Also, if "good cause" (e.g., extended illness of the claimant or communication difficulties) is shown for failure to file within two years, the claim will be deemed to have been filed timely.

Qualifying Definitions of Auxiliary Beneficiaries

There are a number of important provisions relating to definitions of auxiliary beneficiaries (such as duration of marriage required to be recognized as a wife) and initial and final months for benefit payments (including causes of termination). A detailed description of such provisions is presented in Appendix 2-4.

Limitations on Benefits

Certain limitations apply to the benefit amounts described previously. No individual can receive for any month the full amount of more than one type of monthly benefit. For instance, if a woman has an old-age benefit in her own right and a wife's or widow's benefit from her husband's earnings, then, in effect, only the larger of the two benefits may be received, although in actual practice the old-age benefit is always payable, plus any excess of the secondary benefit.[59]

58. When the minimum PIA of $122 was generally eliminated by the 1981 Amendments, it was provided that this would not affect the $255 figure.

59. If wife's benefits are claimed before the NRA and are thus on a reduced basis, when the secondary benefit which would be payable at the NRA is larger than the old-age benefit on the woman's earnings record which would be payable at the NRA, then the procedure is to compute separately the reduced old-age benefit and a reduced residual secondary benefit based on the difference between the two full benefits. For example, assume that a woman has a primary benefit based on her own earnings of

TABLE 2.3. Summary of Eligibility Requirements and Benefit Rates for OASDI Benefits

	Requirement as to		
Type of Benefit	*Age*	*Insured Status of Worker*	*Benefit Rate**
Old-Age	62 or over	Fully	100%†
Disability	Under NRA	Fully and disability	100%
For auxiliaries of retirement or disability beneficiary			
Spouse, no child present	62 or over	Fully	50%†
Spouse, eligible child present‡	None	Fully	50%
Child of worker	Under 18§	Fully	50%
For survivors of insured worker			
Widow or widower	60 or over**	Fully	100%†
Widow or widower, eligible child present‡	None	Fully or currently	75%
Child of worker	Under 18§	Fully or currently	75%
Dependent parent	62 or over	Fully	82½%‖
Lump sum	None	Fully or currently	$255

*Expressed as percentage of Primary Insurance Amount, before effect of maximum benefit provisions. Monthly amounts in all cases, except for lump-sum death payment.

†A reduction applies if benefit is claimed before the NRA or if deceased worker had received early-retirement benefits.

‡A child is not considered "eligible" for the purpose of this benefit if age 16 or over and not disabled before age 22.

§Regardless of age if disabled before age 22; also payable if attending elementary or secondary school at age 18.

‖If two parents, 75 percent each.

**Or as low as age 50 if disabled.

Also, an eligible remarried widow (or widower) who remarried after age 60 can receive only the larger of her widow's benefit or the wife's benefit from her new husband. In addition, there are certain minimum and maximum benefit provisions (described subsequently). Furthermore, certain restrictions on the payment of benefits may apply

$150 and that her husband's primary benefit is $400. Then, if she claims benefits at age 62, her reduced primary benefit is $120 (80 percent of $150), and her reduced wife's benefit is $37.50 (75 percent of the unreduced residual wife's benefits of $50, the latter being 50 percent of $400, minus $150), making a total benefit of $137.50. Note that this procedure is not the same as computing only the reduced full wife's benefit, which would be $150 (75 percent of 50 percent of $400). The procedure for the case when a widow or widower is eligible for both benefits based on own earnings record and survivor benefits is described in Appendix 2-2.

in the relatively rare case of persons convicted of crimes affecting the security of the nation.

A summary of the foregoing eligibility conditions and benefit rates is shown in Table 2.3.

Disability Freeze

Periods of disability of at least five months' duration are excluded in determining insured status and the Average Indexed Monthly Earnings (AIME) if the individual is disability-insured and meets the definition of disability required for cash benefits. This provision, which in essence preserves the benefit rights of disabled workers, is similar to waiver-of-premium clauses in life insurance policies.

In the vast majority of cases, the disability-freeze provision merely establishes the individual's insured status and benefit amount at the time of disablement. It also establishes as of that time the matter of dependency of an auxiliary beneficiary of the insured worker—for example, a child or a parent for subsequent survivor benefits—although such dependency can also be established for later dates, such as the first month of entitlement to disability benefits or the first month of entitlement to retirement benefits. Insured workers who meet the statutory definition of blindness have the advantage of the disability freeze even though they may not be receiving cash benefits because of high earnings. For other disabled workers who are receiving monthly disability benefits, the disability freeze has no ongoing effect if they do not recover from their disability. However, for disability beneficiaries who recover, the disability freeze can be very valuable.

Benefit Amounts

The benefit amounts are computed by first determining the Primary Insurance Amount (PIA) of the insured worker and then applying to it the appropriate beneficiary percentages (as shown in Table 2.3) and any applicable reductions for "early retirement." Finally, the resulting benefits are subject to increases for delayed retirement beyond the NRA and to overall maximum family benefit provisions.

Determination of PIA

Actually, the PIA is calculated in two steps. First, the AIME is computed. Second, the PIA is determined from the benefit formula by

entering it with the AIME. This benefit formula is different for each cohort of persons attaining age 62 in each future year, or dying or becoming disabled before age 62 in each future year.

A different procedure for determining the PIA is applicable to those attaining age 62 before 1979 (regardless of whether they become disabled or die after 1978) and for persons dying or becoming disabled before age 62 before 1979—as described in Appendix 2-5. Also, for the 1979–83 cohorts, an alternative transitional-guarantee method of computing the PIA is available for persons attaining age 62 in those years, or dying in or after the month of so attaining such age, if it produces a higher result—as described in Appendix 2-6.

The reasons that the different benefit-computation procedures are applicable for the 1979 and later cohorts are discussed in detail in Appendix 3-4.

A unique method of computing the PIA is used for persons who qualify for benefits solely because of a totalization agreement—see Appendix 2-14.

Determination of AIME

The average wage used in OASDI is, in essence, an average computed over the entire potential period of coverage, but with certain periods of low earnings being disregarded. Earnings in the year of becoming entitled to old-age and disability benefits, and in years thereafter, are counted for benefit-computation purposes effective for benefits beginning for the January following the year in which such earnings are credited. Such benefit recomputation is made only if it increases the PIA by at least $1. For survivor cases, earnings in the year of death of the insured worker are counted immediately for benefits for that year.

Earnings in years before 1951 are disregarded in computing the AIME. A special alternative benefit-computation method for the PIA is applicable if earnings before 1951 are used and if this produces a higher result—as described in Appendix 2-7.

The earnings used in computing the AIME are not the actual recorded ones, but rather indexed ones that express the actual earnings of the past in terms of current earnings levels two years before the time of attaining age 62 or dying or becoming disabled before then. The method of indexing the earnings record is dealt with after describing the period of years used in computing the AIME. Such period depends upon the individual's year of attainment of age 62, or year of death or disability, if earlier.

In brief, except for persons becoming disabled for the first time in

or after January 1980, this measuring period is five less than the number of years that have elapsed after 1950 (or, if later, the year of attainment of age 21) and before the year in which the worker attains 62, or dies or becomes disabled, if earlier.[60] The reduction of the period by five years (often referred to as "dropout years") is provided so that the average earnings will not be pulled down by the very lowest years of earnings during the potential working lifetime.[61] The minimum period is two years, applicable in cases of death and disability. For age retirements, the minimum period is generally five years.[62] The measuring period increases gradually for persons attaining age 62 in various past years to an ultimate value of 35 years for attainments of age 62 in 1991 or after—i.e., from the calendar year of attainment of age 22 through the year of attainment of age 61, minus five years.

As an example of how the number of years to be used in computing the AIME is determined, consider a person who attained age 65 in 1985. Such period is 26 years—the years in 1951 through 1981 (the year before age 62 was attained) minus five years. From the viewpoint of the year of attainment of age 65, the periods for computing the AIME for retirement cases for which age 65 was attained after 1981 and the Average Monthly Wage (as discussed later) for retirement cases for which age 65 was attained before 1982, where there has been no prior period of disability, are shown in the table on the next page for attainments in 1971 and after.

60. For persons not eligible to use the AIME method, an Average Monthly Wage is computed. The AMW is determined from a measuring period computed in the same manner as that for the AIME, except for men attaining age 62 before 1975. For men attaining age 62 before 1973, the closing year for the measuring period was age 65; thus, for attainments of age 62 in 1972 (i.e., age 65 in 1975), the period was 19 years (as compared with 16 years for women attaining age 62 then). For men attaining age 62 in 1973–74, the period was frozen at 19 years, so that there was smooth phasing-in, and for both men and women the period was 19 years for attainments of age 62 in 1975. Any years any months of which are included in a period of disability are, under the disability-freeze provision, subtracted from the result in determining the number of years to be used in recomputing the AIME (or the AMW) for persons who had recovered from a disability and then needed an AIME (or AMW) computation for a death or retirement event (except that, if the person was entitled to disability benefits in any month in the 12-month period preceding the month of entitlement to old-age benefits, or of death, or of reentitlement to disability benefits, the AIME [or AMW] is not so recomputed). In the case of such subsequent determination of the PIA for disability beneficiaries who had recovered, the new PIA will be increased to that applicable at the time of recovery (i.e., without considering general benefit increases occurring thereafter) if it would otherwise be smaller.

61. This provision was introduced, in large part, to benefit self-employed farmers, who had four years of zero earnings during 1951–54 before their coverage began in 1955.

62. In certain unusual cases of retirement—persons who were disabled for a long time and who recovered shortly before age 62—the period can be as low as two years.

Year of Attainment of Age 65	*Number of Years in Computation of AIME or AMW*	
	Men	*Women*
1971	15	12
1972	16	13
1973	17	14
1974	18	15
1975	19	16
1976	19	17
1977	19	18
1978	19	19
1979	20	20
1980	21	21
1981	22	22
1982	23	23
1983	24	24
1984	25	25
1985	26	26
1986	27	27
1987	28	28
1988	29	29
1989	30	30
1990	31	31
1991	32	32
1992	33	33
1993	34	34
1994 and after	35	35

The period for computing the AIME for death cases (and for cases where disability first occurred before 1980) is similarly determined. For persons born in 1929 or before, and who therefore attained age 21 before 1951, the period is the same as for those who attain age 62 in the particular year. For persons born after 1929, the period for a particular year of death or disability is smaller. For example, for death or disability in 1991 of a person born in 1940, the period is 24 years (the years in 1962, when age 22 was attained, through 1990, inclusive, minus 5 years).

Legislation enacted in 1980 increased the number of computation years for the AIME for persons becoming disabled in and after January 1980 at age 46 or under (i.e., based on the age at disablement and not the age when the first monthly benefit is payable). Instead of the five dropout years generally applicable, the periods shown in the next table are applicable.

Age at Disability	*Dropout Years*
Under 27	0
27–31	1
32–36	2
37–41	3
42–46	4

Thus, for example, a person disabled at age 29 previously had the benefits computed over a two-year period but now has a six-year period (the years at ages 22–28, inclusive, minus one year). As another example, the computation years are eight for persons disabled at either age 31 or 32 (as against four and five years, respectively, under previous law).

The legislation, however, provided for less of an increase in the computation years for persons becoming disabled at ages 36 and under who had child-care years with respect to a child under age 3. Under such circumstances, each child-care year can increase the number of dropout years according to the foregoing table, up to a maximum of three years. For example, for the case of the person disabled at age 29, if he or she had one child-care year, then there would be two dropout years (and thus a five-year computation period); for two or more child-care years, the dropout years would be three and the computation period would be four years. Actually, because of the minimum of two years for computation purposes, the maximum number of child-care dropout years that can be used is two (at ages 26–31). A child-care year is defined as one in which the individual had a child of less than three years of age present substantially throughout the year and did not engage in any employment in the year.

Upon the death of the disabled worker, the AIME (and thus the PIA) is recomputed using a five-year dropout in all cases. This procedure is not followed when the disabled worker attains the NRA and is converted to an old-age beneficiary.

Having determined the number of years in the measuring period, that number of years (not necessarily consecutive) with the highest *indexed* earnings (not counting years before 1951) is used to compute the AIME, regardless of whether these years occurred before age 21 or at or after age 62. If there are not sufficient years with earnings, then zeros must be used to "fill out" the measuring period. Earnings in the year of retirement (whether for age or disability) are not used in the computation of benefits for that year, but they are used to recom-

pute the benefit for subsequent years.[63] On the other hand, earnings in the year of death are applicable immediately for survivor benefits. Similarly, earnings in a year after the year of retirement are used for recomputation of the benefit for the following year.

The total *indexed* earnings in the years of the measuring period are then divided by 12 times the number of such years. The resulting average, if not an even integral dollar, is rounded down to the next lower dollar (i.e., the cents are dropped). This rounding down was done as a partial counterbalance to the practice followed (before legislation in 1981, which moved in the opposite way) of rounding benefit amounts up to the next 10 cents.

The earnings used in computing the AIME are not the *actual* ones, but rather *indexed* ones to reflect changes in general wage levels over the years. For retirement cases (and for death or disability at age 62 or over), the year to which earnings are indexed is the second year before age 62 is attained. For death or disability before age 62, the indexing year is the second year before the year of such event.

The method of indexing the actual earnings of any year is merely to multiply it by the ratio of the average nationwide wage in the indexing year to such average wage for the particular year, which average wages are derived from the so-called SSA indexing average wage series (see Table 2.18, following). As an example, assume that the actual earnings of an individual in 1977 were $15,000. It is desired to index these earnings to 1988. The wage index is $9,779.44 for 1977 and $19,334.04 for 1988. Then the earnings for 1977 when indexed to 1988 are $29,655.13 ($15,000 times the ratio of $19,334.04 to $9,779.44). Thus it might be said that the $15,000 of earnings in 1977 was equivalent to $29,655.13 at the 1988 level of earnings.[64]

63. Earnings for a year that is *entirely* included in a period of disability cannot generally be used (optionally, the disability freeze can be ignored if a larger benefit results). It is rare that, under these circumstances, there would be sizable earnings, but this could occur for rehabilitative work in a trial work period or for self-employment income from a business run by another person. Earnings in the year of recovery from disability can be used.

64. Another way of looking at the concept of indexed earnings, which is mathematically equivalent, is to divide the actual earnings for the particular year by the nationwide average wage. This could then be said to yield the person's relative standing as to earnings level (153.4 percent of the average in this case). Then, multiplying the nationwide average wage in the indexing year by this relative standing yields the comparable earnings in the particular year that would be applicable in the indexing year. Or else, all the relative standings for the required number of years for the computation of the AIME could be averaged to yield the average relative standing, and this would be applied to the nationwide average wage in the indexing year to yield the individual's AIME consistent with the earnings level in that year.

The indexing is done to the second year before age 62 (or earlier death or disability) because of administrative reasons related to when the data on nationwide wages are available.[65] Such nationwide average wages (including those in noncovered employment) for 1978 and after are determined from the individual income tax withholding forms, W-2 (and from the income tax returns, Form 1040), for wages paid by employers, by counting the total wages on such forms and the total number of persons involved on such forms.[66] The average wages in the indexing series for 1977 and before were obtained from OASDI covered wages for the first quarter of each year. After 1977, such average wages have been computed by working forward from the 1977 figure, utilizing the annual percentage changes derived from the average nationwide wages. (See Appendix 2-8 and Table 2.18 for a description and tabulation of these values, as well as an example of an indexed earnings record based on indexing to 1977 and the AIME based thereon.) Earnings in the year to which indexing is done and those in all subsequent years, including years after attainment of age 62, are used in their actual amount and are not indexed.

The earnings used in computing the indexed earnings cannot, for a particular year, exceed the maximum taxable earnings base (sometimes referred to as the contribution and benefit base). This base is $51,300 in 1990, $53,400 in 1991, $55,500 in 1992, and $57,600 in 1993 (for years before 1990, see Table 2.13). Following 1981, it has been (and will continue to be) automatically adjusted for changes in the level of wages in total employment in the country (as discussed later in this chapter).

As an illustration of how the AIME is computed, consider a man who attained age 62 in 1985 and who had qualified for a disability freeze for 1955 and 1956 (having then recovered). His AIME must

65. The fact that indexing back two years gives a lower AIME than if there were no lag (or only one year's lag) is counterbalanced by using somewhat larger percentage factors in the benefit formula (described later) than would be the case if the lag were less than two years.

66. Actually, for 1977–83, the "wages" line on the income tax returns (Form 1040) has been used because of a technical problem. This will yield consistent results, although there are small differences in the data from these two sources (e.g., some wages may be reported on Form 1040 for which a W-2 was not submitted, and some W-2s may be submitted but no Form 1040 was filed by the persons involved). Eventually, all W-2s submitted to the Internal Revenue Service by employers will be considered. (Note that, in some instances, W-2s received by employees from their employer are not submitted with a Form 1040, because the employee does not file an income tax return, due to having a very low income, for example.) There was an overlap for the year when both methods were used; this was done to provide a proper link between the two series of figures (just as was done for 1977, to link together the series for 1951–77 and the later data).

be computed over a period of 27 years (1984 minus 1950, minus five years' dropout, minus two years' disability freeze). If his indexed earnings in his highest 27 years in 1951–84 totaled $300,000, his AIME would be $925 ($300,000 divided by 324 months and rounded to the next lower dollar). If he worked in and after the year he attained age 62, his AIME might be increased. For example, if his covered earnings were $13,000 in 1985 and $14,000 in 1986, these amounts could be substituted for the two lowest years' indexed earnings in the 27 years used previously, if the latter are smaller.

As another example, consider the case of persons who have always had maximum covered earnings, and examine the effect on them of the increases in the earnings base that have been made in the past. In some periods, the base remained unchanged while earnings levels rose; as a result, the base decreased from a relative standpoint. In 1973 and 1974, the base increased more rapidly than the earnings level, and this also occurred in 1979–81. The net result is that currently the base is much higher relatively than it was before 1974. A maximum-earnings case who becomes 62 at the beginning of 1992 then had an AIME of $2,985 (see Appendix 2-8), which is well below the monthly rate of maximum covered earnings in 1991—$4,450.

With regard to the foregoing case, earnings at and after age 62, if at the maximum creditable amount, would significantly increase the AIME. For example, if this individual so worked in 1992–94 at the 1991 base amount, of $53,400, the AIME would be increased to $3,192.

Another example of interest is in connection with women workers who spend much of their potential working lifetimes in the home raising a family. Consider a young woman who worked in covered employment for the 10 years following attainment of age 21, after 1950 (so that she acquired the necessary 40 quarters of coverage to obtain fully insured status regardless of subsequent employment) and then performed no more such work. At age 62, her AIME would be computed by dividing her total 10 years of indexed earnings (as indexed to her age 60) by 420 months (i.e., the average of the indexed earnings over the 10 years that she worked would thus be reduced by being multiplied by $^{10}/_{35}$), so that she would, in effect, be considered a low-wage person. If she dies at age 42, her AIME for purposes of computing survivor benefits would be the total indexed earnings (as indexed to her age 40) divided by only the 180 months after the year of attainment of age 21 and before the year of attainment of age 42, minus five years.

A peculiar, illogical situation occurs for young workers in comput-

ing the AIME for purposes of disability and survivor benefits. Consider workers who die in early 1990 at age 29 or under, or who become disabled in 1990 at age 24 or under, and who have the maximum covered earnings of $45,000 in 1988 and $48,000 in 1989. The AIME for such individuals is based on only the two highest years and is thus $3,875 (their two years of earnings being used unindexed). This is well above the AIME of $2,648 for persons attaining age 62 at the beginning of 1990 (or for persons becoming disabled or dying then who were aged 59–62 and who had had maximum covered earnings ever since 1951.)[67]

The foregoing result occurs because of the sharp ad hoc increases in the earnings base that took place in 1973–74 and again in 1979–81. It will continue for some years in the future, but eventually cease to occur. For persons with average earnings or less (and, in fact, with earnings somewhat above the average), this anomaly between retirees and young deaths or disabilities does not occur at all under the new AIME method. All these effects are illustrated in Tables 2.8 and 2.9 and the subsequent discussion.

Benefit Formula

Under the ongoing permanent benefit-computation procedure, the AIME is put into a benefit formula to yield the PIA. This formula has a dynamic nature, *varying for each cohort of persons attaining age 62, or dying or becoming disabled before age 62, in each future year.* It is important to note that, for retirement cases, the benefit formula is fixed by the year of attaining age 62, not the year of retirement if later (or even, under the unusual circumstances when the individual is not fully insured at age 62, but meets the requirements later). To offset this, the automatic CPI adjustments are given for all years beginning with the one in which age 62 is attained, regardless of when retirement occurs. The initial formula, for the 1979 cohort, is:[68]

67. But note that this discrepancy was much worse before the wage-indexing concept was introduced by the 1977 Act. If there had been no change, the AMW for the maximum-earnings retiree at 62 in 1990 would have been only $1,446, while that for the young disabled or deceased worker at age 29 or under would still have been $3,875.

68. Persons attaining age 62, dying, or becoming disabled before 1979 cannot use the AIME method and the related benefit formula, but rather they have benefits computed in the same manner as though the 1977 Act had not been enacted (see Appendix 2-5). If a disability beneficiary recovers from the disability, the computation for subsequent attainment of age 62, or prior death or recurrence of disability, is based on the year of such subsequent event if the period of recovery (i.e., nonentitlement to disability benefits) was at least 12 months.

90 percent of the first $180 of AIME, plus
32 percent of the next $905 of AIME, plus
15 percent of the AIME in excess of $1,085
with a minimum of $122[69]

This benefit formula is heavily weighted in favor of low AIMEs. Thus, for an AIME of $1,000, the PIA of $424.40 is only 2.5 times the PIA of $168.40 applicable to an AIME of $200, in sharp contrast with the fivefold difference in earnings levels. To look at this example another way, the PIA is 84.2 percent of the AIME for the $200-per-month person but is 42.4 percent for the $1,000-per-month person. Table 2.4 presents more detail on this relationship, which, of course, continues on the same *relative* basis in future years, even though the benefit formula itself changes.

The basic benefit formula also favors persons who are not covered under OASDI for all of their potential working lifetimes. For example, if an individual aged 22 in 1977 has earnings of $1,000 per month and comparable amounts in relation to changes in the general wage level in all future years until attaining age 62 in 2017, the PIA will be 42.4 percent of the earnings at age 60. On the other hand, a person who worked only the last 10 years before age 62—or only 25 percent as long—would have a PIA of 19.6 percent of the earnings at age 60, or 46 percent as large as that of the full-career worker. Note, however, that a provision in the 1983 Act reduces benefits of persons who have pensions based on noncovered employment.

The amount computed under the formula was formerly rounded up to the next higher 10 cents if it was not, before any rounding, an exact multiple of 10 cents. Legislation in 1981, applicable to computations made thereafter, reversed this procedure by providing for rounding down to the nearest dime. The amount formerly (before the 1981 legislation) was also subject to a minimum and, furthermore, continues to be subject to the automatic-adjustment provisions (both discussed subsequently). The same rounding procedure is followed for all types of benefits which are a multiple of the PIA and for

69. This formula can be mathematically manipulated so that it can be expressed as follows:

AIME	*PIA*
$135 or less	$122
$136–$180	90% of AIME
$180–$1,085	$104.40 + 32% of AIME
$1,085 or over	$288.85 + 15% of AIME

TABLE 2.4. Primary Insurance Amount as Percentage of Average Indexed Monthly Earnings for Various AIMEs, 1979-Cohort* Formula

AIME†	*PIA*	*PIA as Percentage of AIME*
$ 135 (or less)	$122.00	90.5%‡
150	135.00	90.0
200	168.40	84.2
300	200.40	66.8
400	232.40	58.1
500	264.40	52.9
600	296.40	49.4
700	328.40	46.9
800	360.40	45.1
900	392.40	43.6
1,000	424.40	42.4
1,100	453.90	41.3
1,200	468.90	39.1
1,300	483.90	37.2
1,400	498.90	35.6
1,500	513.90	34.3
1,600	528.90	33.1
1,700	543.90	32.0
1,800	558.90	31.1
1,900	573.90	30.2
2,000	588.90	29.4
2,075	600.10	28.9

*By "1979 cohort" is meant persons who attain age 62 in 1979, or who die or become disabled before age 62 in 1979. These PIA figures were applicable for benefits for January–May 1979; for the next 12 months they were 9.9 percent higher (due to the operation of the automatic-adjustment provision), with rounding up to the next even 10 cents if not already an exact multiple of 10 cents. In subsequent years these PIA figures have been higher, as a result of the automatic-adjustment provisions, which reflect increases in the CPI.

†A person attaining age 62 in 1979 cannot have an AIME in excess of $1,107 (unless having had a previous disability freeze); the AIME for such a person could be higher in 1980 if account is taken of 1979 earnings. A person becoming disabled in 1979 at age 29 or under could have an AIME as large as $1,425 (and this could be higher in 1980 if account is taken of 1979 earnings). Survivor benefits for death early in 1979 could be based on AIMEs similar to those previously stated for retirements and disabilities, although for those occurring later in the year, larger AIMEs (as much as $1,691 for death at age 29 or under) would be possible by making use of 1979 earnings. If earnings bases in the past had been at a level comparable to what the $29,700 base scheduled for 1981 was, relative to wages then, an AIME of as much as $2,075 would have been possible for 1979.

‡Percentage based on AIME of $135. It would, of course, be larger for lower AIMEs.

the early-retirement and delayed-retirement factors, and also after the automatic-adjustment procedures have been applied. Following the 1981 legislation, additional rounding down is done in the benefit actually payable to each beneficiary (after deduction of the SMI premium, if any)—namely, all cents are dropped.[70]

The foregoing procedures may be illustrated by considering a single worker who retired at exact age 62 in January 1979 with a PIA of $264.40. The benefit initially payable was $211.60 (80 percent of $264.40, rounded up to the next dime if not an exact dime, before any rounding). The Cost-of-Living Adjustment of 9.9 percent for June 1979 increased this to $232.60 (again rounded up to the next dime), and the corresponding COLAs for June of 1980 and 1981 (14.3 percent and 11.2 percent, respectively) similarly increased the benefit to $265.90 and $295.70, respectively. Beginning in January 1982, when the individual became age 65, the SMI premium (always rounded to an even dime, see Chapter 8) was directly deducted. The basis for the COLA and the deduction of the SMI premium was quite different for June 1982, with respect to the benefit payable in early July 1982. The benefit payable before the SMI premium rate of $12.20 was $317.50 after the COLA of 7.4 percent (now rounded down to the dime), while after taking into account the SMI premium, it was $305.00 (dropping all cents). Similarly, for December 1983, the benefit check—after considering the COLA of 3.5 percent and the SMI premium of $14.60—was $314.00 ($317.50 increased by 3.5 percent, then rounded down to the dime, and next subtracting the SMI premium of $14.60 and rounding the result to the next lower dollar if not already an even dollar).

It is important to bear in mind that the foregoing benefit formula applies to members of the 1979 cohort even though they may retire and first claim benefits some years after 1979. However, then the AIME recognizes earnings in and after 1979 (on an unindexed basis), and the PIA is affected by automatic adjustments occurring for 1979 and later. For example, an individual in this cohort who first claims benefits for July 1986 had a PIA computed from the foregoing benefit formula plus the increases arising from all general benefit increases in 1979–85. In this same manner, the person in the 1979 cohort who first claimed benefits for June–December 1979 received, in the PIA,

70. These rounding-down changes were made as a result of "general budgetary" policy, not on grounds of equity or consistency. Actually, the original rounding procedures—down in computing the average earnings for benefit-calculation purposes and up in the resulting benefit amount—were adopted to provide both simplicity and equity, because they were counterbalancing.

the effect of the general benefit increase for June that was given to all who had so claimed benefits during January–May 1979.[71]

The PIA formula for subsequent cohorts is obtained by automatic adjustment of the formula for the 1979 cohort, by varying the dollar bands according to changes in the general nationwide level of wages (the SSA indexing average wage series, as shown in Table 2.18) and not by changing the percentage factors.[72] Such nationwide wages are based on the average annual per capita wages (including those in noncovered employment) as shown by income tax data; namely, the data used for the indexing of the earnings record in order to determine the AIME and for the automatic adjustments of the earnings requirements for quarters of coverage and for the maximum earnings base. Specifically, to obtain the PIA formula for a particular year, each dollar band (sometimes referred to as bend point) in the 1979 formula[73] is multiplied by the ratio of (1) the nationwide average wage for the second year preceding the particular year to (2) such average wage for 1977, with rounding to the nearest $1. Unlike the procedure for quarters of coverage and the earnings base, the dollar bands so derived for the PIA formula are allowed to decrease from one year to the next if the wage level drops, as is also the case for the average wages used in indexing the earnings records.

As an example of how the PIA formula is adjusted for future cohorts, the nationwide average wage was promulgated by the Secretary of Health, Education, and Welfare to have increased by 7.941 percent from 1977 to 1978 (see Table 2.18). So the PIA formula for the 1980 cohort is:

90 percent of the first $194 of AIME, plus
32 percent of the next $977 of AIME, plus
15 percent of the AIME in excess of $1,171

71. For example, for a person in the 1979 cohort who has an AIME of $1,000, the PIA for January–May 1979 as computed by the foregoing benefit formula is $424.40. Based on the 9.9 percent general benefit increase for June, the amount payable for June–December for an AIME of $1,000 would then be $466.50, regardless of whether the initial month of eligibility for benefits was before or after June.

72. It is interesting that this is exactly the opposite of what was done under the pre–1977 law, when the percentage factors were changed and the dollar bands were held constant (see Appendix 2-5).

73. In practice, this is actually done only for the first and third figures; the second one is obtained by subtraction. The same result will usually be obtained as if the dollar bands individually had been multiplied by the applicable percentage increase in wages since 1977, the only possible difference being due to rounding.

TABLE 2.5. Dollar Bands for PIA and MFB Formulas and Old-Law Earnings Bases for Various Years

Year	Old-Law Earnings Base*	Dollar Bands for PIA for Year's Cohort: Applicable to 90-Percent Factor	Applicable to 32-Percent Factor	Applicable to 15-Percent Factor
1979	$18,900	$180	$ 905	$1,085
1980	20,400	194	977	1,171
1981	22,200	211	1,063	1,274
1982	24,300	230	1,158	1,388
1983	26,700	254	1,274	1,528
1984	28,200	267	1,345	1,612
1985	29,700	280	1,411	1,691
1986	31,500	297	1,493	1,790
1987	32,700	310	1,556	1,866
1988	33,600	319	1,603	1,922
1989	35,700	339	1,705	2,044
1990	38,100	356	1,789	2,145
1991	39,600	370	1,860	2,230
1992	41,900	387	1,946	2,333
1993	42,900	401	2,019	2,420

Year	Dollar Bands for MFB for Year's Cohort: Applicable to 150-Percent Factor	Applicable to 272-Percent Factor	Applicable to 134-Percent Factor	Applicable to 175-Percent Factor
1979	$230	$102	$101	$433
1980	248	110	109	467
1981	270	120	118	508
1982	294	131	129	554
1983	324	144	142	610
1984	342	151	150	643
1985	358	159	158	675
1986	379	169	166	714
1987	396	175	174	745
1988	407	181	179	767
1989	433	193	190	816
1990	455	201	200	856
1991	473	209	208	890
1992	495	219	217	931
1993	513	227	226	966

*As used to determine the special-minimum benefit and the benefit amounts under the antiwindfall-benefits provision (and also by the Railroad Retirement system—see Chapter 12).

The PIA formulas for subsequent cohorts were obtained in a similar manner using the appropriate wage-indexing factors (see Table 2.18). The resulting dollar bands for the various PIA formulas which are applicable to date are shown in Table 2.5. It is interesting to note that, for all years in 1981–89, the third bend point (e.g., $2,044 in 1989) is 51 percent of the maximum taxable earnings base (expressed in monthly terms) for that year. In 1990–93, this relationship changed slightly—to a ratio of 50 percent (as a result of the recognition of certain deferred-compensation payments in computing the nationwide average wage involved in the automatic-adjustment process—see page 182).

The 1992 PIA formula can be manipulated mathematically so that it is as follows:

AIME	*PIA*
$387 or less	90% of AIME
$387–2,333	$224.46 + 32 percent of AIME
$2,333 or more	$621.07 + 15 percent of AIME

The vast majority of steady workers will have AIMEs falling within the second range above. Thus, the OASDI program can be considered, in essence, as a two-tier system of a flat benefit amount and an amount proportionately related to AIME. In 1992 dollars, the PIA is $224 a month, plus 32 percent of AIME.

Illustrative PIAs and benefit amounts for various beneficiary categories for the 1991 cohort for January–November 1992 are shown in Table 2.6 for retired and disabled beneficiaries and in Table 2.7 for survivor beneficiaries.

Because different benefit formulas are applicable to cohorts of different years, there are not necessarily smooth junctions in the benefit structure between those with only slightly different dates of attainment of age 62 (or death or disability) but in different calendar years. Generally, the benefit amounts in such cases will not be greatly different. (See Appendix 2-9 for a more detailed discussion of this subject.)

Regular-Minimum Benefit

Under the law as it was before amendments in 1981, if the PIA formula resulted in a very small amount, there was provision for a

TABLE 2.6. Illustrative Monthly Benefits for Retired and Disabled Workers Who Attain Age 62 or Become Disabled in 1992, Benefits Payable under AIME Formula at January–November 1992 Rates

*Average Indexed Monthly Earnings**	*Worker Alone*	*Worker with Spouse Who Claims Benefit at*		*Worker, Spouse, and One Child‡*	
		Age 62	*Age 65*		
Retired worker aged 65 at time of retirement† or disabled worker§					
$ 400	$ 352.40	$ 484.50 (352.40)	$ 528.60 (352.40)	$ 528.60	(352.40)
600	416.40	572.50 (486.60)	624.60 (510.00)	624.60	(510.00)
800	480.40	660.50	720.60	720.60	(680.00)
1,000	544.40	748.50	816.60	876.80	(816.60)
1,200	608.40	836.50	912.60	1,050.90	(912.60)
1,500	704.40	968.50	1,056.60	1,312.00	(1,056.60)
1,800	800.40	1,100.50	1,200.60	1,453.90	(1,200.60)
2,100	896.40	1,232.50	1,344.60	1,582.50	(1,344.60)
2,400	981.00	1,348.80	1,471.50	1,716.40	(1,471.50)
2,985	1,068.80	1,469.60	1,603.20	1,870.10	(1,603.20)
4,362	1,275.30	1,753.50	1,912.90	2,231.40	(1,912.90)

Retired worker aged 62 at time of retirement

$ 400	$ 281.90	$ 414.00	$ 458.10	$ 458.10
600	333.10	489.20	541.30	541.30
800	384.30	564.40	624.50	624.50
1,000	435.50	639.60	707.70	767.90
1,200	486.70	714.80	790.90	929.90
1,500	563.50	827.60	915.70	1,171.10
1,800	640.30	940.40	1,040.50	1,293.80
2,100	717.10	1,053.20	1,165.30	1,403.20
2,400	784.80	1,152.60	1,275.30	1,520.20
2,985	855.00	1,255.80	1,389.40	1,656.30
4,362	1,020.20	1,498.40	1,657.80	1,976.30

*When AIME is based on earnings before 1977, it is affected by the lower earnings bases then. For example, a person attaining age 62 in January 1992 cannot have an AIME in excess of $2,985 (unless having had a previous disability freeze). However, a person becoming disabled in 1992 at age 24 or under can have an AIME as large as $4,362 for benefits payable in 1992.

†Also applies for worker, spouse, and more than one child and for worker and two or more children.

‡The figures relate to the benefits that would be payable if retirement is deferred until age 65 is attained in 1995, not taking into account any CPI increases occurring after 1991. If the worker retires after age 65, the benefit (but not any additional auxiliary benefit) is increased by the delayed-retirement credit.

§The figures in parentheses relate to disabled workers in the cases where a lower maximum family benefit applies.

Note: The figures in this table do *not* take into account the rounding rules enacted in August 1981 to the extent that the final benefit amount for each beneficiary is rounded down to the next lower $1 (if not already an exact dollar).

TABLE 2.7. Illustrative Monthly Benefits for Survivors for Cases of Death before Age 62 in 1992, Benefits Payable under AIME Formula at January–November 1992 Rates

*Average Indexed Monthly Earnings**	*Disabled Widow Aged 50*†	*Widow Aged 60*†	*Widow Aged 62*†	*Widow Aged 65 or Over*†
$ 400	$ 251.90	$251.90	$ 292.10	$ 352.40
600	297.70	297.70	345.10	416.40
800	343.40	343.40	398.20	480.40
1,000	389.20	389.20	451.30	544.40
1,200	435.00	435.00	504.30	608.40
1,500	503.60	503.60	583.90	704.40
1,800	572.20	572.20	663.50	800.40
2,100	640.90	640.90	743.10	896.40
2,400	701.40	701.40	813.20	981.00
2,985	764.10	764.10	886.00	1,068.80
4,362	911.80	911.80	1,057.20	1,275.30
4,537	930.60	930.60	1,079.00	1,301.60

	Sole Dependent Parent	*One Child*	*Surviving Spouse and One Child*‡	*Maximum Family Benefits*§
$ 400	$ 290.70	$264.30	$ 528.60	$ 528.60
600	343.50	312.30	624.60	624.60
800	396.30	360.30	720.60	720.60
1,000	449.10	408.30	816.60	876.80
1,200	501.90	456.30	912.60	1,050.90
1,500	581.10	528.30	1,056.60	1,312.00
1,800	660.30	600.30	1,200.60	1,453.90
2,100	739.50	672.30	1,344.60	1,582.50
2,400	809.30	735.70	1,471.40	1,716.40
2,985	881.70	801.60	1,603.20	1,870.10
4,362	1,052.10	956.40	1,912.80	2,231.40
4,537	1,073.80	976.20	1,952.40	2,277.50

*When AIME is based on earnings before 1977, it is affected by the lower earnings bases then in effect. For example, a person dying at age 62 in January 1992 cannot have an AIME in excess of $2,985 (unless having had a previous disability freeze or very substantial earnings in 1992), although a person dying at age 29 or under can have an AIME as large as $4,362 (or if earnings in 1992 before death exceed $51,300, an even higher AIME—as much as $4,537 if 1992 earnings are at the maximum earnings base of $55,500).

†Also applies to widowers. Age shown relates to age at time of claim. Amounts shown for widow aged 62 or over might be reduced if deceased worker was receiving a reduced old-age benefit, because of retirement before age 65.

‡Also applies to two children and to two dependent parents.

§Payable to spouse and two or more children and to three or more children.

Note: The figures in this table do *not* take into account the rounding rules enacted in August 1981 to the extent that the final benefit amount for each beneficiary is rounded down to the next lower $1 (if not already an exact dollar).

minimum benefit. The minimum PIA was $122 a month, applicable to AIMEs of $135 or less.[74] In the future, this minimum amount would not change as it relates to initial entitlements of retired workers before age 65 or deaths or disabilities before age 65.[75] However, for the first year that the person would be on the roll and receive a benefit (or for the year of attainment of age 65 for the retired worker, if earlier) and for subsequent years, the PIA would be increased for changes in the CPI, just as are all other benefits under the automatic-adjustment provisions.[76]

This freezing of the regular minimum was done in the 1977 Act; under previous law it was increased by the automatic-adjustment provisions, in step with the rest of the benefit structure. (See Appen-

74. This figure is the minimum PIA applicable for June 1978 ($121.80), rounded up to the next higher even dollar (see Appendix 2-5).

75. For these purposes, "initial entitlement" means the first year for which the individual receives some benefits (after the effect of the earnings test) and not the first year when eligibility occurred (e.g., by attainment of age 62 or more and possession of fully insured status) or the first year of entitlement (e.g., being eligible and filing a claim). Thus, inconsistencies could result for two persons with almost similar circumstances. Suppose that both were retired workers eligible for only the regular-minimum PIA and that one did not receive benefits until age 65 (either because of working substantially at ages 62–64 or because of not filing for benefits until age 65), while the other drew one month of benefits at age 62 and then had benefits suspended due to the earnings test. The former would not receive any of the CPI increases for the years of attainment of ages 62–64, whereas the latter would receive all such increases. The same general procedure applied to survivors who receive benefits based on the regular-minimum benefit—namely, that CPI increases began for the year when a benefit was first received by any individual eligible on the deceased's earnings record. However, an exception applied for widow's and widower's benefits when these are of a deferred nature, and no person was entitled to benefits in the deferred period. For example, in the case of a deceased worker whose PIA was computed under the regular-minimum provision and who left an eligible child and a widow aged 40, the CPI increases applied for the year of death and all subsequent years through the last year that the child was entitled to benefits. If the widow then worked substantially in paid employment until the year of attainment of age 63, her widow's benefit would include all the CPI increases applicable to the child's benefits (even though she may not have received benefits then due to the earnings test), plus those in the year of attainment of age 63 and subsequent years.

76. For example, if an individual was initially entitled to retirement benefits in 1980 (or reached age 65 then and was not initially entitled until later), the regular-minimum PIA applicable was $122 for any periods during January–May 1980 for which benefits were payable; but then it would be increased to $139.50 by the CPI adjustment for June 1980 through May 1981 (regardless of whether the initial-entitlement month in 1980 was after May). After May 1981, the amount would continue to be increased by the CPI adjustments. If the initial-entitlement month was in early 1981, the regular-minimum PIA would be only $122, without any CPI adjustment until June 1981. This illustrates the sharp difference that could occur in the regular-minimum benefit between persons becoming first entitled to it at the beginning of a year and those entitled to it at the end of the previous year.

dix 2-5 for a description of how the previous law operated in this respect.) Such action was taken to lessen relatively, over the years, the windfalls available for individuals whose career employment was not covered under OASDI (primarily government workers) but who managed to obtain minimal covered employment and to qualify for the heavily weighted OASDI benefits for short service and/or low earnings. In other words, although $122 seemed like a significant amount currently, if earnings and prices continue to rise over the years, it would not seem like a sufficient amount to strive for, even if it is a good *relative* actuarial bargain.[77]

The regular-minimum PIA for those attaining age 65 at the beginning of 1981 and first retiring then was $153.10. This was increased to $170.30 for June 1981 and to $182.90 for June 1982. However, legislation enacted in 1981 eliminated completely the regular-minimum benefit for almost all persons who first become eligible for benefits after 1981 (as a result of then attaining age 62, or becoming disabled or dying before age 62).[78] Now, such persons receive whatever PIA which the benefit formula produces (unless they qualify for the special-minimum benefit, described next), which can be as low as $16.70 for the PIA (based on an AIME of $13) for persons first becoming eligible at age 62 in 1992 who had the minimum wages of $50 per quarter in 1968–77 needed to obtain 40 QC. In fact, for persons who are subject to the anti-windfall provision (described later), the PIA in this case would be only $5.20.

77. In the very long run, due to the earnings requirement for a quarter of coverage being increased as wages rise, the minimum PIA would eventually have been phased out, because the minimum earnings needed to obtain the necessary 40 quarters of coverage for fully insured status would produce an AIME in excess of $135.

78. Legislation enacted in August 1981 eliminated the regular-minimum benefit for *all* beneficiaries on the roll effective for March 1982 (and also for new eligibles after October 1981). This caused great political turmoil because it was widely believed (although generally incorrectly) that most of the persons affected were poor. Actually, they were mostly individuals with substantial governmental pensions from noncovered employment who had acquired a small, but sufficient, amount of covered work to qualify for OASDI benefits, or homemakers with sufficient work to qualify on their own earnings record, even though they also qualified (or would, in the future, qualify) for a larger benefit based on their spouse's earnings record. As a result, legislation enacted on December 29, 1981, provided that the regular-minimum benefit provision would continue to be applicable for all persons becoming initially eligible prior to 1982. One small exception to this prospective elimination was made—namely, for members of religious orders who have taken a vow of poverty and whose order had elected to be covered under OASDI-HI before the enactment date, but only if they are first eligible for benefits before 1992. This exception was made because such persons were first eligible for coverage as a result of the 1972 Act (with retroactive coverage possible back to 1968) and, considering the low amount of their presumptive wages (as described earlier in this chapter), had not had the opportunity to build up a substantial earnings record, and thus benefit amount.

Special-Minimum Benefit

The PIA can alternatively be computed under a special-minimum formula based solely on years of coverage, and thus not at all related to earnings. This provision has the purpose of providing reasonably adequate benefits for persons with low earnings but a long period of covered work.[79]

A "year of coverage" is defined as a year in which covered earnings total at least 25 percent of the maximum taxable earnings base for years before 1991 and 15 percent thereof for subsequent years, except that for this purpose the ad hoc increases in the base in 1979–81 are not considered.[80] Rather, for 1979 and after, the bases that would have resulted under the law as it was before the 1977 Act will be used (see Table 2.5).[81] Thus the requirement for a year of coverage is earnings of $9,525 for 1990, $5,940 for 1991, and $6,210 for 1992.

The special-minimum formula for the PIA applicable in December 1991 through November 1992 is approximately $23.90 times the years of coverage in excess of 10, but not in excess of 30. The maximum such special-minimum benefit thus was $478.20 per month.[82]

79. It was developed, in the 1972 Act, to answer the criticism of those who believed that the regular-minimum benefit was too low and wanted to raise it significantly to help low-income workers. Such critics did not realize that the regular-minimum benefit was often obtained by persons with short employment periods under OASDI but long ones in noncovered work (such as for the federal government), who thus obtained windfalls. The institution of the special minimum fully answered such criticisms. The special minimum originally was not made subject to the automatic-adjustment provisions. An ad hoc increase, however, was applied to the resulting benefit amounts under the provisions of the 1973 Act. Then, the 1977 Act made the COLAs applicable to such benefits, effective in 1979, and at the same time increased the benefit rate to the same level as if the COLAs had been applicable at all times in the past.

80. A special rule applies for years before 1951 due to the manner in which the earnings records have been maintained. The total earnings in 1937–50 are divided by $900, and the number of full units of $900 (although, of course, no more than 14 such units) is considered to be the years of coverage in that period. The $900 unit is used, instead of the $750 resulting from taking 25 percent of the $3,000 earnings base in 1937–50, as a partial offset to considering total earnings in the 14-year period rather than a year-by-year analysis.

81. The Secretary of HHS determines these "old-law" bases each year at the same time that the actual bases are promulgated.

82. The amount per year of coverage was initially $8.50, increased to $9.00 by the 1973 Act. In June 1978, if the years were 23 or less, the amount was lower than the "regular" minimum of $121.80. Moreover, the special minimum was also not applicable for those with 24–26 years, because with the minimum qualifying earnings for such years of coverage, the benefit table produced larger amounts. As a result, only 12 persons were on the roll in December 1978 with special-minimum benefits. The 1977 Act reactivated this provision by increasing the rate to $11.50, effective January 1979, and by making the automatic-adjustment provisions applicable. This increase brought the amount to the same relative position held when it was first applicable, taking into account the CPI change during the period. As a result, about 85,000 persons in 1979 had benefits computed under this provision. The dollar factor is not automatically adjusted

This brought the level of the maximum such benefit well above the maximum public assistance level under the Supplemental Security Income program (then $422).

The automatic-adjustment provisions are applicable to the special-minimum benefit in the future. Despite the elimination of the regular-minimum benefit, the special-minimum benefit will not apply for those with years of coverage only slightly in excess of 10. The standard benefit-computation procedure, using the AIME formula, will always produce larger amounts for persons attaining age 62 in 1991 than the special-minimum benefit when the years of coverage are less than 24—and often so too for years of coverage in excess of 23 (because the earnings needed to produce years of coverage will also produce AIMEs which are more than minimal).

Despite the reduction in the basis for determining a year of coverage that is applicable for 1991 and after, in the long range the special-minimum benefit will become less and less likely to be applicable because the increasingly higher earnings needed to produce a year of coverage will result in higher benefits under the regular PIA benefit formula. Eventually, the special-minimum benefit will not be applicable in any case (unless its provisions are changed), because the amounts arising thereunder increase with the CPI, while the amounts arising under the regular benefit formula increase with wages (which, most likely, will rise more rapidly than the CPI over the long run).

Special Computation Procedure for Deferred Widow's and Widower's Benefits

The 1983 Act instituted a new, *alternative* method for the computation of the PIA for deferred widow's and widower's benefits under the AIME method. This is applicable if the insured worker dies before the year he or she would attain age 62 and if the widow(er) has not yet attained age 60 (and will not do so in such year). The provision is applicable only to widow(er)s who first become eligible after 1984.

by CPI increases and then multiplied by years of coverage; instead, the amount for each year-of-coverage group as of January 1979 is multiplied by the CPI increase each time (which gives slightly different results, due to rounding rules). In June 1980, for the 1980 age-62 cohort, the regular minimum of $139.50 was larger than the special minimum for less than 20 years of coverage; for exactly 20 years, the special minimum was not applicable, because the minimum qualifying earnings produced a larger benefit under the standard benefit computation. In early 1981, the regular minimum was larger than the special minimum when the years of coverage were less than 19 (for higher numbers of years of coverage, the standard benefit computation could produce a lower amount than the regular minimum, although for 18 years of coverage and less this method, too, always produced a larger amount than the special minimum).

The alternative method involves the indexing of the earnings record of the deceased worker to the earlier of (1) the year that the worker attained age 60 or would have attained age 60 or (2) the year that the widow(er) will attain age 58 or, if earlier, to the second year before the widow(er) becomes eligible for disabled widow(er)'s benefits (with CPI increases for and after the second year after such year). This is done instead of indexing to the second year before the year of death of the worker (with CPI increases for and after such year of death) as long as the changed indexing year is not earlier than that under the standard method. The same number of computation years are used as in the standard method. This change recognizes that, especially for long periods of deferment, price indexing of the benefit amount will not keep it up to date with living standards as measured by rises in the general level of wages (assuming that the latter increase more rapidly than the CPI, as may be expected over the long run).

As an example, consider the case of a male worker who dies in early 1990 and who has had average earnings in all past years back to 1951 (as shown in Table 2.18). He would have attained age 50 in 1990, and his wife attained age 47 in early 1990. Let us assume that in 1990 and all subsequent years, wages increase at an annual rate of 5½ percent and prices rise at 4 percent per year.

Under the previous, general method (which still applies if it gives a larger benefit), the PIA initially is $722.90 (based on an AIME of $1,614), and the widow's benefits at age 60 (in early 2003) is 71.5 percent of the PIA, increased by the 4-percent COLAs for 1990–2002, or $860. Under the alternative method, the earnings record of the deceased worker is indexed to 2000 (two years before the year in which the worker would have attained age 62, which is *before* the year in which the widow will attain age 58). The resulting AIME is $3,069, and this gives a PIA from the 2002-cohort formula (which is 90 percent of the first $677 of AIME, plus 32 percent of the next $3,401 of AIME, plus 15 percent of AIME in excess of $4,078) of $1,374.70. The widow's benefit at age 60 (in early 2002) is 71.5 percent of the PIA, increased by the 4-percent COLA for 2001—or $1,022. This latter amount is payable in this case, and it is 19 percent higher than what would have been paid under the previous-law procedure.

If the deceased worker's year of birth had been less than two years earlier than that of the widow (i.e., he was less than two years older), then the indexing of the earnings record would have been to 2001, instead of 2000, and there would have been no COLA increase in the initial widow's benefit, payable in early 2003 (in an amount of $1,046) until December 2003.

Minimum and Maximum Family Benefits

Before legislation in 1981, there was a minimum family benefit for survivors (applicable only when there was one such survivor, because in other cases the family benefit would always be larger than the prescribed minimum) of $122 a month, prior to any reduction for a widow or widower claiming benefits before age 65. The general principle was that the minimum family benefit would be the same as the minimum PIA, and as such would not change in the future as to initial entitlements, although thereafter it would be automatically adjusted for changes in the CPI.

The Maximum Family Benefit (MFB) is established for each cohort of beneficiaries for the year of attainment of age 62 or, if earlier, the year of death or of becoming disabled.[83] A more stringent formula applies to persons disabled for the first time in January 1980 or later, as described later.

For the 1979 cohort, the MFB formula, applicable for benefits in January–May 1979, was as follows:

150 percent of the first $230 of PIA, plus
272 percent of the next $102 of PIA, plus
134 percent of the next $101 of PIA, plus
175 percent of PIA in excess of $433[84]

The result was rounded up to the next even 10 cents if not already an even multiple.

This complex, rather strange-appearing formula was derived mathematically to approximate closely what the MFB formula in the law prior to the 1977 Act was expected to produce for each of the various PIAs under that law in early 1979 (see Appendix 2-5 for that MFB formula). This formula for the 1979 cohort is automatically adjusted each time the PIAs are so adjusted, with the first adjustment being for June 1979. The procedure is merely to increase the resulting MFB by the percentage increase in the PIAs on a cumulative basis for any previous such increases, with rounding up to the dime for years

83. For those attaining age 62, dying, or becoming disabled before 1979, the MFB is determined under the provisions of the law as it was prior to the 1977 Act (see Appendix 2-5). If a disability beneficiary recovers from the disability, the cohort for subsequent attainment of age 62 or prior death or disability is based on the year of such subsequent event if the period of recovery (i.e., period of nonentitlement to disability benefits) was at least 12 months.

84. For PIAs of $433 or more, this formula approximately breaks down into merely 175 percent of PIA (as is also true for the MFB formula for all subsequent cohorts as to AIMEs in excess of the last bend point).

up through 1981 and rounding down thereafter. Thus, for any individual or family, the PIA and the MFB increase in tandem over the years.[85]

The MFB formulas for cohorts subsequent to the 1979 one are obtained in the same manner as the PIA formula is changed, with the 1979-cohort formula always being the foundation. Specifically, the 1980-cohort MFB formula was to be obtained from the 1979 formula by increasing (or decreasing, if applicable) each of the four dollar figures by the percentage change in the nationwide average wage from 1977 to 1978, with rounding to the nearest $1.[86] As a result, the MFB formula for the 1980 cohort was determined to be as follows (based on the increase of 7.941 percent in the nationwide average wage from 1977 to 1978, as shown in Table 2.18):

150 percent of the first $248 of PIA, plus
272 percent of the next $110 of PIA, plus
134 percent of the next $109 of PIA, plus
175 percent of PIA in excess of $467

Correspondingly, the MFB formula for the 1981 cohort was based on the increase of 17.384 percent in the nationwide average wage from 1977 to 1979. The MFB formulas for subsequent cohorts were obtained in similar manner (see Table 2.5 for the resulting dollar bands, or bend points). Illustrative results of the MFB formula as it applies to the 1992 cohort for January–November 1992 are shown in Tables 2.6 and 2.7.

It will be noted that, contrary to the general principles of social insurance, the MFB is relatively lower for the smaller PIAs than

85. The MFB for the special-minimum benefits is always 150 percent of the PIA resulting under this provision (except for slight differences due to rounding rules). In early 1979, the fortuitous situation occurred that the maximum special-minimum benefit was $230, which was then the upper end of the first step in the MFB formula. For the 1980 cohort, the second step of this formula began for a PIA of $248, but the largest special-minimum benefit in January–May 1980 was $252.80; thus, a person receiving the latter, but with a "regular" PIA slightly lower, could have a larger MFB if it were based on the "regular" PIA, but did not get it. This anomalous situation occurred because wages rose less than prices in 1979. The same situation as to wage and price trends occurred through 1986 (when the largest special-minimum benefit was $380.90, as compared with first bend point in the MFB formula being $379). Thereafter, the situation was reversed, and the MFB for new special-minimum cases has never been lower than the MFB based on the "regular" PIA of any of such cases.

86. In practice, this is actually done for the cumulative dollar figures of the PIA (i.e., in the 1979-cohort formula, $230, $332, and $433), and each dollar band is then obtained by the appropriate subtraction. The same result will usually be obtained if the dollar bands individually are multiplied by the applicable percentage increase in wages since 1977; the only possible difference is due to rounding.

for the middle and higher ones. Specifically, in the formula for the 1979 cohort, for PIAs of $230 or less (AIMEs of $392 or less), the MFB is 150 percent of the PIA. This ratio then increases gradually until it reaches about 187.5 percent for a PIA of $332 (AIME of $711) and thereafter declines to about 175 percent for PIAs of $433 and above (AIMEs of $1,027 and over). It would logically seem that, at the lower end of the PIA range, the MFB should be 175 percent of the PIA. It could even be argued that the MFB should logically be a uniform percentage of the PIA throughout the entire range, such as the present maximum value of 187.4 percent (which, in the 1992 formula, is applicable to a PIA of $714, arising from an AIME of $1,532). This, however, raises considerations of both cost and the desirability of even higher family benefits for the highest PIAs, where the level already seems excessive relative to prior take-home pay.

The MFB applies to the total benefits payable before account is taken of reductions due to early retirement (i.e., before the NRA for workers, spouses, and widows and widowers) and of the increase in the primary benefit due to the delayed-retirement increment (discussed in the second following subsection), but after account is taken of nonpayment of benefits to one or more beneficiaries in the family group as a result of the earnings test.[87] The benefit payable to a divorced spouse either as a spouse's benefit or as a widow(er)'s benefit is not subject to the MFB (i.e., it is not considered along with other benefits based on the same earnings record in determining whether there will be a reduction due to the MFB), but such a benefit payable to a surviving divorced spouse solely because of an eligible child is subject to the MFB.

As an example of how this operates, consider a worker who retires at age 62 with a wife and two children under age 18 and who has a PIA of $800 (with the corresponding MFB being $1,400). The worker's actual benefit payable is $640, and each auxiliary's benefit rate is $400 (50 percent of $800) *before* the effect of the MFB, or a total of $1,200 for all three auxiliaries. The remainder of the MFB applicable

87. The MFB has a special exception when child survivors are eligible on more than one earnings record, most commonly when both the mother and father die. Under these circumstances of full orphans, the children do not merely draw benefits on the earnings record of the parent who had the higher PIA, thus becoming limited by the corresponding MFB. Rather, the maximum is the sum of the two MFBs, but not in excess of the MFB based on an AIME equal to one twelfth of the maximum taxable earnings base for the year for which the benefit was initially payable, with adjustment for subsequent automatic (or other) increases in benefits. In other cases where not all children involved are eligible on all earnings records—for example, in the case of a couple having children of their own and the husband also having children by a former marriage—there are complicated rules which attempt to give the various children the highest benefits possible.

to them is $600 ($1,400, minus $800), so that each one receives $200 (the $400 rate, times $600 divided by $1,200).

Special Maximum Family Benefit for Disability Cases

Legislation enacted in June 1980 put a cap on disability benefits for persons who become disabled in January 1980 or later. This cap, in reality, is a special lower MFB. It is the *smaller* of 85 percent of the AIME or 150 percent of the PIA, but it can never reduce the family benefit below the PIA. The several bases for the disability MFB for persons disabled in 1992 apply as shown:

AIME	*Basis*
$423 or less	100% of PIA
$424–909	85% of AIME
$910 or more	150% of PIA

The disability MFB is lower than the regular MFB by as much as 33 percent for AIMEs of $424 or less for 1992 cases. This differential falls to about 3 percent for AIMEs of $850–909, then increases to about 25 percent for AIMEs of about $1,510–1,550, and finally drops to 14 percent for AIMEs of $2,209 or more (for which the regular MFB is always 175 percent of the PIA).

This cap was introduced because of the relatively high benefits that could otherwise arise, especially when the possible tax-free nature of disability benefits is considered (see Appendix 2-10). Such a situation, it was believed, could discourage rehabilitation of disabled workers and thus result in higher costs for the program.

It is significant to note that the MFB for the survivor family after a disability beneficiary dies is the regular amount, and not the reduced one resulting under the cap. This may result in a larger benefit being paid after the death of the disabled worker than was paid before then. Although this may seem anomalous, it leads to a better result than if the lower MFB for disability benefits continued through to the survivors. Under such circumstances, a survivor family would be unfairly penalized if the insured worker filed for disability benefits and received them for only a few months before death as against what would have occurred if disability benefits had not been filed for. There would thus often be the question as to whether or not it would be desirable to file for disability benefits (and even the Social Security Administration could not always give sound advice, in advance, on this matter).

The lower MFB for disability is not applicable when the beneficiary reaches the NRA and is converted to an old-age beneficiary. Nor would it be applicable if, at ages between 62 and the NRA, the beneficiary elected to shift to a reduced old-age benefit (which, under some circumstances, could be advantageous).

Illustrative Benefits

Tables 2.6 and 2.7 show illustrative monthly benefits under the AIME method for various beneficiary categories for the 1992 cohort, considering the applicable benefit proportions, the maximum benefit provisions, and the applicable reductions for persons claiming benefits before age 65. The figures in this table do not allow for any effect of the delayed-retirement increment.

Table 2.8 presents further data on the maximum primary benefits possible in early 1992 for men who had retired at age 65 (and, alternatively, age 72) in various past years and who had not had a disability freeze. It shows the effects of the higher earnings bases that have gone into effect over the years and of the change to the age-62 computation point for men, which has gradually raised the level of the primary benefit. This table also shows the initial primary benefit awarded for the age-65 cases.

Considerably larger primary benefits can result for persons who had a disability freeze for some years and then recovered and had maximum covered earnings. As an extreme (and very unlikely) case, consider a man who attained age 65 in early 1991 and had sufficient covered earnings before January 1956, when he became disabled, to qualify for a disability freeze. If he recovered from the disability at the end of 1988 and had maximum covered earnings in 1989–90, his monthly primary benefit in early 1991 would be $1,214.20, or well above the benefit of $1,022.90 for a person who attained age 65 at the same time and had always had maximum covered earnings, who is often cited as the maximum-benefit case. This result is achieved because such individual's benefit-computation years, after allowing for the effect of the disability freeze for 33 years, are only 2 years (despite the indexing of the earnings record tending to offset this).

Table 2.9 compares (1) the primary benefit for a man who has always had maximum creditable earnings and who retires at age 65 at the beginning of the year with (2) his rate of covered earnings, expressed in monthly terms, in the year prior to retirement.[88] This ratio

88. The primary benefits are higher for women who attained age 65 before 1978, because of the shorter period over which their AMW was computed (see Appendix 2-5).

TABLE 2.8. Illustrative Monthly Benefits for Men Who Retired in Various Years at Age 65 or at Age 72 with Maximum Creditable Earnings in All Previous Years, as of Beginning of 1992*

Year of Attainment of Age	Man Retiring at Age 65			Man Retiring at Age 72, Current Benefit†	
		Current Benefit			
	Initial PIA	Unmarried	Married	Unmarried	Married
1972	$ 216.10	$ 777.40	$1,166.00	$ 867.30	$1,296.80
1973	266.10	797.30	1,196.00	900.10	1,341.50
1974	274.60	822.40	1,233.70	946.30	1,405,90
1975	316.30	853.50	1,280.30	1,012.20	1,498.90
1976	364.00	909.00	1,363.50	1,062.10	1,568.30
1977	412.70	968.70	1,453.10	1,106.20	1,628.20
1978	459.80	1,019.20	1,529.50	1,146.10	1,681.80
1979	503.40	1,047.50	1,571.30	1,174.50	1,723.30
1980	572.00	1,083.00	1,624.50	1,216.00	1,784.40
1981	677.00	1,121.40	1,682.10	1,260.70	1,850.10
1982	679.30	1,011.60	1,517.60	1,310.50	1,923.00
1983	709.50	984.00	1,475.90	1,382.80	2,029.20
1984	703.60	942.70	1,414.00	1,455.50	2,135.70
1985	717.10	928.50	1,393.10	1,512.50	2,226.00
1986	760.10	954.50	1,431.80	1,539.10	2,272.00
1987	789.20	978.40	1,467.60	1,580.40	2,333.10
1988	838.60	997.90	1,496.80	1,622.00	2,394.30
1989	899.60	1,029.30	1,544.00	1,393.70	1,999.80
1990	975.00	1,065.60	1,598.40	1,331.60	1,923.30
1991	1,022.90	1,060.70	1,591.00	1,283.80	1,842.00
1992	1,088.70	1,088.70	1,633.00	1,242.20	1,782.30

*These figures do *not* take into account the rounding rules enacted in August 1981 to the extent that the final benefit check is rounded down to the next lower $1 after taking into account the deduction of the SMI premium (if not already an exact dollar). Calculations assume: (1) man attains age at beginning of year and retires then; (2) wife is same age as worker and does not have benefits on her own earnings record. Figures for attainments of age 65 in 1978 and after are also applicable to women workers. For earlier years, figures for women workers are somewhat higher.

†Assumes that no monthly benefits were received before date of retirement, except that, for the 1984 and later cases, benefits could have been received for the month of attainment of age 70 and thereafter (and yet the benefit at age 72 would be as shown).

is frequently referred to as the replacement rate.[89] Such rate was generally between 28 and 32 percent in 1953–79, except for unusual years when the earnings base increased sharply in the previous year (such as 1967, 1969, and 1975) or when the benefit level rose considerably (such as 1959, 1965, and especially 1973).

89. The Office of the Actuary, Social Security Administration, uses a slightly different definition—namely, the ratio of (1) the total primary benefits in the first year of retirement (including, before the 1983 Act changed the COLA date, the automatic

TABLE 2.9. Ratios of Initial Primary Benefit for Man Retiring at Age 65 at Beginning of Year with Maximum Covered Earnings in All Previous Years to His Earnings in Year before Retirement*

Year	*Primary Benefit (on Annual Basis)*	*Earnings Base in Previous Year*	*Ratio*
1953†	$ 1,020.00	$ 3,600	28.3%
1954	1,020.00	3,600	28.3
1955	1,182.00	3,600	32.8
1956	1,220.40	4,200	29.1
1957	1,242.00	4,200	29.6
1958	1,302.00	4,200	31.0
1959	1,392.00	4,200	33.1
1960	1,428.00	4,800	29.8
1961	1,440.00	4,800	30.0
1962	1,452.00	4,800	30.2
1963	1,464.00	4,800	30.5
1964	1,476.00	4,800	30.8
1965	1,580.40	4,800	32.9
1966	1,592.00	4,800	33.2
1967	1,630.80	6,600	24.7
1968	1,656.00	6,600	25.1
1969	1,926.00	7,800	24.7
1970	2,277.60	7,800	29.2
1971	2,557.20	7,800	32.8
1972	2,593.20	7,800	33.2
1973	3,193.20	9,000	35.5
1974	3,295.20	10,800	30.5
1975	3,795.60	13,200	28.8
1976	4,368.00	14,100	31.0
1977	4,952.40	15,300	32.4
1978	5,517.60	16,500	33.4
1979	6,040.80	17,700	34.1
1980	6,864.00	22,900	30.0
1981	8,124.00	25,900	31.4
1982§	8,151.60	29,700	27.4
1983	8,514.00	32,400	26.3
1984	8,443.20	35,700	23.7
1985	8,605.20	37,800	22.8
1986	9,121.20	39,600	23.0
1987	9,470.40	42,000	22.5
1988	10,063.20	43,800	23.0
1989	10,795.20	45,000	24.0
1990	11,700.00	48,000	24.4
1991	12,274.80	51,300	23.9
1992	13,064.40	53,400	24.5

*Figures for attainment of age 65 in 1978 and after are also applicable to women workers. For earlier years, figures for women workers are somewhat higher.

†First year for which "new-start" AMW method was fully available.

§First year for which AIME method was applicable.

The ratio increased steadily for retirements in 1975–79, as a result of both the economic conditions prevailing then (relatively high price rises with wage levels increasing at only a slightly higher rate) and the faulty nature of the automatic-adjustment provisions (as discussed in Chapter 3). The decrease for the 1980 case is due to the sharp increase in the earnings base in 1979, while the lower level for the 1982 case and later cases is the result of the "notch" situation (see Appendix 2-9) and reflects the results of correcting the aforementioned faulty benefit-computation procedures of the 1972 Act. The slowly rising trend after 1984 results from the increasing effect of the relatively higher maximum earnings bases after 1979. Over the long run, the ratio will increase to a level of about 27–28 percent.

In considering replacement rates, it should be kept in mind that these are gross "before taxes and work expenses" rates. Retired persons have lower taxes than do younger employed persons, because OASDI benefits are not usually subject to income tax, except for relatively high-income persons (as will be discussed hereafter), because they have certain special tax privileges, and because no OASDI-HI taxes are payable. They also do not have expenses arising from employment.

As a result, replacement rates can be much less than 100 percent and yet provide full equivalence of income. This will be achieved for the lowest-income persons if such rates are about 85–90 percent, whereas for an average-income person, the corresponding figure would be about 70–75 percent. In turn, such figure would be about 55–60 percent for individuals with an earnings level equal to the maximum taxable base, and it would be increasingly lower for higher-income persons. However, any substantial income supplementing OASDI benefits, in order to raise the OASDI replacement rates to such "equivalence" figures, would be taxable (although at lower average rates than the preretirement income). Later in this chapter, a more detailed analysis of replacement rates is presented on both a gross basis and a net-after-taxes basis (see Appendix 2-10).

At times, in considering replacement rates, a comparison is made

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adjustment in the benefit amount for June and following months and, after the 1983 Act, the adjustment for December only) to (2) the covered earnings in the previous year; the effect of this is to show higher replacement rates (before the 1983 Act, by about 2 percent *relatively* and after the 1983 Act, by ½ percent *relatively* if the CPI is assumed to rise at an annual rate of 4 percent). Other persons, at times, determine the rates for those with earnings above the maximum taxable base on the basis of total earnings, rather than taxable ones. Still others prefer to use some other basis for "final" salary than that in the last year—for example, the average of the last 5 years or the average of the highest 5 years (alternatively, consecutive or nonconsecutive) in the last 10 years.

with the 150-percent benefit rate for a husband and wife combined (both assumed to be age 65 at the initial claim). This is not the typical retirement case for three reasons. First, the wife is usually somewhat younger than the husband. Second, and much more important over the long range, most wives will have primary benefits based on their own earnings records and thus either no wife's benefit or else only small partial ones. The same is true in reverse, and to even a greater extent, with regard to men and husband's benefits. Third, the spouse's benefit is reduced in many instances because of the government-pension-offset provision.

The lump-sum death payment shows no variation by AIME level because it is a flat $255. This amount, first established in 1954, was enacted to limit the amounts payable to undertakers to discourage elaborate funerals, and it has not been changed since then, despite large increases in the general benefit level.

Delayed-Retirement Credit

The primary benefit (for the retired worker) for persons who attain age 65 after 1981 and before 1990 is increased by a Delayed-Retirement Credit (DRC) of ¼ percent for each month (3 percent a year) that the worker does not receive benefits because of the earnings test (described in the next section) or for any other reason, such as not filing a claim in the period beginning with the month of attainment of age 65 and ending with the month before attainment of age 70.[90] For persons attaining age 62 before 1979, the DRC is at the rate of only 1 percent a year.[91] This discrimination is more apparent than real, because the additional 2 percent per year was provided largely to offset the method of indexing earnings to the year of attainment of age 60 (i.e., using subsequent earnings in their actual amounts), and this procedure is not applicable to those who attain age 62 before 1979. In other words, the DRC was *not* increased solely (or even predominantly) as an incentive to continue working.

The 1983 Act further increased the DRC, as a clear incentive for

90. The percentage increase is applied to the PIA *after* it is reduced for any months before age 65 for which benefits were paid. Actually, the 1977 Act created a small anomaly by leaving in the previous age-72 end point when it lowered the age after which the earnings test was applicable from age 72 to 70 (effective in 1982, although later changed to become effective in 1983), and by not also setting an age-70 limit for the DRC when the change became effective for the earnings test. This situation was remedied by the 1983 Act, effective in 1984.

91. The DRC was not given for months before 1971. The reason for this was that, due to the manner in which the records were maintained, it would have been very difficult and costly to do so.

continuing work after the NRA. This is done on a deferred, phased-in basis, applicable to persons attaining age 65 after 1989.[92] (See next table.) Thus the DRC is at the rate of 8 percent per year for persons attaining the NRA in 2009 (when it is age 66) and for those attaining the NRA in subsequent years. It should be noted that the amount of the DRC is based on the year of attaining age 65 (or, equally, on the year of birth) and not on the years when it is earned (although, in the view of the author, it would have been better to have used the latter basis). The eventual value of the DRC (8 percent per year) is not much less than the true actuarial equivalent (about 9 percent), so that it may be said that, after 2008, the earnings test applicable after the NRA has been virtually eliminated from a cost-effect standpoint. Moreover, the DRC will ultimately apply to only three years (between exact ages 67 and 70).

Year of Attaining Age 65	*Normal Retirement Age*	*Annual Rate of DRC after the NRA*
Before 1982	65	1%
1982–89	65	3
1990–91	65	3½
1992–93	65	4
1994–95	65	4½
1996–97	65	5
1998–99	65	5½
2000–01	65	6
2002–03	65/65⅙	6½
2004–05	65⅓/65½	7
2006–07	65⅔/65⅚	7½
2008	66	8

It should be noted that the DRC can be earned at any time from the month of attainment of the NRA through the month before attainment of age 70, regardless of whether benefits have been received in a previous month. Thus it applies to a person who has retired, but who then returns to substantial employment and does not receive benefits for one or more months. Also, a DRC is not earned for any month in which benefits are only partially reduced (and thus not eliminated) by the earnings test.

92. It seems to the author that, in the interest of smoothness and equity, the increases in the annual DRC for year-of-birth cohorts should have been by ¼-percent changes each year, rather than ½-percent changes every other year.

The delayed nature of the increase in the DRC occurred because of cost reasons—that is, to assure to a greater extent the financial viability of the OASDI program in the 1980s.

The DRC applies only to the primary benefit based on the benefit formula and not to the special-minimum benefit based on years of coverage. It is not passed on to benefits for auxiliary beneficiaries or for survivors other than widows or widowers.[93] Also, such increase is not subject to the MFB; it is payable over and above any benefit total that is reduced by the MFB. If the "regular" PIA plus the DRC is larger than the special-minimum PIA, the former amount is payable (but the MFB continues to be based on the latter).

The DRCs earned for a year are recognized for benefit purposes in the check for the next January, except that, for the year of attainment of age 70, they are included in the benefit for the month of such attainment.

An example may be worthwhile to illustrate the interacting effects of the DRC, the reductions for early retirement, the retirement earnings test, and the roundup at the NRA for earlier months when the benefit was reduced, in whole or in part, because of the retirement earnings test. Suppose that Mr. A attained age 62 in July 1989 and initially claimed retirement benefits for January 1991. His benefit then was 90 percent of the PIA (based on an 18-month reduction). However, he returned to work in July 1991 and had his benefits completely withheld for each of the last six months of 1991, under the monthly earnings test. Then, at the end of 1991, he again retired, and his benefit for January–June 1992 was once again 90 percent of the PIA. Beginning with July 1992, when he attained the NRA, the benefit was increased to 93⅓ percent of the PIA by the roundup provision (based on a 12-month reduction).

Next, in January 1993, he returned to work. His benefit was completely withheld for six months of that period, under the annual earnings test, but for the other months of 1993 it was payable at 93⅓ percent of the PIA. Beginning with the benefit for January 1994, the amounts payable became 95.2 percent of the PIA (93⅓ percent increased by 2 percent—6 months of DRC at the applicable 4-percent annual rate).

Table 2.8 presents illustrations of monthly benefits for persons who always had maximum covered earnings and who retired at age 72, or

93. The availability of the DRC for widows and widowers resulted from the 1977 Act. It is interesting that this legislation also eliminated the previously existing anomaly that prevented a person from ever getting any DRC if he or she had received a reduced old-age benefit for a month before age 65, even though he or she had returned to work and had benefits withheld for months after age 65.

first claimed benefits then. This shows the effect of both the DRC and the substitution of years of high earnings after age 62 in computing the benefit (and also the higher age used as the computation point for men attaining age 62 before 1975).

Automatic Adjustment of Benefits

Beginning in 1975, benefits have been automatically adjusted according to increases in the cost of living, as measured by the Consumer Price Index for All Urban Wage Earners and Clerical Workers (CPI-W) developed by the U.S. Department of Labor. If the CPI for a particular base quarter increases from what it was in the previous base quarter, the benefits in payment are increased by the percentage rise (rounded to the nearest 0.1 percent), effective for the next following December.[94] This is accomplished through action of the Secretary of Health and Human Services and must be announced within 30 days after the end of the base quarter—that is, currently by October 30 (see Appendix D). Until 1985 a 3.0-percent "trigger" requirement had to be met, too, or no increase would be made.

The 1983 Act provided that, beginning with the cost-of-living adjustment (COLA) for December 1984, its amount will be based on the increase in nationwide wages if this is less than the CPI rise *if the OASDI Trust Funds have a relatively low balance*. This possible lower ba-

94. The automatic-adjustment provisions as originally enacted in the July 1972 legislation provided for benefit increases being effective for Januarys, beginning with 1975, and based on base quarters of the second quarter of each year. The December 1973 legislation modified this approach by making the increases effective for Junes, with the base quarters being the first quarters. The 1983 Act made the increases effective for Decembers, with the base quarters being the third quarters (the December 1983 COLA was, however, determined from first-quarter base periods; if third-quarter base periods had been used, the COLA would have been 2.5 percent, instead of the actual 3.5 percent). In hindsight, one might ask why the automatic-adjustment provisions as to benefit levels did not become effective for January 1974, instead of a year later. Technically, this would have been quite feasible. Probably it was thought that the nine-month measuring period then resulting would not have been long enough to affect the 3.0-percent trigger (although, in fact, it would have). Had this been done, there probably would not have been the two quickie amendments legislated in 1973. The CPI used is that for all urban wage earners and clerical workers (which has been in existence for many years) rather than the new, more broadly based one for all urban consumers (first introduced in 1978). Generally slightly higher but only marginally different results would occur if the latter were used (e.g. the 9.9-percent increase for June 1979 would instead have been 9.8 percent; the increases for June 1980 and 1981 would not have changed; the increase for June 1982 would have been 0.2 percent higher; the subsequent increases (for Decembers) would have been 0.1 percent higher for 1983, 0.7 percent higher for 1984, 0.3 percent higher for 1985 and 1986, the same for 1987, 0.4 percent higher for 1988, 0.1 percent lower for 1989, and 0.2 percent higher for both 1990 and 1991.

sis for the COLA will be described after the "normal" CPI method has been dealt with.

For persons who attain age 62 after 1978 for whom the "earnings indexing and cohort benefit formula" procedure is used, all CPI increases occurring in and after the year of attaining age 62 are applicable. For example, an individual who attained age 62 in 1990 but who continued working through November 1996 would have the PIA computed under the 1990 benefit formula augmented, on a compound basis, by the CPI increases for the seven years from 1990 to 1996. Similarly, for the 1990 cohort, benefits for December 1990 would include the CPI increase for 1990 regardless whether benefits were first received before December or only beginning then.

The base quarter was initially the second quarter of 1974 (because the 11-percent benefit increase legislated in December 1973 was effective for June 1974). Subsequent base quarters for the automatic operation of this provision were the first quarter of each year for the 1975–83 COLAs and the third quarter in subsequent years. The special-minimum benefit based on years of coverage was originally not affected by this automatic adjustment, but beginning in 1979, it is subject to such adjustment. At all times, this adjustment has applied to the flat-rate benefits for transitional-insured and transitional-noninsured beneficiaries (see Appendix 2-3).

Originally there was a trigger requirement such that the COLA would not be given if the CPI increase is less than 3.0 percent. For example, if this provision had been in effect in 1987–89 (which, as described later, it was not), and if the CPI rose by only 2.8 percent from the third quarter of 1987 to the third quarter of 1988, the latter would not be a base quarter. If the rise measured from the third quarter of 1987 to the third quarter of 1989 was 6.4 percent, the latter would be the new base quarter, and benefits would be increased by this amount, beginning with December 1989, including (illogically) those for new eligibles in 1989. The latter should receive a COLA of only 3.5 percent (the increase from the third quarter of 1988 to the third quarter of 1989).

The 3-percent trigger requirement was waived for the COLA for December 1983 as a result of the 1983 Act. This was done because, in early 1983, it appeared that the CPI might not increase as much as 3.0 percent from the first quarter of 1982 to the first quarter of 1983, and the COLA was to be delayed for six months. As it turned out, this was unnecessary because the CPI rise was 3.5 percent.

In mid-1984 the same situation seemed very likely for the COLA for December 1984. President Reagan proposed that the requirement be waived for this COLA, and Congress so legislated after much con-

troversy as to its being done solely for political reasons. Actually, if the trigger requirement would have been effective in preventing a COLA from being paid, its waiver would have resulted in increased outgo in 1985—amounting to about $5 billion. However, this would have been largely offset by other factors. Approximately one third of the increased outgo would have been offset by the higher tax resulting from the increase in the earnings base (which would also be triggered). The remainder would be counterbalanced over the long run by the resulting elimination of the windfall for new eligibles in 1985 (previously referred to as a general case). As a result of a relatively sharp increase in the CPI for August 1984, this legislation was not effective, because the CPI rise was 3.5 percent. The trigger requirement was established in the 1972 Act for administrative (not fiscal) reasons.

In mid-1986, it appeared almost certain that the 3-percent trigger requirement would not be met for the COLA for December 1986 (as it would not have been, because the actual CPI rise turned out to be only 1.3 percent). Strong bipartisan action resulted in the permanent elimination of this trigger.

The 1983 Act introduced, as a stabilizing device, an alternative method of computing the COLA when the balance of the OASDI Trust Funds is relatively low. Under such circumstances, the COLA may be based on the increase in the nationwide average wage (as measured by the wage-indexing series, as shown in Table 2.18) from the second year preceding the particular year for which the COLA is to be determined (for December) to the year preceding such year. This is done only if such wage increase is smaller than the otherwise applicable increase in the CPI. For example, if the trust-fund ratio were below the specified level, the COLA for December 1985 would be based on the smaller of (1) the increase in the CPI from the third quarter of 1984 to the third quarter of 1985 or (2) the increase in the nationwide average wage from 1983 to 1984.

It should be observed that there is a considerable lag between the periods over which the average-wage change and the CPI change are computed. The reason for this is that the average-wage figures are on an annual basis, and the ones used are the latest available (and no other average-wage data of comparable reliability and accuracy are available).

The relative balance of the trust funds with regard to the use of the "lesser of wages or prices" procedure is determined from the "OASDI fund ratio." Except for the COLA for December 1984, this is defined as being the assets in the OASDI Trust Funds at the beginning of the year for which the December COLA is being determined, expressed

as a percentage of the estimated outgo from such trust funds during the year (including both benefit payments and administrative expenses). For the 1984 COLA only, the assets to be considered are those at the *end* of the year, rather than at the *beginning* of the year.[95]

Not included as "assets" for this purpose are any loans (including accumulated interest thereon) from the HI Trust Fund, except that such loans were to be considered for the COLA for December 1984 as being part of the assets[96] (any loans between the OASI and DI Trust Funds are, of course, completely offsetting). However, if there were any loans from the OASDI Trust Funds to the HI Trust Fund, they would be considered assets of the former. The provision that permitted loans among the trust funds expired at the end of 1987, and any existing loans had to be repaid by the end of 1989 (as they were—in fact, in 1986).

Included as assets are the OASDI taxes for January transferred at the beginning of the month, on an estimated basis, under the so-called normalized tax transfer provision (described later). However, the advance payments, at the beginning of the quarter, of the estimated accrued income taxes on OASDI benefits (described later) are not included as assets.

Not included as "outgo" for this purpose are payments of interest or principal on loans to the OASDI Trust Funds from the HI Trust Fund and any transfer payments from the OASI Trust Fund to the DI Trust Fund, or vice versa. Also, any payments to the Railroad Retirement Account will, for this purpose, be reduced by any payments to the OASDI Trust Funds from the Railroad Retirement Account

95. The different treatment for the 1984 COLA resulted from a historical accident. The original recommendation of the National Commission on Social Security Reform and the House version of the 1983 Act provided that the stabilizing device of "the lesser of wages or prices" would first apply to the 1988 COLA. Those who were not anxious to have such provision go into operation realized that it was less likely to do so for the 1988 COLA if the end-of-year fund balance were used (because it was most likely that the trust funds would increase greatly in 1988, as a result of the large rise in the tax rate in that year). The Senate version of the bill replaced this stabilizer by a much more effective provision—a fail-safe device, which would reduce (or even eliminate) the COLA when the fund ratio was low. The conference committee between the House and Senate compromised this matter by adopting the stabilizing device, but making it effective for the 1984 COLA.

96. The law, as to the special treatment for the COLA for December 1984, was incorrectly drafted in that it did not provide for reducing the balance of the OASDI Trust Funds by the amount of the loan outstanding from the HI Trust Fund (as is done for all subsequent years). On this basis, the promulgated fund ratio was 24.0 percent for this COLA, or well above the trigger point. As it turned out, the fund ratio on the "proper" basis was 17.1 percent, or again above the trigger point. However, if the fund ratio had been below the trigger point, the COLA would still have been based on the CPI increase, because it was lower than the applicable wage increase (3.5 percent versus 4.9 percent).

(e.g., if the financial-interchange provision requires a payment from the OASI Trust Fund to the RR Account and, at the same time, a payment from the RR Account to the DI Trust Fund).

The critical OASDI fund ratio was 15.0 percent with respect to the COLAs for December of 1984–88 and is 20.0 percent thereafter. The Secretary of HHS is to determine the fund ratio before November 1 of the year for which the COLA will apply (for the benefit checks for December). By that time, the actual trust-fund balance will be known (except in the case of the 1984 COLA), and there will be a considerable amount of actual experience data as to the outgo for the year, so that considerable reliability of the result will be present. If the fund ratio is less than the critical amount, the COLA will be based on the "lesser of wages or prices" procedure. Current estimates indicate that only under the pessimistic-cost estimate (Alternative III) will the fund ratio fall below the critical value in the next 40 years, and even then only after 2015.

A "catch-up" procedure is provided to compensate beneficiaries who have been affected by the "lesser of wages or prices" procedure, in that the wage increase was used one or more times in the past. If the OASDI fund ratio at the beginning of a year exceeds 32.0 percent, the COLA for December of that year for persons who, in the past, received a COLA based on wage increases (rather than CPI ones) will be larger than that based on the CPI as determined for that year. The increase in the COLA percentage will be the accumulated percentage "lost" in the COLA as compared with what such cumulative percentage would have been if it had always been based on the CPI (but such increase is subject to sufficient funds being available in the trust funds, as discussed later).

As an example, assume that the COLA for December of Year 1 is based on the wage increase and is 4 percent, instead of the 7 percent based on the CPI rise. Then, suppose that for Years 2 to 5, the COLA is based on CPI increases of 4, 5, 6, and 5 percent, respectively. Finally, in the determination of the COLA for Year 6, the OASDI fund ratio exceeds 32.0 for the first time since Year 1. Beneficiaries who had been affected by the COLA reduction in Year 1 (but not those who first became eligible for COLAs later) would receive an additional COLA for Year 6 which would be 2.9 percent in addition to (and after) the regular COLA for that year.[97]

97. This percentage-points addition to the COLA based on the CPI is derived as follows: The cumulative rate of increase in benefits from Year 1 through Year 5 is 26.40118 percent ($1.04 \times 1.04 \times 1.05 \times 1.06 \times 1.05 - 1$), while the corresponding figure if the COLAs had always been based on the CPI increases is 30.04737 percent.

The full amount of the catch-up percentage would not be given for the COLA for any December if the Secretary of HHS estimates that the OASDI fund ratio will fall below 32.0 percent *at any time* during the next calendar year (not merely at the beginning of the year, or even at the beginning of any month). If such a condition prevails, the additional percentage-points increase for the COLA will be reduced so that the ratio will not fall below 32.0 percent at any time according to the estimate. The 32.0-percent figure was chosen as representing about four months' outgo.

As discussed later, when benefits are increased as a result of the automatic-adjustment provision, the earnings base that determines the maximum amount of earnings creditable for benefit purposes (and also taxable) may also be increased, as are the annual and monthly exempt amounts in the earnings test.

The automatic-adjustment provision is made temporarily inoperative, however, when Congress enacts an across-the-board benefit increase.[98] For example, if such a law is enacted in 1992 and is first effective for benefits payable in a month of that year, the provision would not apply for 1993; the new base period would be the quarter in which the legislated benefit increase is effective. Further, if the benefit increase is first effective for a month in the year after the legislation is enacted, the provision is inapplicable for two calendar years. For example, if the legislation increasing benefits is enacted in October 1992, to be effective for benefits for January 1993, the provision

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The difference between these two figures is 3.64619 percent. When this is divided by the sum of 100 percent and the cumulative actual increase in benefits of 26.40118 percent, the result is 2.885 percent, which is rounded to 2.9 percent. This additional percentage increase is then applied to the next benefit adjustment, on a cumulative basis, after the regular COLA has been applied (assuming that this will not bring the anticipated fund ratio in the next year below the critical level of 32.0 percent).

This produces an equitable result, as may be seen from an example based on the next regular COLA being 4 percent (based on the CPI rise). For those who were affected by the COLA for Year 1 being based on a wage increase, the benefit for Year 5 of 1.2640118 times the benefit before the COLA in Year 1 would first be increased to 1.3145723 of such pre–Year 1 benefit (by multiplication by 1.04) and then to 1.3526949 thereof. The latter figure is very close to the benefit of 1.35249 times the pre–Year 1 benefit which would have resulted if all COLAs had been based on the CPI (the difference being due to the rounding of the additional COLA amount).

98. The legislation enacted in July 1973 that provided a 5.9-percent benefit increase for June–December 1974 (which was subsequently negated and superseded by the increases provided by the December 1973 legislation) specifically stated that this action would not be considered as affecting these provisions for suspending the automatic adjustment of benefits. In other words, the automatic provisions would otherwise have become operative for January 1975, with the 1972 benefit formula being increased on the basis of the rise in the CPI from the third quarter of 1972 to the second quarter of 1974. At the same time, the benefit increase provided by the 1973 legislation would have lapsed and thus have been overridden.

cannot be operative until 1995, and the new base period will be the first quarter of 1993 (which would be compared with the third quarter of 1995). Note, however, that this does not affect any automatic increase for the year of enactment of an ad hoc increase (even if the effective date of the increase were prior to the following January—but even then the ad hoc legislation could, and probably would, eliminate the automatic increase).

The law also provides that Congress should be notified by the Department of Health and Human Services whenever it seems likely that the automatic-adjustment provision will become operative for benefits for the following December.[99] In any event, Congress is to be notified by October 30, when the CPI data for the preceding quarter are available, if an increase is certain. It does not seem at all unlikely that, under such circumstances, Congress would then legislate an increase and thus make the automatic provision inoperative. In this manner, some might say, members of Congress would get the credit for the benefit increase, rather than some actuary or statistician in the executive branch. However, as yet, there has been no attempt to do this.

Benefits would not be decreased if the CPI decreases. Although logically this should be done, political considerations seem to dictate otherwise. In any event, however, historically the CPI has rarely decreased, and even then it soon increased again.

The automatic adjustments that have gone into effect in the past have been as shown in the following table.

Year	*COLA*	*Year*	*COLA*	*Year*	*COLA*
1975	8.0%	1981	11.2%	1987	4.2%
1976	6.4	1982	7.4	1988	4.0
1977	5.9	1983	3.5	1989	4.7
1978	6.5	1984	3.5	1990	5.4
1979	9.9	1985	3.1	1991	3.7
1980	14.3	1986	1.3	1992	3.0

Replacement Rates for Retired Workers

As discussed briefly earlier in this chapter, it is important to analyze replacement rates in considering the relative sizes of OASDI benefits. This can be done most easily by comparing the PIA with the gross earnings immediately before retirement (or disability or death, as the

99. This notification is to be given within five days after the CPI is published for any month, and it has risen by at least 2½ percent over that for the previous base quarter.

case may be); this yields what may be termed the *gross replacement rate*. A perhaps more significant comparison involves the after-tax and after-business-expense figures (taxes not usually being applicable to OASDI benefits); this yields what may be termed the *after-tax replacement rate*. Appendix 2-10 presents analyses of after-tax replacement rates for persons retiring at age 65 under the assumption that the gross replacement rates are those that will ultimately occur under the wage-indexing procedure, according to the data shown in Table 2.10.

Table 2.10 shows projected future gross replacement rates for the PIA for three different earnings histories and three different retirement ages for steadily employed persons whose earnings change at

TABLE 2.10. Ratios of Annualized PIA for Persons Retiring at Beginning of Various Years to Earnings in Year before Retirement

	Age at Retirement		
Year of Retirement	*62*	*65*	*67*
Low-earnings individual			
1973	63.6%[§]	63.6%[§]	63.6%[§]
1978	58.9[†]	61.0[†]	61.0[†]
1979	58.9[‡]	60.9[†]	61.6[†]
1980	58.7[§]	62.9[†]	64.9[†]
1981	61.6[§]	68.1[†]	69.5[†]
1982	62.2[§]	63.0[‡]	71.7[†]
1983	63.3[§]	63.3[§]	75.2[†]
1984	62.5[§]	62.5[§]	63.3[‡]
1985	61.1[§]	61.1[§]	61.1[§]
1990	58.2	58.1[§]	58.1[§]
2000	57.5	56.2	55.1
Ultimate	57.6	56.2	55.5
Average-earnings individual			
1973	38.3%[†]	39.2%[†]	40.1%
1978	43.3[†]	45.0[†]	45.0
1979	43.6[‡]	45.5[†]	46.1
1980	41.3[‡]	47.1[†]	48.7
1981	41.2	51.1[†]	52.6
1982	40.8	46.6[†]	55.4
1983	42.6	45.7	58.5
1984	42.8	42.7	47.4
1985	42.3	40.8	45.3
1990	43.1	43.0	41.3
2000	42.6	42.9	41.1
Ultimate	42.6	42.9	41.1

TABLE 2.10 (continued)

Year of Retirement	Age at Retirement 62	65	67
Maximum-earnings individual			
1973	34.6%†	35.5%†	36.2%†
1978	33.5†	33.4†	33.4†
1979	33.0‡	34.1†	34.5†
1980	26.4‡	30.0†	30.6†
1981	25.0	31.4†	32.0†
1982	24.0	27.4‡	32.4†
1983	24.4	26.3	33.0†
1984	23.5	23.7	26.2
1985	23.5	22.8	25.3
1990	24.2	24.4	23.5
2000	25.8	25.1	24.8
Ultimate	28.4	27.6	27.4

*Not considering the DRCs for those retiring after the NRA or the actuarial reduction for early retirement for the age-62 case and for the ultimate age-65 case. Ratios are based on taxable earnings in previous year.

Note 1: The earnings record prior to 1989 for the average-earnings individual is the actual wage-indexing series used for indexing the earnings record under the AIME method (see Table 2.18). For years after 1988, the earnings for the average worker are those which would be present in such series as it would be under the Alternative II-B assumptions of the 1990 OASDI Trustees Report. The earnings record for the low-wage case is, in all years, 45.0 percent of the earnings of the average-earnings individual. It may be noted that, in 1951–90, the ratio of (a) the legal hourly minimum wage multiplied by 2080 (40 hours per week times 52 weeks) to (b) the nationwide average wage varied from about 35 percent to 59 percent and averaged about 45 percent. Assumed earnings after 1990 are on the basis of the Alternative II-B assumptions in the 1989 OASDI Trustees Report (annual increases ultimately, after 1999, of 5.3 percent), as are the assumed CPI increases (applicable to cases of retirement after age 62), which are assumed to be 4.0 percent after 1993.

Note 2: All benefits are computed under new formula using indexed earnings, except where indicated († denotes not eligible for new formula; ‡ denotes old formula frozen is more favorable than new formula; § denotes that special-minimum benefit is the most favorable method).

Source: Based on data from Office of the Actuary, Social Security Administration.

the same rate as the national average.[100] This table shows the diverse effect of two elements—the AIME benefit-computation methodology and the sharp ad hoc increases in the earnings base in both 1973–74 and 1979–81. Note that, for the age-62 case (and, when applicable,

100. It is important to note that the estimated future figures depend to a small extent on the underlying economic assumptions. Because of the decoupling procedure adopted in the 1977 Act, different assumptions would not produce greatly different replacement rates (see Appendix 2-9).

the age-65 case), the reduction for early retirement is *not* taken into account,[101] nor, for the age-67 case, is consideration given to the DRCs.

Absolute dollar figures for the benefits projected into the future are quite startling, because of the assumptions made about earnings and price increases. For example, for a person retiring at age 65 in the year 2000 who always had maximum taxable earnings, the PIA is $1,644 (or 25.1 percent of the monthly rate of the $78,600 earnings base in the previous year). For the similar case of a person retiring at age 65 in 2050, the PIA is $21,820 (or 27.6 percent of the monthly rate of the $947,400 earnings base in 2049).

Replacement rates are shown for persons who attain various ages in 1973, and then for various years from 1978 on. This is done to demonstrate the results of the faulty benefit-computation procedure adopted in the 1972 Act (as discussed in Appendix 2-9 and Chapter 3). With the exception of the low-earnings individual who retires at age 62 (for whom the effect of the special-minimum benefit is predominant), the replacement rates rise sharply between those who retired in 1973 and those who attained age 62 in 1978 and retired then or at a later age.

The replacement rate drops significantly between those who attain age 62 in 1978 and work several years thereafter and those who attain age 62 in the next few years. (See Appendix 2-9 and Chapter 3 for more detailed discussion of why this "notch" occurs.) For persons with earnings at or below the earnings base in 1978, the decreases vary considerably according to age at retirement. They are only about 5 percent relatively (or less) for retirement at age 62, but about 10–15 percent for retirement at age 65 and somewhat more for retirement at age 67, although for that age, the increased DRC (from 1 percent to 3 percent per year) tends to make up some of the difference. The decreases are—somewhat artificially and nonmeaningfully—more for persons who are at the maximum earnings levels resulting from the ad hoc increases in 1979–81 (as a result of the numerator of the ratio being so much larger, with the higher bases having relatively little effect on the benefit amount).

For any given age at retirement for persons who attain age 62 after 1979–80, the gross replacement rates are very stable for those with average earnings (which was the intent of the new benefit-computation method). For those at the higher earnings bases, the

101. In other words, the resulting PIA is the benefit payable to a person retiring at age 62 who waits until the Normal Retirement Age to draw it (disregarding CPI increases in the year of attaining age 62 and the succeeding years).

rates for retirement at ages 62 and 65 decrease sharply for those who attain age 62 after 1978–79, reaching a minimum in 1985–90 and then rising slowly for subsequent years of retirement until they reach the ultimate level. One reason for this trend is that the earnings bases before 1973 were much lower relatively than the $17,700 in 1978. A more important reason for this trend for those at the higher bases after 1978 is that such bases gradually have more and more effect in increasing the benefit, while at the same time the last year's earnings are rising less rapidly.

The gross replacement rates show an apparently peculiar trend when considered for different ages at retirement in the ultimate condition. The rates for ages at retirement beyond age 62 depend, in part, on the trend in the CPI and its relationship to wage trends. Under the assumptions on which Table 2.10 is based, the *ultimate rates* are lower for retirement at age 65 than for retirement at age 62—as a result of the indexing procedure. (See Appendix 2-9 for more details.) However, the benefit amount in terms of dollars under such circumstances is somewhat larger. (Again, see Appendix 2-9 for more details.)[102] For retirement at age 67, the small decreases in the rates from those at age 65 are more than offset by the effect of the DRC, because this more than offsets the elements that caused the decrease in the rates from age 62 to age 65 (and operate after then as well). It is of great significance that the rates for retirement at age 62 will eventuate in the future virtually *regardless of future wage or CPI trends.* (See Appendix 2-9 for more details.)

There is a very significant drop in the replacement rates for ages at retirement 65 and over as between those who attained age 62 before 1979 and those who attained age 62 later—the so-called notch problem. (See Appendix 2-9 for more details, as well as an explanation.) In fact, for a given age at retirement, the rates rise steadily for later years of retirement for those who attained age 62 before 1979—as a result of the continued use of the old "coupled" method of benefit computation in conjunction with the large increases in the CPI in recent years. For example, for retirement at age 67 for the average-wage case, the replacement rate is 45 percent for retirements in 1978, and it rises to 59 percent for retirements in 1983, before falling to 47

102. Specifically, the PIA at age 62 is compared with the earnings at age 61. If the individual continues working, the AIME will be increased somewhat, and this will produce a larger PIA. In addition, the PIA is higher at age 65 because of the CPI increases in the year of attaining age 62 and in the following two years. At the same time, the earnings at age 64, against which the PIA for retirement at age 65 is measured, are higher than at age 61. The interaction of these several elements produces the effect mentioned.

percent for those in 1984 (from attainments of 62 in 1979) and, eventually, to the ultimate level of 41 percent. This is a vivid illustration of why decoupling of the benefit-computation procedure was necessary, as done by the 1977 Act.

Table 2.10 demonstrates quite well the social-adequacy nature of the benefit formula. For retirement at age 65, the low-earnings individual has gross replacement rates ultimately of about 56 percent, compared with the average-earnings one, who has rates of about 43 percent, and the maximum-earnings one, who has rates of about 28 percent.

When a married couple (both at the NRA) is considered, the ultimate gross replacement rate of 84 percent for the low-earnings case provides about full "equivalent" replacement of preretirement earnings, so that no private-savings supplementation is needed. Similarly, considering the average-earnings case of a married couple with a replacement rate of 64 percent, a small amount of supplementation through private pensions, savings, and/or homeownership is needed to reach the "equivalence" point of 70–75 percent. As mentioned previously, the case of a married couple both at the NRA is not typical.

The examples in Table 2.10 are based on the assumption of level *relative* earnings over the working career. In practice, many persons do not have such an earnings history. The general result is that those with relatively flat histories (other than for general wage-inflation increases) or even somewhat declining ones at the older ages—as in the case of blue-collar or production workers—tend to have higher replacement rates relative to their final salary (however measured) than do those with increasing earnings histories, such as white-collar or professional workers.[103] Appendix 2-9 gives a more detailed analysis of this subject.

Replacement Rates for Disabled Workers

Table 2.11 presents data on gross replacement rates for a young-disability case, also applicable to a young-survivor case. Figures are shown for ages at disablement of both 29 and 24 or under so as to

103. As a specific example, consider two individuals who must compute their AIME over the best 35 years, the ultimate situation. Each of them has, for the best 35 years, 15 years at the nationwide average, 10 years at 90 percent of such average, and 10 years at 110 percent of such average. Both will have the same AIME (100 percent of such average) and thus the *same* PIA. However, if one individual had the high earnings at the end of the working career and the other had the low earnings then, the latter would have a replacement rate which is 22 percent higher than that of the former individual (the same PIA being divided by earnings of 90 percent relatively in the one case and by earnings of 110 percent relatively in the other case).

TABLE 2.11. Ratios of Annualized PIA for Persons Disabled before Age 25 or at Age 29 (or Dying before Age 30), at Beginning of Various Years to Earnings in Year before Disablement (or Death)

Year of Disablement (or Death)	*Disabled at Age 29, Earnings Level**			*Disabled before Age 25 (or Dying before Age 30), Earnings Level**		
	Low	*Average*	*Maximum*	*Low*	*Average*	*Maximum*
1978	79.2%	60.3%	45.3%	79.2%	60.3%	45.3%
1979	57.2	42.7	34.1	57.2	42.7	34.1
1980	55.9	41.6	28.4	56.8	42.5	29.6
1981	55.8	41.5	27.8	56.7	42.4	29.8
1982	55.4	41.2	27.0	56.3	42.2	29.0
1983	57.6	42.8	27.8	58.2	43.3	29.4
1984	57.8	42.9	27.2	58.3	43.4	28.7
1985	57.3	42.6	27.7	57.9	43.2	28.9
1986	58.2	43.2	28.3	58.6	43.6	29.1
1987	58.9	43.7	28.3	59.2	44.0	28.8
1988	57.1	42.4	28.1	57.8	43.1	28.7
1989	57.8	42.9	29.1	58.4	43.4	29.5
1990	57.3	42.6	28.7	57.9	43.2	29.1
Ultimate	57.5	42.7	28.7	58.1	43.3	29.1

*See Note 1 in Table 2.10 for definition of earnings categories and for assumptions as to future economic conditions.

Note: All benefits are computed under new formula using indexed earnings, except for 1978 cases (not eligible for new formula).

bring out the effect of the longer period required under the AIME method for the age-29 case (6 years, rather than only 2 years). The replacement rates, due to a technical fault which was corrected by the 1977 Act, were very high for disabilities occurring before 1979. (See Appendix 2-5 for a more detailed discussion of how this occurred.) In fact, considering the benefits payable when eligible auxiliaries were present, the total-benefits replacement rates in these cases frequently exceeded 100 percent—and even more often, exceeded the "equivalence" level.

The gross replacement rates for these cases of disability (or death) at the young ages are markedly lower after 1978. They tend to stabilize for all future years at about the same level as the ultimate rates for cases of retirement at age 62, which is a logical situation. Nonetheless, the total-benefits replacement rates when maximum family benefits are payable would, prior to the amendments enacted in June 1980, have come close to, or even exceeded, the level of net take-home pay before disability. For example, for the worker with average earnings and two eligible auxiliaries, the total-benefits replacement

rate for the ultimate condition would have been 78 percent, while for the low-earnings case, it would have been 87 percent. Under the revised law, the corresponding figures are 64 and 81 percent, respectively.[104]

Workers' Compensation Offset

When a disabled worker is entitled to Workers' Compensation (WC) monthly benefits or other governmental disability benefits (except needs-tested payments, Veterans Administration benefits, and benefits based on public employment covered by OASDI) as well as to OASDI benefits, an offset may be made against the latter so that the total benefit income will not be so large as to discourage rehabilitation and return to work. This offset does not apply to the disabled worker after disability benefits are automatically converted to old-age benefits at attainment of the NRA, nor does it apply to survivor benefits. Furthermore, the offset is not applicable when the WC program provides for an offset or reduction when OASDI disability benefits are payable (and so provided before February 19, 1981).

In determining the amount of the offset (if any), a new concept is involved—Average Current Earnings (ACE). This is defined as the largest of (1) the Average Monthly Wage (AMW) (even though the PIA is based on an AIME, not on an AMW), (2) the monthly average of *total* earnings in covered employment in the highest five consecutive years since 1950, or (3) one twelfth of the highest annual *total* earnings in covered employment in the period consisting of the year of disablement and the preceding five years. It will be noted that the second and third methods consider earnings without regard to the maximum earnings base. In the vast majority of cases, the third method will produce the most favorable result and will be used.

The offset applies only if the total of the WC or other disability benefit and the OASDI benefit (including auxiliary benefits) exceeds 80 percent of ACE. No increases in the OASDI benefit due to legislation or the general automatic-adjustment provisions are considered for purposes of the offset provision. If such 80 percent of ACE is exceeded, then the OASDI benefit is reduced by such excess, but never to the extent that the total of the WC and OASDI benefits is smaller than the OASDI benefit alone.[105]

104. For the low-earnings case, the regular MFB is 150 percent of the PIA, while the disability MFB is about 141 percent of the PIA (being based on 85 percent of AIME). For the average earnings case, the regular MFB is 182.6 percent of the PIA, while the disability MFB is 150 percent of the PIA.

105. Any offset is applied first to any auxiliary benefits payable (and not to the disabled worker's benefit).

As an example, assume that a disabled worker has an OASDI disability benefit of $260 before offset (including auxiliary benefits), a WC benefit of $100, and an ACE of $400. Then, the OASDI benefit would be reduced to $220 (80 percent of $400, minus $100). If the ACE were $450 or more, no offset would be applicable. Or if the ACE were $300, the OASDI benefit would be reduced to $160, so that the total of WC and OASDI would at least equal the original OASDI amount of $260; the application of the general offset method would have yielded an OASDI benefit after offset of $140 (80 percent of $300, minus $100), or total benefits of only $240.

Every three years, effective for the third January after the year of the first benefit receipt and every third January thereafter, the ACE as initially determined is adjusted to reflect any increases in the general nationwide wage level from the year before the ACE was initially determined to the second year before the particular January. Thus, the limit for the offset based on 80 percent of ACE will increase if earnings rise, and the amount of the offset will be reduced or even eliminated. The adjustment is made in exactly the same manner as is done under the automatic-adjustment provisions for the maximum taxable earnings base. In fact, this procedure used for the WC offset, initiated by the 1965 Act, was the model for such automatic-adjustment provisions enacted in 1972. Table 2.18 presents actual operating data that are used to determine the percentage increases that have been made in these offset cases.

As an example of how the automatic adjustment of ACE operates, consider a worker first entitled to disability benefits in December 1990, with an OASDI benefit of $380 before offset (including auxiliary benefits), a WC benefit of $300, and an ACE of $800. For 1990–92, the OASDI benefit would be reduced to $340 (plus the automatic benefit increases on the unreduced OASDI benefit of $380 based on rises in the CPI). Suppose that average wages increased by 15 percent from 1989 to 1991 and that the benefit increases for December 1991 and December 1992 were both 5 percent (so that the original benefit of $380 increased to $419 for January 1993). The ACE for benefit purposes for 1993–95 will be $920. The benefits will not be offset at all after 1992 (because 80 percent of $920 is more than the sum of the current unreduced OASDI benefit of $419 and the WC benefit, which did not increase, of $300). On the other hand, if the recomputation of the ACE, and the comparison of 80 percent thereof with the WC benefit did not yield a difference equal to the initially reduced benefit, plus the "protected" COLAs, the latter amount would be continued. Of course, if at any time the OASDI family benefit is reduced because one or more auxiliary beneficiaries

are no longer eligible, the offset will be recomputed (and probably eliminated). Furthermore, if the beneficiary reaches age 65 during 1991–92, the offset automatically terminates.

Elimination of Windfall Benefits

Before the enactment of the 1983 Act, it had been possible for individuals to receive both OASDI benefits based on their own covered employment and pensions from government-employee pension plans (federal, state, or local), without any offset or reduction. This created considerable public discussion of the windfalls (or so-called double dipping) involved. (This is dealt with in more detail in Chapters 3 and 5.) The 1983 Act introduced a provision to handle this situation—essentially by providing proportionate benefits in these cases, instead of heavily weighted ones.

The procedure involved in the elimination—or, at least, alleviation—of windfall benefits under the OASDI program for retired and disabled workers who receive pensions based in whole or in part on earnings from noncovered employment after 1956 is rather complicated. In large part, this is so because it attempts to provide equitable treatment to various categories and is gradually phased in. It does not apply to the following categories:

1. Persons who attain age 62 before 1986 or who were eligible for such pension before 1986.
2. Disabled-worker beneficiaries who become disabled before 1986 (and were entitled to such benefits in at least one month in the 12-month period preceding the month of attaining age 62).
3. Persons who have at least 30 "years of coverage" (as defined in connection with the special-minimum benefit, except that the 25-percent factor continues to apply after 1990—see page 87).
4. Persons who were employed by the federal government on January 1, 1984, and were then brought into coverage by the 1983 Act.
5. Persons who were employed by a nonprofit organization on January 1, 1984, which organization had not been covered (by its election) on December 31, 1983, and had not been so covered at any time in the past.

The third exemption above was made so as not to penalize persons, as to their having a windfall OASDI benefit, if they actually had long OASDI coverage *in addition to* the noncovered employment which gave them a pension. The fourth exemption affects primarily mem-

bers of Congress and federal judges who were in office before 1984 and, unlike general federal workers under the Civil Service Retirement system who were in active service at the end of 1983, were covered mandatorily under OASDI in January 1984. The fifth exemption similarly affects persons newly covered on a mandatory basis except for those who were employed by a nonprofit organization that voluntarily withdrew from the OASDI-HI program (and presumably established a substitute plan, which took advantage of the windfall-benefit situation for its employees based on their partial coverage under OASDI-HI).

The pensions considered under this provision are those from *any* type of noncovered employment, and not merely from governmental employment (as is the case for the "spouse public-pension offset," discussed in the next section). Thus, such noncovered employment includes work with nonprofit agencies or work outside of the United States and its affiliated territories. However, employment covered under the Railroad Retirement Act is not considered, for these purposes, to be noncovered employment (because, in essence, it is really covered employment, due to the financial-interchange and other coordinating provisions).

If the "noncovered-employment" pension is based on service before 1957,[106] or if part of the service on which it is based occurred when OASDI-HI coverage applied, only a pro rata portion thereof is considered for the windfall purposes. For example, if an individual worked for a nonprofit organization for the entire period 1954–93, and if such organization was covered under OASDI only during 1960–79 (having withdrawn at the end of 1979) and from 1984 on, then the pro rata portion of the pension considered to be "noncovered" would be 7/40 (1957–59 and 1980–83 being periods of noncoverage).[107]

When the AIME method of benefit computation is used, ultimately the percentage benefit factor applicable to the first band of earnings will be 40 percent, instead of 90 percent. As a transitional matter, persons first becoming eligible in 1986 will have an 80-percent factor, and this will be 70 percent for 1987 eligibles, 60 percent for 1988 eligibles, and 50 percent for 1989 eligibles.

In those few cases where the "old-start" method of benefit computation is used (considering the earnings record back to 1937), the re-

106. This year was taken as the starting point because the members of the armed forces were first covered on a contributory basis then.

107. If the noncovered pension is reduced to provide a survivor benefit, the unreduced amount is considered for the purposes of this provision. Similarly, if a pension is commuted into a lump sum, it will nonetheless be considered as being payable.

sulting PIA will be reduced by 50 percent when a noncovered pension is present.

Further, if the individual has 21–29 years of coverage, the percentage benefit factors will be larger than 40 percent—namely, 85 percent for 29 years, 80 percent for 28 years, and so on, down to 45 percent for 21 years (and, as mentioned previously, the regular 90 percent for 30 or more years). If an individual with less than 30 years of coverage first became eligible in 1986–89, such percentage benefit factor is based on whichever of the two methods yields the higher result. Also, if the PIA is determined under the "special-minimum benefit" procedure, the windfall provision will not apply.

Finally, the resulting modified PIA will never be less than the regular PIA, minus 50 percent of the noncovered-employment pension. The 50-percent factor has no real "logic" behind it; it seems to be merely a "reasonable" figure chosen not to penalize too much those who are affected by the provision.

Let us consider an example of how this provision will operate in the ultimate situation. Consider an individual who attains age 62 in 1990 and who has a noncovered-employment pension of $660 per month from the Civil Service Retirement system (based on coverage during 1955–89).[108] The person has an AIME of $500, based on other employment, but has less than 21 years of coverage.

Under these circumstances, the regular PIA would be $366.40, while the modified PIA (based on a 40-percent factor on the first $356 of AIME) is $188.40, or a reduction of $178.00 (or 49 percent). Because 50 percent of the noncovered pension is larger than $178, the "50-percent maximum reduction" provision would not be applicable. However, if the noncovered pension were only $300, instead of $660, the modified PIA would be $216.40 (instead of $188.40).

Spouse Public-Pension Offset

Until the 1977 Act, eligible spouses of workers insured under OASDI who had retired for age or disability (or had died) had no restrictions on the receipt of both such benefits and government-employee pensions based on their own work. This legislation made significant changes in this area by introducing the Government Pension Offset provision. OASDI benefits for spouses (including surviving spouses) would be reduced on a dollar-for-dollar basis by the amount of any government-employee pension of the spouse based on

108. The actual total pension of $700 is multiplied by 3⅗ to recognize that two years of service were before 1957.

her or his own employment that was not simultaneously covered by OASDI on the last day of employment of such person. It is important to note, however, that this provision does not prevent such spouses from being eligible for HI benefits, even though they may have continuing health insurance from their government-employee plan.

This provision was legislated as a result of court decisions that required equal treatment of spouses regardless of sex (so that dependency could no longer be required for husband's benefits if not required for wife's benefits—and similarly for widow's and widower's benefits). The result of this action by the courts was that large numbers of men would, in the future, qualify for husband's or widower's benefits on the basis of their wife's OASDI earnings record, when they themselves had never been in covered employment but rather had acquired a very sizable government-employee pension. Such a result did not seem socially desirable or politically acceptable.

As a result of the 1977 Act, except for certain "grandfathering" provisions discussed later, an individual who receives a pension from employment with a government entity that is not covered under OASDI[109] will not be able to obtain a full OASDI benefit as a spouse or surviving spouse—and quite often, when such governmental pension is sizable, no OASDI benefit at all.

For spouses who first became eligible for such governmental pensions before July 1983 and are affected by the offset provision (as described subsequently), the OASDI benefit is reduced, on a month-to-month basis, by the full amount of the governmental pension. As a result of the 1983 Act, those becoming so eligible after June 1983 have the reduction based on only two thirds of the governmental pension. The "logic" for this change is that, in general, governmental pensions which are not coordinated with OASDI may be said to represent a combination of a benefit replacing OASDI and a supplementary pension.[110]

109. The determining point as to whether such government entity is covered under OASDI is the status on the last day of employment of the spouse. Thus, if an entity terminated coverage in the past, persons retiring from it thereafter with employment after the termination date would have the offset applicable, even though a substantial part of the service under the plan was simultaneously covered by OASDI. Conversely, the offset would not apply for persons covered under a plan for any period after OASDI was elected, even though a substantial part of the service under the plan was not simultaneously covered by OASDI. This basis, thus, was such as to discourage terminations of OASDI coverage by government entities (which was permitted before 1983) and to encourage new elections of coverage by government entities.

110. Illogically, this change was not made applicable to those affected by the offset who were pre–July 1983 eligibles (the group which pointed out the unfairness of the 100-percent offset!). However, legislation in 1984 remedied this inequity, effective for July 1983.

This change produces a reasonable and equitable situation as compared with that which has always prevailed under OASDI when both the husband and wife had covered employment. Then, no spouse's benefit was payable unless it was larger than the primary benefit (in which case only the excess was payable).

Quite naturally, such a significant provision could, in all equity, be introduced only with some type of savings clause or grandfather provision. All persons who were entitled to OASDI benefits before the month of enactment of this legislation (December 1977) are not subject to it. Also, it does not apply to persons who received a government-employee pension at any time before December 1982 (or are eligible to receive such a pension before then), if their entitlement to the OASDI spouse's, widow's, or widower's benefit would have met the requirements for such benefits as they were being administered in January 1977. This exception was incorporated to protect those persons who, at the time of enactment of the legislation, had been expecting an OASDI benefit based on their spouse's earnings record under the benefit eligibility rules prevailing at the beginning of 1977, but were not receiving it due to their age or because their spouse was not yet receiving OASDI benefits.

This quite complicated exception really means that it applies to all women as spouses, but only to men who can prove dependency on the female covered worker. The court decision eliminating this requirement was made in March 1977. Thus, the reference to the provision as it was administered in January 1977 means that the dependency requirement for men was applicable.

There may be considerable question from a constitutional standpoint as to whether this exception will be held valid by the courts, because it involves unequal treatment by sex. The 1977 Act specifically states that, if the courts do find that this provision is unconstitutional, then the entire exception will become inoperative (except with respect to those who became entitled to the OASDI auxiliary benefits before December 1977), rather than having it be applicable to men without the dependency requirement, as it is for women. Although it seems likely that the provision is unconstitutional, it may never be successfully tested, because no male plaintiff could gain by any legal action (rather, he could only cause female beneficiaries to lose). Actually, such a legal test has been made, but the plaintiff lost.

Legislation enacted in December 1982 provided that persons first becoming eligible for such governmental pensions in the period December 1982 through June 1983 would not be subject to the offset if they could prove dependency on their spouse. Those becoming so eligible after June 1983 have the offset applicable regardless of de-

pendency on their spouse, but, in all cases, only at a two-thirds offset rate. The "logic" of having only a two-thirds reduction is that, broadly speaking, for persons who are under both OASDI and a private pension plan the OASDI benefit represents approximately two thirds of the retirement income. Thus for a person having a pension from noncovered government employment it could be said that, on the average, two thirds of it is the OASDI component.

Restrictions on Payment of Benefits to Prisoners

Legislation enacted in October 1980 restricted the payment of benefits to convicted felons who were inmates of penal institutions. Benefits are not paid on the basis of a disability arising or aggravated during the commission of a felony or while incarcerated therefor. Also, a person convicted of a felony cannot receive child school-attendance benefits (currently available only for attendance at a primary or secondary school while age 18) while in prison. Furthermore, disability benefits not arising from commission of a felony for disabled workers and for disabled-child beneficiaries are suspended for prisoners unless they are actively and satisfactorily participating in a rehabilitation program specifically approved by a court.

The 1983 Act went further and prohibited all payment of benefits to prisoners, except those who were in an approved rehabilitation program. Benefits, however, are paid to the auxiliary beneficiaries.

Earnings Test

Benefits for retired workers and their auxiliaries, for auxiliaries of disabled workers, and for survivors are, in general, not paid when the beneficiary is engaged in substantial employment, nor are benefits paid to the spouse and children of a retired worker engaged in such employment. This provision is sometimes termed the *retirement test*—to some extent a misnomer in regard to young beneficiaries. It might better be termed the *earnings test* or the *work clause*.

Benefits are payable for all months in a year[111] if the annual earnings from all types of employment, whether or not covered by OASDI, are not in excess of the "annual exempt amount" and, as an alterna-

111. For those who have only wages, the consideration is solely on a calendar-year basis, as it is for self-employed persons who file their income tax on such a time basis. For the relatively few self-employed individuals who have a different filing basis for income tax than calendar year, the earnings test is operated on their fiscal year (including any wages they may also have).

tive, for all months after the individual on whose earnings the benefit is based (and whose earnings are being considered for purposes of the test) has attained the "limiting age" (including the month of such attainment). For beneficiaries who are under the NRA, for each full $2 of earnings in excess of the annual exempt amount, benefits payable for the year are reduced by $1. Beginning in 1990, the reduction is on a $1-for-$3 basis for persons who have attained the NRA (then, 65); this change was made in the 1983 Act, with the delay being made so as to assure to a greater extent the financial viability of the OASDI program in the 1980s. A special monthly test is applicable in what might be called the "initial year of claim" if it produces a more favorable benefit than the annual test. In all instances, wages are considered on a "when-earned" basis, rather than on a "when-paid" basis (as applies to the payment of taxes and the crediting on the earnings record for benefit-determination purposes).[112]

If an individual both has wages in a year and has engaged in self-employment but had a loss from such activity, the earnings to be considered for the earnings test are the wages earned in the year minus the self-employment net loss.

The annual exempt amount for 1993 is $7,680 for beneficiaries under the NRA of 65 and $10,560 for those aged 65 and over.[113] The respective figures for earlier years are shown in Table 2.12. The exempt amounts, both for those under the NRA and those at and above the NRA, are automatically adjusted annually, according to changes in the general wage level, in exactly the same manner as the maximum taxable earnings base (as discussed later), except that the special transitional rule was not used for the determination of the retirement-test amounts, but rather the "regular" method based on the indexing average wages was used. Any necessary rounding in the adjustment process is to the nearest even multiple of $120.[114] When an increase in the exempt amount is to be made for a particular cal-

112. This prevents possible manipulation of the earnings test if the "paid" basis were used—as might be done by remuneration being paid only once a year or even once every other year (at the beginning or end of alternate years).

113. Persons who attain the NRA in a particular year (or who, except for dying, would have done so) have the full amount available to them for that year (even though they may live for only part of the year). The NRA as used for the earnings test is that applicable to retired workers and spouses (as noted previously, in some years the NRA for widow(er)s will be slightly lower, and sufficiently so that it will be attained in a year when the NRA for retired workers is not attained—see Table 2.2); such a procedure is desirable for the sake of uniformity (and, besides, there will be few widow(er)s who are not eligible for retired-worker benefits and who are working when near the NRA).

114. For example, the 1978 figure of $3,240 was based on the 1977 figure of $3,000, increased by the rise of 6.9003 percent in average wages between 1975 and 1976 (see Table 2.18). The resulting figure of $3,207.01 was then rounded to $3,240.

TABLE 2.12. Annual Exempt Amounts under Earnings Test for Various Years

Year	*Beneficiaries Aged 65 or Over**	*Beneficiaries under Age 65*
1955–65	$ 1,200	$1,200
1966–67	1,500	1,500
1968–72	1,680	1,680
1973	2,100	2,100
1974	2,400	2,400
1975	2,520	2,520
1976	2,760	2,760
1977	3,000	3,000
1978	4,000†	3,240
1979	4,500†	3,480
1980	5,000†	3,720
1981	5,500†	4,080
1982	6,000†	4,440
1983	6,600	4,920
1984	6,960	5,160
1985	7,320	5,400
1986	7,800	5,760
1987	8,160	6,000
1988	8,400	6,120
1989	8,880	6,480
1990	9,360	6,840
1991	9,720	7,080
1992	10,200	7,440

*In 1955–82, the earnings test did not apply at age 72 and over. Thereafter, it does not apply at age 70 or over.

†These were ad hoc increases, as a result of the 1977 Act.

endar year, the Secretary of HHS must announce it on or before the previous November 1.

As an example of how this provision operates, consider a beneficiary aged 65 or over in 1990 who had earnings of $12,360 in the year. The amount of withholding from all benefits based on the earnings record of such an individual was $1,000 under the annual test (33⅓ percent of the excess of $12,360 over $9,360). Appendix 2-11 gives details on how the withholding of benefits under the annual test takes place in actual administrative practice as between the primary and auxiliary beneficiaries and on which months' benefits are affected. If an auxiliary beneficiary is involved (e.g., a spouse or child of the insured person), any earnings of such beneficiary are applicable to the withholding of his or her benefits and not to those of the insured worker or any other auxiliary beneficiary.

The limiting age beyond which the earnings test does not apply is 70 (before 1983, it was 72).[115] Specifically, a person who attains age 70 in a particular month receives benefits for that month and all later ones regardless of earnings. This provision is really an anomaly. It changes the basis from retirement benefits to annuity benefits, which is not the underlying philosophy of the program. This provision, as discussed in Chapter 3, came about as a result of political compromise when groups were covered who claimed that their members rarely retired and thus would never draw benefits if the "retirement" basis applied without limit as to age.

An alternative monthly test is applicable, generally only in the initial year of claim—that is, for retirement cases, the year of retirement (before 1978, this test was applicable in all years). Specifically, it applies *only* in the first calendar year both in which the individual is entitled to benefits[116] and in which there is a month in the period beginning with the first month of entitlement in which he or she neither has earned wages in excess of one twelfth of the annual exempt amount applicable nor has rendered "substantial services" in self-employment.[117] A clear-cut case of this is a person who completely

115. In the year of attainment of the limiting age, wages earned in and after the month of attainment of that age are disregarded in applying the annual test, while self-employment income for the year is prorated over the months when there was self-employment, and the portion for the month of attainment and thereafter is also disregarded. At the same time, the annual exempt amount is not reduced by prorating. For example, a person who attains age 70 in February 1990 would have the full $9,360 exempt amount. This can result in undeserved windfalls for highly paid persons who attain age 70 early in a calendar year. For example, consider an individual who attains age 70 in February 1990 and who is employed at a salary of $112,000 per year ($9,333 per month). Full benefits will be paid for January (and all later months), because the only earnings which count against the retirement test are the $9,333 for January, and this is less than the $9,360 annual exempt amount applicable. In essence, for situations like this, the earnings test is eliminated at the *beginning* of the year of attaining age 70, not beginning with the month of attaining age 70.

116. If an individual shifts from one type of benefit in one month to another type in the next month (e.g., from disability benefits to old-age benefits, or from widow's benefits to old-age benefits), this does not activate the monthly test.

117. The term *substantial self-employment services* is not defined in the law, but rather by regulations, which are based partly on congressional intent as expressed in committee reports. More than 45 hours of work per month are generally considered substantial, but as few as 15 hours can be so considered if they involve management of a large business or are in a very highly skilled occupation. A special rule applies for self-employed persons who have many of the characteristics of an employee, as in personal-service types of self-employment where monthly earnings are readily determinable and where no significant investment is involved (e.g., ministers). Under these circumstances, more than 45 hours of work in a month are not deemed to be substantial services if the total pay for the month does not exceed one twelfth of the annual exempt amount (applicable, of course, only when the rate of pay is low; for example, for those aged 65 or over in 1990 who work for, say, 60 hours in a month at $13 per hour or less).

retires from a salaried job on attaining age 65 on October 1, 1990, files a claim then, and does not work at all during the remainder of the year.

The monthly test is applicable when, as a result of using it, more benefits are payable for the year. Specifically, under this test, benefits will be paid for all months in the initial year of claim in which both (1) wages earned did not exceed one twelfth of the annual exempt amount applicable, which is $780 in the foregoing case (actually, in the actual operation of the provision, the upper allowable amount is $780.99), and (2) the individual did not render substantial services in self-employment. For example, in the case described in the previous paragraph, if the benefit payable was $800 per month, application of the monthly test would yield a total for the year of $2,400. If the individual had wages of $16,560 or more in January–September, the annual test would have wiped out all benefits for October–December (the benefit reduction being $2,400, or 33⅓ percent of the excess of $16,560 over $9,360).[118] Of course, if the annual test produced a more favorable result—as, for example, if the individual returned to work in December and earned wages of more than $780 but had total wages for the year of $9,660—then it would be applicable. In this case,

118. The individual in this particular case, if earnings were between $27,603 and $29,880 (both inclusive), could avoid this situation—and, in fact, receive partial benefits for September—by filing a claim (for reduced benefits) in January. Then, the "excess" earnings for the year would apply to the reduced benefits for months before October, so that full benefits would be paid for October–December even though those for January through August are withheld. At the same time, the reduction in the benefit amount would be eliminated by the "roundup at NRA" provision. To do so would take careful, informed advance planning.

The 1977 Act prohibited retroactive filing when it would result in reduced benefits, and legislation in 1981 reduced the amount of retroactivity possible from 12 months to 6 months. Nevertheless, it is possible to "work off" some (or even all) of the earnings in the calendar year of retirement (or substantial retirement) at the NRA by the procedure of filing in advance for reduced benefits which are withheld before the month of attaining the NRA as a result of the earnings test. Then, the reduction is restored by the "round up," under which the reduction for retirement before the NRA (made upon attainment of the NRA) does not apply for any prior month for which full benefits were not paid. The Social Security district offices have the practice of assisting claimants to apply in advance in these cases, so as to work off excess earnings prior to retirement.

As a general rule, persons who expect to retire at the NRA, after working substantially in the months preceding attainment of the NRA, are well advised to file claims in January of such year. This should be done so that there will be full benefit retroactivity to the beginning of the year. Then the individual will be able to "work off" the maximum amount of her or his earnings in excess of the annual exempt amount by having benefits withheld from the first of the year. At the same time, little (or no) effect will occur as to their monthly benefit amount but possibly more benefits for that year will result.

Persons who actually retire in a year after that in which they attain the NRA can sometimes benefit under the annual test by retroactive filing back to the beginning of the year of retirement even though they had then been fully employed.

the annual test would produce a benefit reduction of only $100, compared with $800 under the monthly test (i.e., the December benefit).

The monthly test was retained for the initial year of benefits to take care of the typical situation where the individual retires during the year after having had high earnings and then is completely retired during the remainder of the year. The monthly test was eliminated for all later years by the 1977 Act to remedy what were believed to be windfall situations. High-paid persons (such as doctors, lawyers, professors, and teachers) could go on vacation for several full months and collect OASDI benefits for such months despite their high earned income in the year. Yet lower-paid persons who worked steadily throughout the year could not receive any benefits, even though they had smaller annual earnings. The 1977 Act eliminated the monthly test for all persons who had an "initial year of benefits" before 1978, but legislation enacted in October 1980 permitted such individuals to use the monthly test in any one year after 1977.

Nonetheless, the elimination of the monthly test after the initial year of benefits created some new problems, and even anomalies. Self-employed persons who are under the limiting age (70, currently), who retire completely from the operation of their business but who continue to receive income therefrom could not, under the 1977 Act, receive OASDI benefits after the initial year of retirement.[119] Formerly, benefits were payable in such cases under the monthly test for all applicable periods.

Another problem under the 1977 Act was with respect to child beneficiaries whose benefits terminate upon graduation from school in May or June (at age 18 or over, although following legislation in 1981, over the long run all child school-attendance benefits terminate upon attaining age 19). Although they may not have worked at all while in school, and thus had logically received benefits then, if their earnings in the rest of the year after graduation were sufficiently large, the benefits paid would be repayable to the Social Security Administration.[120] The same situation could also occur for widowed

119. Examples of this situation are the small store owner and the life insurance agent receiving renewal commissions. The former could remedy the situation by incorporating or selling the store.

120. For example, if the child's benefit was $200 per month for January–May 1990, and if the child's earnings in the remainder of the year after graduation were $8,840 or more, all $1,000 of the benefits would be repayable. Another strange result of the elimination of the monthly test after the initial claim was that an individual who received survivor benefits at a young age (such as child's or mother's benefits) could not have the advantage of using the monthly test in the initial year of retirement. This situation, however, did not arise for prior receipt of disability benefits. However, the 1980 legislation eliminated this anomaly.

mothers who go off the roll at some time during the year and have high earnings during the remainder of the year.

Legislation enacted in October 1980 remedied the foregoing anomalies retroactively to January 1978. The monthly test was made applicable to mother's, father's, and child's benefits for the year in which benefits are terminated. Self-employment income derived from services performed in or before the first month of entitlement to benefits will not be counted for purposes of the earnings test, except in the initial year of entitlement. Furthermore, if an individual files for Hospital Insurance benefits coverage, it is no longer required that the filing also be for OASDI benefits (so that it could, undesirably in some cases, trigger an "initial year of benefits").

A special test applies to beneficiaries under the limiting age who are outside the country and work in other than covered employment. Under these circumstances, no benefits are paid if the beneficiary works more than 45 hours in a month.[121] This procedure, based on hours of employment rather than on earnings, is necessary because of the widely differing earnings rates among nations.

In the case of survivor families and disability-beneficiary families, the earnings of any beneficiary can affect only his or her own benefit. The earnings test does not apply to disabled-worker, disabled-child, or disabled-widow beneficiaries because they presumably cannot engage in substantial gainful work except in a trial work period while being rehabilitated.[122] For example, if the widowed-mother beneficiary has substantial wages, this will have no effect on the benefits payable to the children (and, in fact, may not even decrease the total

121. Before the 1983 Act, this was on the basis of seven or more days in a month.

122. Although the law does not prescribe any dollar amounts to test whether the disabled beneficiary has demonstrated the ability to engage in substantial gainful activity (and thus no longer be considered disabled), regulations have been established to do this. For 1992, these regulations provide that when, over a period of time, the person (other than blind individuals) has earnings as an employee averaging over $500 a month, this will ordinarily prove that the person is not disabled for benefit purposes. Similarly, if such wages are less than $300, this will not bar a person from benefits, while for wages between $300 and $500, individual consideration of the circumstances will be made. Interestingly, and somewhat anomalously, the $500 amount is less than the monthly exempt amounts in the earnings test for persons under age 65 in 1988 and later. If the individual is working in a sheltered workshop and has earnings averaging $500 or more per month, any "subsidy" will be deducted from such average earnings in the determination of whether the individual has established an ability to engage in substantial gainful activity. The $500 amount was $240 in 1977, $260 in 1978, $280 in 1979, and $300 in 1980–89, while the current $300 amount was $160 in 1977, $170 in 1978, $180 in 1979, and $190 in 1980–89. For blind persons, a higher limit is established statutorily in determining the ability to engage in substantial gainful activity—namely, one twelfth of the annual exempt amount for persons at the NRA under the earnings test, whatever that may be for the particular year.

payable to the family if the maximum family benefit available can be paid on the basis of the children's benefits alone).

In the year of death of the beneficiary, the full annual exempt amount is available (before legislation in 1988, the exempt amount was one-twelfth of the annual exempt amount, times the number of months elapsed, including the month of death), with the $1-for-$2 reduction band (or the $1-for-$3 band for those at or beyond the NRA beginning in 1990) then being applicable. The previous basis produced an anomalous result for a person who earns the annual exempt amount and then stops working, expecting to have no benefits withheld, but who dies during the year. The reduced exempt amount would then result in "excess" earnings and thus the necessity of repayment of some benefits.

Payment of Benefits Abroad

Benefits are not payable abroad under certain circumstances such as when the individual is not a citizen and had only a short period of coverage, when the individual was deported, or when the individual is residing in certain countries where there is no reasonable assurance that checks can be cashed at full value.[123] As a practical matter, however, the various restrictions are so lenient and so easy to overcome that relatively few beneficiaries residing abroad do not receive benefits for which they have met the age and insured-status requirements.

The 1983 Act further provided that auxiliary and survivor benefits with respect to aliens living abroad are suspended after six consecutive months of being outside the United States, unless they had pre-

123. For aliens residing outside the United States and coming on the roll after 1956, benefits are payable beyond six months only if the insured worker had 40 or more QC or resided in the U.S. for 10 or more years, or if the country of which he or she is a citizen has a reciprocity treaty with the U.S. There is a further restriction on the payment of benefits of those aliens who meet the 40-QC or 10-years-of-residence requirement. If their country has a social insurance system of general application, it must pay full benefits to U.S. citizens while they are outside that country, or else OASDI benefits will not be payable to such aliens. The "social insurance system" exception applies to only a few countries (e.g., Iran, Iraq, Libya, New Zealand, Paraguay, Saudi Arabia, and Uruguay). A number of countries changed the provisions of their systems so that their citizens could meet the requirements, and thus reciprocity resulted for U.S. citizens. On the whole, far more aliens were benefited thereby than were U.S. citizens. In the case of countries where it is believed by the U.S. government that beneficiaries may not be able to receive their benefit checks or to negotiate them for their full value (e.g., Cuba, North Korea, and Vietnam), the benefits are withheld in all cases. Such benefits are withheld but are credited to the individual and can subsequently be claimed if conditions change, but with only 12 months' payments for those who are not U.S. citizens. Otherwise, U.S. citizens (and also aliens who were on the roll in 1956) can readily receive benefits while abroad.

viously lived in the United States for at least five years during which their relationship with the insured worker was the same as that on which benefit receipt depends. Children will be deemed to meet such five-year requirement if both parents meet it (or died while in the United States). Children adopted outside the United States will not be paid benefits while living abroad. This provision is not applicable to citizens or residents of countries with which the United States has a treaty or totalization agreement which would prevent its application.

When Monthly Benefits Are Paid

The law provides that the monthly benefit for a particular month is to be paid generally on the third day of the following month (either by a check or by direct deposit in an account at a financial institution). As an exception to this rule, if the third day of a month is on a Saturday, Sunday, or legal holiday, payment is made on the first preceding day that is not a Saturday, Sunday, or legal holiday. Thus, for example, if New Year's Day falls on a Monday, the benefit payments are made on the preceding Friday, December 31—and are so dated. However, for income-tax purposes (as discussed hereafter) such December 31 checks are considered to be paid in January. Also, the statistics of operation of the OASDI Trust Funds are adjusted so as to show the payments as being made in January, rather than December; thus the data are not distorted by showing 13 benefit checks being paid in one calendar year and only 11 in the next.

OASDI Financing Provisions

OASDI benefits and the accompanying administrative expenses are paid out of two separate trust funds. The old-age and survivor benefits come from the Old-Age and Survivors Insurance (OASI) Trust Fund, while the monthly benefits for disabled workers and their dependents come from the Disability Insurance (DI) Trust Fund. The administrative expenses include all of those involved—salaries and fringe-benefit costs for the employees of the Social Security Administration and the Department of the Treasury who deal with the OASDI program; the cost of supplies, postage, equipment, rental of space, travel, and so forth; and the cost of state agencies which make determinations of disability. In addition, two trust funds are maintained for the Medicare program, one for Hospital Insurance (HI) and the other for Supplementary Medical Insurance (SMI) (see Chapter 8).

The question of whether the OASDI program is adequately and

soundly financed following the enactment of the 1983 amendments is discussed in Chapter 3 (and also to some extent in Chapters 4 and 10).

Tax Rates

The income to these trust funds is derived from contributions (taxes) from covered workers and employers, from interest earnings on the invested assets of the trust fund, and from the proceeds from income taxes on a portion (no more than 50 percent) of the OASDI benefits of high-income persons—as described in a subsequent section of this chapter. The total tax income is subdivided so that part is allocated to the DI Trust Fund and the remainder goes to the OASI Trust Fund.[124]

Before 1984, the employer and employee tax rates were always the same. This is also the case after 1984. However, for 1984, the 1983 Act provided that the employer rate would increase from the previously scheduled 6.7 percent to 7.0 percent. It also provided that the employee rate should so increase, but at the same time the employee would receive an *immediate* tax credit of 0.3 percent when the OASDI-HI tax was withheld from wages. The net effect, of course, is exactly the same to the employee as if the employee tax rate had been left at 6.7 percent.

The OASDI Trust Funds, however, received the tax revenues for 1984 that would have resulted if the combined employer-employee rate had been 14.0 percent. This means that the revenues that would have been raised from the "missing" 0.3 percent rate came from general revenues—a subsidy to the OASDI Trust Funds from the General Fund of about $4.5 billion. This is a clear case of "doing it with mirrors"! In the author's view, this was one of the worst features of the 1983 Act, necessary as it may have been to obtain bipartisan consensus.

The DI allocation from the combined employer-employee OASDI rate as a proportion of the total rate for past years and as scheduled for the future is shown in the table on the next page.

The increasing trend following 1967 and especially in the 1970s was the result of the gradually worsening experience (actually, this occurred only until the mid-1970s). The drop in the DI allocation for 1980–81 and 1983–89 was legislated in 1980 and 1983 to alleviate

124. The allocation for the DI Trust Fund with respect to the self-employed for years before 1984 was derived from the allocation for the employer-employee rate multiplied by the ratio of the self-employed total tax rate to the employer-employee total tax rate, with very small rounding differences for 1981–83.

Period	Proportions	Period	Proportions	Period	Proportions
1966	9.1%	1973	11.3%	1982	15.3%
1967	9.0	1974–77	11.6	1983	11.6
1968	12.5	1978	15.3	1984–87	8.8
1969	11.3	1979	14.8	1988–89	8.7
1970	13.1	1980	11.0	1990–99	9.7
1971–72	12.0	1981	12.1	2000 and after	11.5

the short-term financing problems of the OASI Trust Fund (and because the experience of the DI program had turned favorable). (See Chapter 4 for more detailed discussion.) Over the long run, the DI allocation is a relatively higher proportion, reaching 11.5 percent in 2000 and afterward.

The DI allocations with regard to the combined employer-employee tax in various past and future years are shown in Table 2.13, which also shows the OASDI and HI tax rates. The corresponding figures for the self-employed tax rates are presented in Table 2.14.

TABLE 2.13. Past and Future Tax Rates and Taxable Earnings Bases for Employer and Employee Combined

Period	Taxable Earnings Base	Tax Rate			Maximum Employee Annual Tax
		OASDI*	HI	Total	
1937–49	$ 3,000	2.0%	—	2.0%	$ 30.00
1950	3,000	3.0	—	3.0	45.00
1951–53	3,600	3.0	—	3.0	54.00
1954	3,600	4.0	—	4.0	72.00
1955–56	4,200	4.0	—	4.0	84.00
1957–58	4,200	4.5 (0.5)	—	4.5	94.50
1959	4,800	5.0 (0.5)	—	5.0	120.00
1960–61	4,800	6.0 (0.5)	—	6.0	144.00
1962	4,800	6.25 (0.5)	—	6.25	150.00
1963–65	4,800	7.25 (0.5)	—	7.25	174.00
1966	6,600	7.7 (0.7)	0.7%	8.4	277.20
1967	6,600	7.8 (0.7)	1.0	8.8	290.40
1968	7,800	7.6 (0.95)	1.2	8.8	343.20
1969	7,800	8.4 (0.95)	1.2	9.6	374.40
1970	7,800	8.4 (1.1)	1.2	9.6	374.40
1971	7,800	9.2 (1.1)	1.2	10.4	405.60
1972	9,000	9.2 (1.1)	1.2	10.4	468.00
1973	10,800	9.7 (1.1)	2.0	11.7	631.80
1974	13,200	9.9 (1.15)	1.8	11.7	772.20
1975	14,100	9.9 (1.15)	1.8	11.7	824.85

TABLE 2.13 (continued)

Period	Taxable Earnings Base	Tax Rate			Maximum Employee Annual Tax
		OASDI*	HI	Total	
1976	$15,300	9.9% (1.15)	1.8%	11.7%	$ 895.05
1977	16,500	9.9 (1.15)	1.8	11.7	965.25
1978	17,700	10.1 (1.55)	2.0	12.1	1,070.85
1979	22,900	10.16 (1.50)	2.1	12.26	1,403.77
1980	25,900	10.16 (1.12)‡	2.1	12.26	1,587.67
1981	29,700	10.7 (1.30)‡	2.6	13.3	1,975.05
1982	32,400	10.8 (1.65)	2.6	13.4	2,170.80
1983	35,700	10.8 (1.25)	2.6	13.4	2,391.90
1984	37,800	11.4 (1.00)	2.6	14.0§	2,532.60
1985	39,600	11.4 (1.00)	2.7	14.1	2,791.80
1986	42,000	11.4 (1.00)	2.9	14.3	3,003.00
1987	43,800	11.4 (1.00)	2.9	14.3	3,131.70
1988	45,000	12.12 (1.06)	2.9	15.02	3,379.50
1989	48,000	12.12 (1.06)	2.9	15.02	3,604.80
1990	51,300	12.4 (1.20)	2.9	15.3	3,924.45
1991	53,400**	12.4 (1.20)	2.9	15.3	5,123.30
1992	55,500**	12.4 (1.20)	2.9	15.3	5,328.90
1993	57,600**	12.4 (1.20)	2.9	15.3	5,528.70
1994–99	†	12.4 (1.20)	2.9	15.3	†
2000 and after	†	12.4 (1.42)	2.9	15.3	†

*Figure in parentheses is the portion of total OASDI tax that is allocated to DI.

†Base is subject to automatic adjustment after 1981.

‡Before amendments in 1980, the DI allocation for 1980 was the same as for 1979 and that for 1981 was the same as for 1982.

§This is the total rate credited to the trust funds. The total rate actually payable by the employee, after the prescribed tax credit, is 6.7 percent (the same as in 1983), while the employer rate is 7.0 percent, or a total of 13.7 percent, with the difference between that and the 14.0 percent rate coming from general revenues.

**The earnings base for the HI portion of the tax is $125,000 in 1991, $130,200 in 1992, and $135,000 in 1993 (but was the same as for OASDI for all prior years).

Note: Cumulative employee taxes at maximum wages are $46,819.54 for 1937–91 and $46,384.54 for 1951–91.

TABLE 2.14. Past and Future Tax Rates and Taxable Earnings Bases for Self-Employed Persons

Period	Taxable Earnings Base	Tax Rate			Maximum Annual Tax
		OASDI*	HI	Total§	
1951–53	$ 3,600	2.25%	—	2.25%	$ 81.00
1954	3,600	3.00	—	3.00	108.00
1955–56	4,200	3.00	—	3.00	126.00
1957–58	4,200	3.375 (0.375)	—	3.375	141.75
1959	4,800	3.75 (0.375)	—	3.75	180.00

TABLE 2.14 (continued)

Period	Taxable Earnings Base	Tax Rate			Maximum Annual Tax
		OASDI*	HI	Total§	
1960–61	$ 4,800	4.50% (0.375)	—	4.50%	$ 216.00
1962	4,800	4.70 (0.375)	—	4.70	225.60
1963–65	4,800	5.40 (0.375)	—	5.40	259.20
1966	6,600	5.80 (0.525)	0.35%	6.15	405.90
1967	6,600	5.90 (0.525)	0.50	6.40	422.40
1968	7,800	5.80 (0.7125)	0.60	6.40	499.20
1969	7,800	6.30 (0.7125)	0.60	6.90	538.20
1970	7,800	6.30 (0.825)	0.60	6.90	538.20
1971	7,800	6.90 (0.825)	0.60	7.50	585.00
1972	9,000	6.90 (0.825)	0.60	7.50	675.00
1973	10,800	7.00 (0.795)	1.00	8.00	864.00
1974	13,200	7.00 (0.815)	0.90	7.90	1,042.80
1975	14,100	7.00 (0.815)	0.90	7.90	1,113.90
1976	15,300	7.00 (0.815)	0.90	7.90	1,208.70
1977	16,500	7.00 (0.815)	0.90	7.90	1,303.50
1978	17,700	7.10 (1.0900)	1.00	8.10	1,433.70
1979	22,900	7.05 (1.0400)	1.05	8.10	1,854.90
1980	25,900	7.05 (0.7775)‡	1.05	8.10	2,097.90
1981	29,700	8.00 (0.9750)‡	1.30	9.30	2,762.10
1982	32,400	8.05 (1.2375)	1.30	9.35	3,029.40
1983	35,700	8.05 (0.9375)	1.30	9.35	3,337.95
1984	37,800	11.40 (1.00)	2.60	14.00 (11.3)	4,271.40
1985	39,600	11.40 (1.00)	2.70	14.10 (11.8)	4,672.80
1986	42,000	11.40 (1.00)	2.90	14.30 (12.3)	5,166.00
1987	43,800	11.40 (1.00)	2.90	14.30 (12.3)	5,387.40
1988	45,000	12.12 (1.06)	2.90	15.02 (13.02)	5,859.00
1989	48,000	12.12 (1.06)	2.90	15.02 (13.02)	6,249.60
1990	51,300	12.40 (1.20)	2.90	15.30	7,848.90
1991	53,400**	12.40 (1.20)	2.90	15.30	10,246.60
1992	55,500**	12.40 (1.20)	2.90	15.30	10,656.80
1993	57,600**	12.40 (1.20)	2.90	15.30	11,057.40
1994–99	†	12.40 (1.20)	2.90	15.30	†
2000 and after	†	12.40 (1.42)	2.90	15.30	†

*Figure in parentheses is the portion of total OASDI tax that is allocated to DI.

†Base is subject to automatic adjustment after 1981.

‡Before amendments in 1980, the DI allocation for 1980 was the same as for 1979 and that for 1981 was the same as for 1982.

§For 1984–89, the figures represent the rates for the amounts going into the trust funds, while the figures in parentheses are the rates actually payable after the prescribed tax credit is taken into account—with the difference coming from general revenues. For 1990 and after, the tax rates shown apply to a reduced basis for net earnings from self-employment except that, for persons with net earnings at least 8.3% above the earnings base, the tax rates apply to such base; further, an income-tax deduction for 50 percent of the OASDI-HI tax is given.

**The earnings base for the HI portion of the tax is $125,000 for 1991, $130,200 for 1992, and $135,000 for 1993 (but was the same as for OASDI for all prior years).

Note: Cumulative self-employed taxes at maximum earnings are $75,916.15 for 1951–91.

The basis for determining the OASDI self-employed tax rate was, until 1984, 75 percent of the combined employer-employee rate (i.e., 1½ times the employee rate), rounded to the nearest 0.05 percent.[125] In the 1965 Act, a maximum of 7 percent was established for the self-employed OASDI rate on the ground that the tax burden for this category would otherwise be "excessive."[126] In 1973, this limit was reached. The 1977 Act, however, eliminated it, effective for 1981 and after.[127] The 1983 Act provided that, beginning in 1984, the self-employed will pay the full combined employer-employee OASDI-HI tax rate, but with certain reductions or offsets to reflect the fact that employer taxes are counted as business expenses for income-tax purposes. As brought out in Chapter 6, the self-employed HI rate was the same as the HI employee rate from the inception of the program through 1983 but is double it thereafter.

The 1983 Act revised the OASDI-HI tax-rate basis for the self-employed, so that it would be the same as for employers and employees combined. Under this principle, self-employed persons will be in the same position from the standpoint of OASDI-HI taxes whether or not they incorporate their business activity.

In 1984–89, self-employed persons paid the combined employer-employee rate, minus percentage-point credits, so that the rates actually payable were lower, as shown in Table 2.14. These credits were 2.7 percent in 1984, 2.3 percent in 1985, and 2.0 percent in 1986–89. The credits were arbitrarily developed so as to approximate, on the average, at least the net reduction in income-tax liability that employers have with regard to the employer OASDI-HI taxes. The higher credit for 1984 reflects the tax credit given to employees for that year alone—or, actually, their lower net tax rate. The decrease in the credit for 1986–89 as against 1985 is merely a phasing-in to the situation which prevails after 1989.

The use of a uniform percentage-point credit regardless of earnings level favors the low-earnings self-employed as against the high-

125. Before the 1977 Act, the rounding was to the nearest 0.1 percent. The 1982–83 rate of 8.05 percent was not exactly 1½ times the employee rate of 5.4 percent (which would be 8.10 percent). This occurred because the Senate-passed bill, which contained this employee rate, erroneously had a self-employed rate of 8.0 percent, while the House-passed bill had a rate of 8.05 percent (based on an employee rate of 5.35 percent). Accordingly, in the conference committee agreement between the two bodies, when the employee rate was set at 5.4 percent, the highest that the self-employed rate could go was 8.05 percent.

126. This figure was probably selected because it was the employee contribution rate under the federal Civil Service Retirement plan and seemed to represent a relatively high burden.

127. Although the OASDI rate for the self-employed did slightly exceed 7.0 percent in 1978–80, this resulted from the reduction in the HI rate (for both self-employed and employees) then and its shift to OASDI.

earnings ones. Suppose that the basis had been that the self-employed would pay the full employer-employee rate and then be able to count 50 percent thereof as a deduction from their net self-employment income as a business expense for income-tax purposes—as is the general basis after 1989. Then, the deduction is much more valuable to the high-income person than to lower-income ones.

In fact, as the situation was as of 1983, if the individual were in the 50-percent income tax bracket, the result would have been that he or she would be in the same position as to OASDI tax by having such a deduction of half of the tax for income-tax purposes as under the previous self-employment basis of paying 75 percent of the combined employer-employee rate. This does not take into account any further savings of state and local income taxes. On the other hand, the situation would not be as favorable for the high-income self-employed as to the increase in the HI tax-rate basis (i.e., doubling the rate).

As to the receipt of OASDI-HI self-employed taxes by the trust funds in 1984–89, general-revenue funds made up the difference between the amount of tax receipts based on the combined employer-employee OASDI-HI rate and that based on the lower rate actually paid. Although some may view this as a general-revenue subsidy, the author does not believe that such is the case, because the same general situation would result if all self-employed persons were to incorporate.

After 1989 the procedure is somewhat different. The full employer-employee rate is paid by the self-employed, and the proceeds go into the trust funds. However, the self-employed person receives an income-tax credit, as a business expense, for 50 percent of the OASDI-HI taxes paid. Thus general-revenue receipts are lower than if this procedure were not followed. But again no government subsidy is really involved, because the same result would occur if all of the self-employed were to incorporate.

Before 1990, the self-employed tax rate was applied to the net earnings from self-employment, subject to the effect of the maximum taxable earnings base, as has always been the case. However, after 1989, a different procedure is followed, so as to recognize that the total remuneration of employees consists of cash pay *plus* the employer OASDI-HI tax. The procedure followed for the self-employed is to reduce the net earnings from self-employment by an amount equal to the product of the employer tax rate and such net earnings.[128] Of

128. The mathematical procedure prescribed by the law is slightly erroneous. Strictly speaking, the self-employed person's total remuneration (i.e., net earnings from self-employment) for persons below (or slightly above) the earnings base equals the modified net earnings for Social Security purposes minus the OASDI-HI employer tax

course, for self-employed earnings well in excess of the earnings base, the tax will still be based on such base (this being the case, under present law, when net earnings are at least 108.284 percent of the base—that is, 1/(1 − .0765).

An example of how this modified self-employment income is derived may be helpful. Suppose that Ms. A has, for a year after 1989, net earnings from self-employment of $30,000. Then, this is reduced by 7.65 percent, to yield $27,705. The OASDI-HI tax is based on this amount and is $4,238.86, and the net earnings from self-employment to be considered for income-tax purposes is $30,000 minus 50 percent of $4,238.86, or $27,880.57.

As indicated previously, the tax schedule in the law is intended to provide sufficient income to finance the program adequately over a long-range period—75 years. As discussed in more detail in Appendix 4-1 and in Chapter 10, the official cost estimates made in 1983–84 indicated a close actuarial balance as being present, but such is no longer the case (although the lack of balance is not very large).

Taxable Earnings Base

The tax rates are applied to the earned income of the covered worker up to a maximum annual amount, which is termed the *earnings base* (sometimes referred to as the contribution and benefit base). The taxes are levied on wages at the time they are paid, rather than when earned,[129] whereas for self-employment income they are levied on the net earnings in the individual's taxable year. When a worker's annual wage rate exceeds the amount of the earnings base, the taxes are collected on the wages paid on and after January 1 until they equal the base.

The bases applicable in the past are shown in Table 2.13. Projected figures based on the 1992 Trustees Reports are available. Under the intermediate, Alternative II assumptions, the OASDI base will rise to

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rate on such modified earnings. Solving this equation algebraically, one finds that the modified net earnings is the net earnings divided by 1 plus the OASDI-HI employer tax rate (i.e., 1.0765). Furthermore, for 1991 and after (when the HI maximum taxable earnings base is higher than the OASDI one), the use of the 92.35 percent factor is erroneous for instances where earnings are above 108.284 percent of the OASDI base, and only the HI tax rate is applicable (except where earnings are so much above the HI base that such base would be applicable to the modified earnings in any event).

129. Before 1981, if the employer paid the employee's tax, the amount thereof was not considered additional remuneration (which would be further subject to tax) for OASDI-HI purposes. It was, however considered additional income to the employee for income-tax purposes. Generally, after 1980, when the employer pays the employee tax, this is considered wages and is subject to further OASDI-HI tax. (See Appendix 2-13 for details.)

$62,700 in 1995 and $80,400 in 2000. When these estimates are extended for many years into the future, the results are truly mind-boggling—for example, an earnings base of $2,514,000 in 2069. Thus, the compounding effect of continuing inflation has a most important impact.

If a worker is employed by more than one employer during a calendar year (either concurrently or consecutively), the maximum taxable earnings base applies to each one separately. Under these circumstances, the employee receives a refund on the income tax return of the taxes paid in excess of those on the earnings base. No such refund is payable to the employers under such conditions. This procedure is followed in part because of the administrative problems involved and in part because otherwise the personal liberties of the employee would be violated (each employer would then know that the employee was working elsewhere and, to some extent, what the other earnings were).

If a worker is both an employee and self-employed during a year, the taxable self-employment income cannot be larger than the excess, if any, of the earnings base over the taxable wages.

Beginning with 1982, the base is adjusted automatically whenever benefits are similarly adjusted in the previous year. The adjustment for a particular year, however, is based on changes in the average annual wage in the country (in both covered and noncovered employment, as determined from the income tax forms 1040 and W-2), rather than on changes in the CPI (as for benefits). Specifically, for a particular year, if there was an automatic benefit increase for the previous December, the base is that for the previous year multiplied by the increase in the average wage between the second preceding year and the third preceding year, with the result rounded to the nearest $300. Such average wages for past years are shown in Table 2.18, and their derivation is discussed in Appendix 2-8. Legislation enacted on December 19, 1989 made a change in the procedure for determining the earnings base for 1990–92. This was done to recognize that deferred-compensation payments (under qualified "cash or deferred" agreements) have been taxable in 1984 and after for OASDI-HI, but not for income taxes. Such payments have been increasing more rapidly than wages as a whole. Thus, the earnings bases, which were developed from income-tax data, were understated. A transitional rule was developed for the computation of the indexing average wage (as discussed in more detail in Appendix 2-8) as used for this purpose. The net effect of the changed procedure on the earnings base for 1990 was a finally promulgated base of $51,300, as against the originally promulgated one of $50,400.

It should be noted that ever since the HI program began in 1966, through 1990, the earnings bases were the same for OASDI and HI. However, as a result of legislation in 1990, the HI earnings base for 1991 was established at $125,000, whereas the OASDI base became $53,400, under the automatic-adjustment provision. Both bases are subject to the same automatic-adjustment procedure after 1991 and became $55,500 and $130,200 respectively in 1992.

Before 1974 the earnings bases were specifically legislated. During 1975–78 they were derived by automatic-adjustment procedures. Then the 1977 Act provided specific amounts for the bases in 1979–81—far more than would have been derived if the automatics had prevailed.[130] After 1981, the automatics again applied. Appendix 2-12 describes in detail how these provisions will operate in the future and how they have operated in the past.

Relative Magnitude of Tax Rates

The total employer-employee cost of OASDI and HI combined, which was 13.7 percent in 1984, first exceeded 10 percent of covered payroll in 1971 and increased to 15.3 percent in 1990, at which it is scheduled under present law to remain forever (but undoubtedly will not!). There is a real question as to how high this tax burden can increase without either a taxpayer revolt or a serious, destructive effect on the provision of economic security through the private sector.[131] In the early 1960s, both political conservatives and political liberals were asserting that a Social Security tax rate of 10 percent for the employer and employee combined was the absolute maximum!

Interfund Borrowing

The OASI Trust Fund was developing severe cash-flow problems in 1981–82 (as discussed in more detail in Chapters 4 and 10). As a result, legislation in late 1981 provided that the OASI and DI Trust Funds could borrow from each other or from the HI Trust Fund at

130. Determinations of what the earnings base would have been if these ad hoc increases had not been legislated will be made each year for three purposes, namely, (1) for determining years of coverage for the special-minimum benefit and for the antiwindfall-benefits provision; (2) for determining the maximum base for the employer and employee Railroad Retirement tax rates for tier-2 benefits—those in excess of the OASDI benefits (see Chapter 12), and (3) for determining the maximum amount of pension insured by the Pension Benefit Guaranty Corporation under the Employee Retirement Income Security Act of 1974 (see also footnote 81 and Table 2.5).

131. Other taxes, either directly or indirectly as a so-called government subsidy, could be introduced in lieu of increasing payroll taxes. However, no matter what is done, there are still taxes involved!

any time before 1983, repayable with interest at the rate which the lending trust fund would have earned. The committee reports on the legislation (which generally indicate the intent of Congress) prescribed that the amount of the loans should not be any larger than enough to assure prompt payment of benefits through the checks for May 1983.

Such loans to the OASI Trust Fund were needed by November 1982 and amounted to $17.5 billion ($5.1 billion from DI and $12.4 billion from HI) in that month and the next one.

The 1983 Act renewed and extended the interfund borrowing provisions. Borrowing between the OASI, DI, and HI Trust Funds, repayable with appropriate interest, was permitted until December 31, 1987. The interest on loans was required to be paid monthly.

Any loans between OASDI and HI were to be repaid when the "fund ratio" of the borrowing fund (considering OASI and DI as a whole) at a December 31 exceeded 15 percent. "Fund ratio" is defined as the trust-fund balance on that date (after deducting any loans from the other trust fund) as a percentage of estimated outgo for the coming year. Such outgo is exclusive of any payments on loans from the other trust fund (either interest or principal) and of any transfers between the OASI and DI Trust Funds and netting out any payment *from* the Railroad Retirement Account to either of the trust funds under the financial interchange provisions against any payments *to* such account from either one. (Note that this is a slightly different definition of "fund ratio" than is used for triggering the "lesser of wages or prices" provision for the COLAs, because the advance tax transfers are not considered. See also Appendix E.)

No specific provision was present as to repayment of loans between OASI and DI, except that such repayment must be made before 1990. Presumably, this could be done at any time that monies are available.

No loans could be made by OASDI to HI in a particular month when the OASDI fund ratio at the end of the second preceding month was less than 10 percent. For such purposes, in determining the fund ratio, the annual outgo was taken as 12 times the outgo (on the basis described above) for the month for which the determination was made, and the fund balance could not count any outstanding loans to other trust funds (loans between OASI and DI thus were self-canceling). Note that this is a different definition than is used for the fund ratio for repayment of loans. The same applied in reverse for loans from HI to OASDI.

All loans between trust funds must have been repaid before 1990. As between OASDI and HI, any loan balance as of January 1, 1988, must have been liquidated in the next 24 months. The monthly pay-

ment for a particular month must have been at least equal to (*a*) the outstanding balance of the loan, including accrued interest, at the beginning of the month, divided by (*b*) the number of months remaining before 1990. Thus, at a minimum, the payment each month would be 1/24 of the loan balance on January 1, 1988, plus interest for the previous month on the loan balance for that month (after the payment for that month is taken into account). Because of the declining loan balance (and, accordingly, the interest thereon), the total payments would not be the same each month, but rather would be of a slowly decreasing nature.

Near the end of 1982, it was necessary for the OASI Trust Fund to borrow money in order to pay monthly benefits on time. Loans of $5.1 billion from the DI Trust Fund and $12.4 billion from the HI Trust Fund were obtained. Beginning in 1985, repayments were made by the OASI Trust Fund; the debts to the HI Trust Fund were completely liquidated in January 1986 and to the DI Trust Fund in April 1986.

Normalized or Advance Tax Transfers

The 1983 Act provided for so-called normalized tax transfers (or advance monthly tax transfers) for OASDI (and for HI as well). This is a euphemism for what are really one-month loans, repayable with appropriate interest. What is done is to make available at the beginning of each month the estimated payroll taxes to be collected in that month from the self-employed and from all employers (and their employees).[132] The purpose of this, insofar as the OASDI program is concerned, is to help to meet the cash-flow problem that arises at the beginning of the month, when the vast majority of benefit checks go out. Through this means, the OASDI Trust Funds can pay benefits on time with smaller balances than would otherwise be necessary—one of the several means by which the short-range financing problem was alleviated. In the author's view, this procedure does not involve real (and undesirable) general-revenue financing of OASDI.

Legislation in 1984 eliminated this procedure for HI as being unnecessary (because its monthly pattern of outgo is relatively level). Legislation in 1990 eliminated this procedure likewise for OASDI, except that it can be reinstituted if the Secretary of the Treasury de-

132. Before 1987 the payments from state and local governments for their covered employees were not included because they are not collected by the Internal Revenue Service, but instead go directly to the trust funds through the SSA and the Secretary of the Treasury.

termines that it is necessary to assure sufficient funds to meet current benefit obligations.

Effect on Unified Budget

The operations of the OASDI Trust Funds were, according to the 1983 Amendments, to be included in the unified budget of the U.S. government for fiscal years before 1993. Then and thereafter, such operations would not be so included. However, legislation in 1986 advanced this date, to be effective for fiscal year 1986 and after; virtually nullifying this action, however, it was legislated concurrently that the operations of the OASDI Trust Funds would be included in determining whether the deficit-reduction targets under the Gramm-Rudman-Hollings Act are met. Then, legislation in 1990 provided that the operations of the OASDI Trust Funds should be completed "off-budget" and should be removed from the budget-deficit estimates and the calculations made in the requestration process. For more detailed discussion of this subject, see Chapter 4.

The legislation in 1990 also added so-called fire-wall provisions in an attempt to assure that any benefit or tax changes made would not adversely affect the financial status of the OASDI system. In particular, a point of order can be raised against the legislative consideration of any proposal that does not meet certain fiscal requirements, with differing requirements between the House and the Senate. It should be recognized, however, that various parliamentary procedures and maneuvers are possible to override a point of order.

The House requirements are (1) that, if the benefit changes have a net increase in long-range cost of over 0.02 percent of taxable payroll, such excess cost over 0.02 percent must be met by increased tax income, and (2) that, if, over the next 5 years, net benefit outgo is estimated to increase by more than $250 million, then increased tax income must be provided to make the net balance be $250 million or less. Further, these requirements apply in a similar manner to reductions in OASDI taxes (taking into account, at the same time, any accompanying increases), considering both the 75-year and 5-year periods; however, a decrease in OASDI taxes and a corresponding increase in HI taxes would not violate this requirement.

The Senate requirements are more general and apply only to the short-range future. They prohibit, as being out of order, the consideration of any budget resolution calling for a reduction in the excess of OASDI income over outgo and, after action has been completed on a concurrent budget resolution, the consideration of any other legislation that would have such effect.

The author believes that, on the whole, these requirements are desirable in their effort to assure fiscal responsibility in connection with proposals to change OASDI benefit and/or financing provisions. However, these requirements should really not apply to the short range, because what is important in a social insurance system is the long-range financial status.

Both the House and Senate requirements would seem to prevent the consideration of the Moynihan proposal to lower near-future tax rates and to increase long-term rates (so as to place the program on a pay-as-you-go basis), because although it would more than meet the long-range requirements, it would fail the short-range ones (for more details, see page 390). However, there are parliamentary procedure methods by which these requirements can be avoided or overcome.

Investment of Assets

The assets of the trust funds are invested by the Secretary of the Treasury solely in U.S. government obligations, except for a relatively small cash working balance. The securities can be any of three types—obligations bought on the open market, obligations bought at issue (as part of a new issue offered to the public), and special issues. In the actual operations in the past, most investments have been in special issues. The law provides that the special issues shall bear an interest rate equal to the average market yield rate on all U.S. government obligations with at least four years to go until earliest maturity (as of the issuance date of the special issue), rounded to the nearest ⅛ percent. There is no specific provision as to the period until maturity for the special issues, but in practice it is attempted to have them in a maturity schedule spread equally over a period of 15 years.[133] Investment is also permitted in debt obligations that are guaranteed as to both principal and interest by the U.S. government, such as those of the Government National Mortgage Association (commonly referred to as "Ginnie Mae").[134]

133. In actual operation, monies made available for investment during the 12-month period ending June 30 are placed into certificates maturing at that time. Then, the proceeds from the certificates are invested in bonds (at the special-issues interest rate then prevailing), with maturities spread out as much as possible to achieve the result of equal amounts maturing in each of the next 15 years for the total portfolio (including previous years' investments). If at any time during the fiscal year money is needed because current income is less than current outgo, the short-term certificates on hand are redeemed first, using those with the lowest interest rates. If no certificates are available, then the bonds with the shortest time until maturity are redeemed.

134. Over the years, facilities for the SSA have been constructed in various cities, with the largest such costs being for the headquarters buildings in Baltimore. Although under generally accepted accounting principles these would be reported as assets of

The special issues are redeemable at par when this is necessary—for example, to make benefit payments. This can be either advantageous or disadvantageous to the trust funds as compared with what would occur if marketable securities were held and then sold on the open market. If, at the time of sale, the level of interest rates was lower than when the securities were bought or issued, the market value would be higher than the cost price, and a profit would be made—and vice versa if the level of interest rates at the time of sale were higher. In any event, the procedure in the law seems equitable to both the trust funds and the General Fund.

Current monies available are invested in short-term certificates of indebtedness (special issues) maturing at the next June 30. On that date, all amounts maturing are invested in special-issue bonds, whose maturities are established so that, in conjunction with the existing long-term special-issue bonds, as nearly as possible the portfolio is equally invested over the next 15 years insofar as the maturities are concerned. Whenever securities must be redeemed before maturity, those nearest to maturity are redeemed first.

A question is sometimes raised about the validity of the trust-fund investments, on the grounds that the investment procedure is "merely borrowing from one's self and writing a piece of paper to prove it." Actually, the investments are valid and are, in fact, considered as part of the National Debt.

In this connection, an interesting event occurred in 1985, when the National Debt approached the debt limit. In order to keep the government operating from September to November, some of the investments of the OASDI Trust Funds (and other trust funds as well, including the two Medicare funds) were "dis-invested"—held as non-interest-bearing cash balances. Quite naturally, this action created a public uproar. However, all was properly settled by legislation in December that restored the status quo of all the trust funds involved, as to both the specific investment instruments and the interest lost.

Administration of OASDI

The OASDI system is, with one exception, administered by the Social Security Administration (SSA) in the Department of Health and Hu-

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the trust funds, with later appropriate amortization, instead they have been shown as current expenses. To this extent, the assets are understated and current administrative expenses are overstated; this will be offset in the future, however, by lower reported administrative expenses. In fiscal years 1977–81, such expenditures averaged about $15 million per year, but they were $27 million in 1982 and $41 million in 1983, but fell off to $6 million in 1984 and $3 million in 1985 (and were zero after 1985).

man Services (until May 1980, the Department of Health, Education, and Welfare). The earnings records are maintained in a central office in Baltimore, Maryland. SSA staff members in about 1,300 district and branch offices make personal contacts with covered workers and their employers, and perform other functions such as assigning account numbers, receiving and adjudicating claims applications, and giving out information. In addition, SSA has a toll-free (800) telephone number and 37 teleservice centers.

The SSA provides, without charge and upon request, a statement showing year-by-year credited earnings and OASDI-HI employees taxes thereon, total number of quarters of coverage, and illustrative benefits. These benefits are shown for the occurrence of death or disability in the current year and for a projection of the retirement benefits at the person's planned retirement age, at the Normal Retirement Age, and at age 70.

The projected retirement benefits are, quite properly, expressed in terms of current dollars. This is done by introducing an assumption as to future earnings that an increase of 1 percent per year (not compounded) will occur for each year up until age 62 for each individual considered, using the current-year earnings as the base. At the same time, the current-year PIA formula is used unchanged, and no COLAs are assumed. This results in showing benefit estimates which give the impression of being unrealistically high for young workers in relation to their current earnings. The remedy to this undesirable situation would be to show the resulting earnings for the last year before the assumed retirement date.

As a result of legislation in 1989–90, the law provides that the SSA shall provide such earnings and benefit-estimate statements to certain categories of persons who have any earnings record, on an automatic basis. The statements will be mailed to the latest known address, with SSA being allowed to obtain addresses from the Treasury Department (from income-tax records). Before October 1995, this must be done for all persons who attain age 60 before then and are not already receiving benefits. In each of the next four 12-month periods after September 1995, this must be done for persons who attain age 60 in such period and are not already receiving benefits. Then, beginning not later than October 1, 1999, this must be done *annually* for all persons aged 25 or over who are not in receipt of benefits.

Earnings records are maintained through the use of Social Security numbers, which each person who has covered wages or self-employment income should have. These numbers consist of nine digits, of which the first three indicate the geographical area where the number was applied for (except that those applying for a number when being

a railroad worker have a special three-digit series). Many people obtain account numbers even though they are not in covered employ; often, this is for identification purposes and is in fact required therefor for income-tax filing. Also, all children aged 1 or over who are claimed as dependents in connection with income taxes must have an account number (and frequently these are obtained by the parents at the birth of the child); this requirement was introduced in 1988, with a limiting age of 5, which was gradually lowered to the present limit of age 1.

The Treasury Department collects the taxes, prepares the benefit checks according to the certifications of the Social Security Administration, and maintains the OASI and DI Trust Funds. The SSA has the responsibility for preparing the actuarial cost estimates that monitor the long-term financial soundness of the system and provide the basis for the tax schedule in the existing law and as may be needed for proposed changes in the program.

The trust funds are the general responsibility of the Board of Trustees, which, until the 1983 Act, was composed of the Secretary of the Treasury, the Secretary of Labor, and the Secretary of Health and Human Services. The 1983 Act provided that there should also be two public members (of different political parties). The Secretary of the Treasury serves as managing trustee and has the responsibility for the operation of the trust funds (including making the investments, holding the investments, and accounting for the financial operations). The trustees make an annual report, required to be submitted by April 1 (although since 1970 this requirement has been complied with only three times, although in some other years it was missed by only a few days), which contains both an analysis of the long-range actuarial status of the system and estimates of its operation during the next five fiscal years, along with an actuarial opinion, which certifies that the techniques and methodology used are generally accepted within the actuarial profession and that the assumptions, other than the economic ones, are reasonable. The board also is authorized to recommend changes in the program, especially as to financing matters. Furthermore, the board is to report immediately to Congress whenever it believes that the size of either trust fund is too low (such a report has never been made).

The 1983 Act further requires that the board must report to Congress whenever the "balance ratio" (the same as the more commonly used "contingency fund ratio," except as to the treatment of any interfund loans) for either the OASI or DI Trust Funds (and for the two Medicare trust funds as well) is estimated to be less than 20 percent. Such balance ratio is the balance in the trust fund at the beginning of

the year (after deducting any loans from other trust funds, but including as assets any loans to other trust funds) as a percentage of estimated outgo for the year. Such outgo is exclusive of any payments on loans from other trust funds (either interest or principal) and of any transfers between the trust funds. Any payment *from* the Railroad Retirement Account to such trust fund under the financial interchange provisions is netted out against any payments *to* such account from such trust fund.

This reporting provision is to become operative, for each of the four trust funds separately, only when the balance ratio is higher than 20 percent after the enactment date of the 1983 Act (April 20) and then is expected to fall below 20 percent at some future date (time frame unspecified). Even though the balance ratios of the OASI and DI Trust Funds were less than 20 percent in 1983–84, this provision was not triggered then, because the requirement of first exceeding 20 percent and then dropping below it was not met. The report, which can be made at any time during the year when a need for it becomes apparent, must give recommendations for statutory changes in benefits and/or taxes necessary to restore a balance ratio of 20 percent. In 1992 the Board of Trustees made such a report about the DI Trust Fund, because it was expected to fail this test at the beginning of 1996, according to the intermediate estimate. No recommendation was made as to how to remedy the situation, but a small change in the DI tax-rate allocation would have done so without harming the OASI Trust Fund's situation.

Determinations of disability are made by state agencies (usually the vocational rehabilitation agency) under the authority of regulations promulgated by the Secretary of Health and Human Services and on a reimbursable basis. A large proportion of the determinations of the state agencies are reviewed by the Social Security Administration to assure consistency and conformity with national policies.

Income Taxation of OASDI Benefits[135]

At various times in the past, subjecting OASDI benefits to income taxation (and putting the proceeds in the trust funds) was suggested (for example, by the 1979 Advisory Council on Social Security). Several times, both the House and the Senate unanimously (or almost so) passed nonbinding resolutions stating that this should never be done.

135. The material in this section is excerpted (with some modification) from an article by the author in *Tax Notes*, May 21, 1984 (published by Tax Analysts, Arlington, Va.).

Yet, when the National Commission on Social Security Reform sought methods of solving the financing crisis of the OASDI program, this was made part of the package of recommendations, and Congress enacted it in the 1983 Amendments.

Present Law and Procedures

Beginning for 1984, a portion (but not more than half) of OASDI benefits are included in income for federal income-tax purposes for persons with relatively high income. About 8 percent of the beneficiaries in 1984 initially were affected by this measure. However, the proportion will grow over the years, because the thresholds for determining the portion of the benefits to be included in taxable income are *not* indexed, but rather remain fixed over the years (at least under present law).

Unfortunately, there are not good data as to the numbers of beneficiaries affected (although excellent data exist as to the dollar amounts involved). The problem is that income tax returns filed jointly as between spouses do not show whether both or only one are OASDI beneficiaries. The author believes that, from conflicting estimates made by the Social Security Administration, the Treasury Department, and the Congressional Budget Office (CBO), about 14 percent of the beneficiaries paid income tax on their benefits in 1989, with corresponding proportions estimated at 16 percent and 18 percent, respectively, for 1990 and 1991 (the CBO estimate for 1991 is 21 percent).

All other things being equal in the future experience, an updating of the thresholds to recognize price inflation would require additional financing for the OASDI system from some other source.

For each individual who files a federal income tax return, the specific procedure for taxing OASDI benefits is as follows. First, there is determined the sum of (a) adjusted gross income (AGI) as defined for income-tax purposes; (b) interest from tax-exempt bonds, such as municipal and state bonds; and (c) 50 percent of the OASDI benefits (including the so-called unrecompensed tier-1 benefits of the Railroad Retirement system, which are the OASDI component) received in the year (with appropriate adjustments for repayment of benefits by the beneficiary and for lump-sum retroactive payment of benefits which would have been payable in previous years).[136] This sum is

136. When OASDI benefits are reduced because of the receipt of workers' compensation benefits (or other governmental disability benefits), such reductions are counted as "OASDI benefits received" for purposes of income taxation. Also, any reduction in

compared with the threshold amount—$25,000 for single persons, $32,000 for married persons filing joint returns, and *zero* for married persons filing separate returns unless they lived apart from each other during the entire taxable year (in which case they are considered single persons). If this sum exceeds the threshold, there is then added to AGI in computing income-tax liability the *smaller* of (a) 50 percent of the excess or (b) 50 percent of the OASDI benefits received in the year.[137]

Amounts Are Not Indexed

It is very important to note that these two threshold amounts are not indexed so as to increase with rises in the general price or wage level, as are so many other elements of the OASDI program. Thus, in the long run, an ever-increasing proportion of beneficiaries will be affected by this provision (as compared to the 8 to 10 percent who were affected for 1984). This is clearly indicated by the fact that the income taxes transferred to the OASDI Trust Funds have represented about 1.6 percent of total benefits paid during 1984–89, but are estimated to be about 4.5 percent after 2030.

This situation did not occur by accident or oversight. The intent was very gradually to phase in the income taxation of 50 percent of the OASDI benefits. The theory underlying the 50-percent portion is that half of the benefit is "bought" by the employer tax, on which the individual did not pay any income tax at the time (whereas the employee tax came out of post-income-tax income). At the time of the legislative consideration of the 1983 Amendments, it was well recognized that this gradual extension of income taxation of OASDI benefits would occur—and some persons believed that it should not be allowed to do so. Efforts to change the procedure by providing for indexing of the threshold amounts were not successful. If they had

AGI for the deduction for a married couple when both work and certain income derived while outside of the 50 states and D.C. must be added back into AGI for those purposes.

137. Special, stringent conditions apply as to the income taxation of OASDI benefits payable to nonresident aliens. Such persons have a withholding of tax at the rate of 30 percent on all income received from the United States, except for persons residing in Egypt, Italy, Japan, Malta, Romania, and the United Kingdom, with respect to whom treaties provide that their residents do not pay U.S. taxes on such income. A tax treaty with Canada (where there are about 65,000 total beneficiaries) provides that the withholding rate shall be 15 percent, instead of 30 percent. As a result, 15 percent of all benefits (7½ percent for Canada) paid to such persons will, except as noted, be withheld as income tax. In these cases, such withholding will be the tax liability on the individual (and so the amount withheld will always go to the trust funds).

been, the long-range cost effect of this provision would have been less, and then other financing sources would have been needed.

Examples

As an example of how income taxation of OASDI benefits works, consider a married couple filing a joint return. Assume that their total benefits received in 1984 (including the check for December 1983, paid in early January 1984, but not the check for December 1984, and not any lump-sum retroactive payment for months before December 1983 which was received in 1984) were $12,000. The following table shows, for various assumed amounts of AGI and tax-exempt interest, the amount of the OASDI benefits which will be included in income for income-tax purposes.

Assumed AGI	*Assumed Tax-Exempt Interest*	*50 Percent of Assumed OASDI Benefits*	*OASDI Benefits Included in Taxable Income*
$26,000 or less	None	$6,000	None
28,000	None	6,000	$1,000
32,000	None	6,000	3,000
38,000 or more	None	6,000	6,000
22,000 or less	$4,000	6,000	None
24,000	4,000	6,000	1,000
28,000	4,000	6,000	3,000
34,000 or more	4,000	6,000	6,000

A question is often raised as to the point at which 50 percent of OASDI benefits will be taxable. This depends both on the level of the person's AGI (plus tax-exempt interest) and on the level of the OASDI benefit. Illustrative examples of *the amount of AGI plus tax-exempt interest* which would result in, alternatively, (1) any benefits being taxable or (2) 50 percent of benefits being taxable are shown in the next table.

The mathematical relationship involved in the determination of the amount of the AGI plus tax-exempt interest to result in any benefits being subject to taxation is: the applicable threshold amount, plus $2, minus 50 percent of the annual OASDI benefits. That for 50 percent of benefits being taxable is: the threshold amount, plus 50 percent of the annual OASDI benefits.

Annual OASDI Benefits	Single Person with AGI plus TEI Sufficient to Make: Any Benefits Taxable	Single Person with AGI plus TEI Sufficient to Make: 50% of Benefits Taxable	Married Couple Filing Jointly with AGI plus TEI Sufficient to Make: Any Benefits Taxable	Married Couple Filing Jointly with AGI plus TEI Sufficient to Make: 50% of Benefits Taxable
$ 1,000	$24,502	$25,500	$31,502	$32.500
3,000	23,502	26,500	30,502	33,500
5,000	22,502	27,500	29,502	34,500
7,500	21,252	28,750	28,252	35,750
10,000	20,002	30,000	27,002	37,000
15,000*	17,502	32,500	24,502	39,500
20,000†	15,002	35,000	22,002	42,000
50,002‡	§	50,001	7,001	57,001
64,002‡	§	57,001	§	64,001

*An unlikely case currently, especially for single persons.
†An impossible case currently for single persons, and unlikely for married persons.
‡An impossible case currently, but possible many years hence.
§Some benefits are taxable even if AGI is zero.

Effect on Child Beneficiaries

Mention should be made as to how the income taxation of OASDI benefits affects child beneficiaries (for both those of old-age and disability beneficiaries and those who are survivor beneficiaries). Actually, the child benefits "belong" to the child and are so treated for income-tax purposes. Accordingly, for example, a retired worker with high income might have as much as 50 percent of his or her own benefits (and the spouse's benefits as well) be taxable, but none of the benefits of the eligible child would be taxable because the child's income is below the threshold. Similarly, a young widow with eligible children might pay tax on as much as 50 percent of her benefit because of relatively large other income, but the children's benefits would *not* be taxable in most cases, because the children's income would be relatively low (with each one having a $25,000 threshold).

Three Anomalies

There are three anomalies in the income taxation of OASDI benefits. First, there is the severe treatment of married persons who live together at least part of the year when they file separate returns and thereby have a zero threshold as to taxation of their OASDI benefits;

they must include 50 percent of the benefits as taxable income regardless of the level of their other income. Congress did this intentionally to discourage separate filing.

Second, there is a "marriage penalty," because the threshold for married persons is by no means twice that for a single individual. This could be avoided by a "divorce of convenience," and the couple could continue to live together, with each having a $25,000 threshold.

Third, some people view the use of tax-exempt interest in measuring whether the threshold is surpassed as making such interest taxable. It is true that the inclusion of tax-exempt interest in the base may make more of an OASDI benefit be subject to income taxation. However, if this were not done, persons with large incomes, mostly from tax-exempt bonds, would find none of their OASDI benefits to be taxable, while other persons with much smaller incomes from taxable sources (such as pensions or savings accounts) would pay tax on some of their OASDI benefits.

State Taxation

State income taxes in the 43 states and the District of Columbia which have such taxes did not usually apply to OASDI benefits before 1984. There are eight states that more or less closely follow federal procedures and tax the benefits, but 23 states which also follow the federal procedures have made special exemptions for Social Security benefits. An additional six states which do not follow the federal procedures do tax benefits, while five states of this type do not do so.

The Longer Run

In the long run, if wages and prices increase (even if only moderately), all beneficiaries will find that some of their Social Security benefits are subject to income taxation if the threshold amounts remain unchanged, as the law now provides. This will be true even for those with no income other than their benefits. For example, for workers with no auxiliary beneficiary present who retire at the normal retirement age (age 67) on December 1, 2034, and who have had steady earnings at a low wage,[138] the benefits payable in 2035 will, according to the Alternative II-B assumptions of the 1990 OASDI Trustees Report, be about $51,360. Thus, about $680 of the benefits would be considered taxable income (50 percent of the excess of

138. Defined as 45 percent of the average wage.

50 percent of $51,360 over the $25,000 threshold). However, it is not likely that tax would be due unless there were substantial other income.

Appendix 2-1

Coverage of Life Insurance Agents on the Employee Basis under OASDI-HI

A number of types of employment present difficult problems of classification as to whether the individual involved is an employee or a self-employed person. Before 1951, when self-employment was first covered by OASDI, this resulted in significant differences in whether OASDI coverage was present in certain cases. However, after 1950, the only question was on which basis the individual was covered.

Individuals can fall into both categories, employee and self-employed, for different portions of their work and income (either at different times or even simultaneously for different sales procedures). Then some income will be treated one way and some another way.

Many types of employment do not meet the common-law test of an employer-employee relationship, and yet so many elements of control over the individual are present (such as hours and place of work and method of performing the job) that, in reality, such a relationship really seems to exist. Among these types of employment is that of a life insurance agent. The life insurance business agreed, in connection with the 1950 Act, that such individuals should be covered on the employee basis if certain conditions were met.

In general, if the common-law test is not met, then the individual will still be considered an employee for OASDI-HI purposes if:

1. The contract of service contemplates that the individual will personally perform substantially all of the work.
2. The individual has no substantial investment in facilities used in performing the work, other than a car.
3. A continuing work relationship exists between the individual and the organization (or person) for whom the services are performed.

Furthermore, the individual must meet other conditions pertinent to the life insurance business. The solicitation of life insurance and annuity contracts must be the principal business activity, taking up the major portion of the work time of the individual, and the work

must be done primarily for a single company. Thus, for example, an individual who sells mostly casualty insurance is covered as a self-employed person for any life insurance sold (unless he or she is an employee under the common-law test).

Insurance brokers are, of course, covered as self-employed persons because they have significant business investment (and often sell policies of many companies, including nonlife policies). Such brokers who have agents working for them are, of course, employers for OASDI-HI purposes, and their agents have employee status.

The term *general agent* is used in different senses by different life insurance companies. In some instances, such individuals are employees, even under the common-law test. In other instances, even though they sell policies for only one company, they are self-employed because of their substantial investment in the facilities used in their business (and also the limited scope of control of their procedures by the company).

The matter of whether a life insurance agent is considered an employee or a self-employed person is important not only in connection with the tax rate payable on earnings but also as to how the earnings from renewal commissions affect the earnings test. For the employee, such commissions are considered earned in the year of sale, whereas for the self-employed until amendatory legislation was enacted in 1980, they were considered earned in the year of receipt.

Following the elimination of the monthly earnings test (except for the initial year of retirement) by the 1977 Act, those in the self-employed category were at a considerable disadvantage. Even though they may actually be completely retired, if renewal commissions are relatively large, no benefits would be payable (at least after the initial year of retirement and before the limiting age of the earnings test). Formerly, when the monthly test was applicable in all years, benefits were equitably payable under such circumstances because no substantial services were being performed. However, legislation in 1980 remedied this situation, retroactive to 1977; now, commissions for policies sold in or before the month of first entitlement to benefits are not considered as earned in the year of receipt for purposes of the earnings test for years after the year of entitlement.

Somewhat anomalously, life insurance agents who are covered as employees (and their employers too) pay OASDI-HI taxes on their gross earnings before deduction of business expenses (as is done for income-tax purposes). Although, by the standards considered for their employee status, they do not have extremely large business expenses, such amounts can be significant, and their gross remuneration is not really representative of their true earned income.

Appendix 2-2

Procedure for Reductions in Benefits for Retirement before Normal Retirement Age for Persons Eligible for More than One Type of Benefit

The procedure for reducing benefits for persons who first claim them before the NRA (i.e., currently, retired workers at ages 62–64, spouses at ages 62–64, widowed spouses at ages 60–64, and disabled widowed spouses at ages 50–59) is quite simple when only one such benefit is involved. However, when the individual is eligible for two such benefits, the procedure is rather complicated.

First, consider the situation when a primary benefit and a spouse's benefit are involved. The individual is required to file for both benefits simultaneously and *cannot* claim only one at the time of initial filing (and then claim the other later). If the individual's own PIA is at least as large as 50 percent of the PIA of the individual's spouse, only the former (after reduction for early retirement) is payable. On the other hand, if the latter is larger than the individual's PIA, the excess is taken as the spouse's benefit, and then each benefit is subject to the appropriate reduction.

As an example, let us consider Mrs. A, who is currently age 62 and has a PIA based on her own earnings record of $150, and whose husband is age 65 (or any age over 62) and has a PIA of $500. Her full wife's benefit (which she could receive at age 65 if she waited until then to file for any benefits) is then $100 (50 percent of $500, minus $150). Her primary benefit is $120 (80 percent of $150), and her wife's benefit is $75 (75 percent of $100), for a total of $195. Mr. A is eligible for only a primary benefit, because his PIA is larger than 50 percent of his wife's PIA.

When an individual is eligible for both a primary benefit and a widowed spouse's benefit, there is no requirement that both benefits be claimed simultaneously or when first possible (i.e., a widow who claimed widow's benefits at age 60 need not claim primary benefits when she reaches age 62, if she is then eligible by being fully insured). This procedure permits the judicious choice of the best combination of filing alternatives.

When the individual receives both a primary benefit on his or her own earnings record and a widowed spouse's benefit simultaneously, the procedure is always to pay the primary benefit amount (after any reduction for claiming benefits before the NRA and after any increase for DRCs). In addition, a partial widowed spouse's benefit is

payable in the amount of the excess (if any) of the widowed spouse's benefit that would be payable in the absence of the primary benefit (i.e., after any reduction for the widowed spouse claiming benefits before the NRA or for the deceased worker having claimed benefits before the NRA and after any increase for any DRCs earned by the deceased worker). In the event that the widowed spouse is subject to the Government Pension Offset provision, the reduction therefor is applied to the partial widowed spouse's benefit.

As an example, let us consider Mrs. G, who is age 62 at widowhood, has a PIA based on her own earnings record of $100, and has a governmental pension subject to the GPO provision of $900; her deceased husband had a PIA of $1,000 and had initially claimed benefits at age 63½ and so had a benefit of $900. Mrs. G's benefit on her own earnings record is $80. Her full widow's benefit would be $829 ($1,000 times the reduction factor of 82.9 percent for her being age 62). Thus her partial widow's benefit *before* the GPO would be $749. The GPO would reduce this to $149 ($749 minus two-thirds of $900). So her total Social Security benefit would be $229 ($80 plus $149).

Consider next the case where the widowed spouse is currently at least age 62 but under age 65. The individual can choose the primary benefit to begin at once and then shift over to full widowed spouse's benefit at age 65, with no reduction to correspond to that made in the primary benefit. Or exactly the reverse procedure could be followed.

As an example, consider Mrs. B, who is currently widowed at age 62 and whose PIA based on her own earnings record is $250, while her deceased husband (who never received reduced old-age benefits) had a PIA of $400. She could either (1) claim her reduced old-age benefit of $200 (80 percent of $250) immediately and then switch over to the full widow's benefit of $400 when she reaches age 65 or (2) claim her reduced widow's benefit of $331.60 (82.9 percent of $400) immediately, and this would be payable for life (because her unreduced primary benefit at age 65 would not be as much). On the whole, the first alternative would be the better actuarial buy, unless she anticipated that she would be subject to a relatively high probability of death in the near future.

Before legislation enacted in 1989 (effective for persons attaining age 62 after 1989), if the individual took a reduced widowed spouse's benefit before age 62 and then later switched to a primary benefit, the reduction in the former applicable to the period before age 62 was also applicable to the latter. For example, consider Mrs. C, who was currently 60 at widowhood and who at age 62 (or later) would have a PIA of $400. Her husband, who never drew reduced old-age benefits,

had a PIA of $300, so her widow's benefit at age 60 was $214.50 (71.5 percent of $300), which she claimed then. If she were to file for her own old-age benefit at age 62, it would be $285.80 (80 percent of $400, minus the reduction in the widow's benefit for the period between ages 60 and 62—11.4 percent of $300, or $34.20), which she would receive from then on, instead of the widow's benefit of $214.50. However, her better choice (unless she is subject to very high mortality) would have been not to file for her old-age benefit until age 65, when it would be the full $400 minus the $34.20 reduction in the widow's benefit for the period between ages 60 and 62, or $365.80. The 1989 legislation eliminated this carryover reduction provision.

Thus, when a person under the NRA is eligible for both primary benefits and widowed spouse's benefits, a difficult choice can arise. In any event, however, only one of the reduced benefits should be claimed (generally, the smaller one), and the other should not be filed for until the NRA. No advantage can result from claiming both benefits simultaneously.

When one of the dual benefits does not involve a reduction on account of being claimed before the NRA (parent's benefits, spouse's benefits when an eligible child is present, and child's benefits for an adult disabled child), but the other benefit does, no complexity is present. The full benefit of the former type is merely compared with the reduced benefit of the latter type, and the larger amount is payable.

Appendix 2-3

Description of Special Age-72 Benefits

The special flat-rate benefits payable to certain persons aged 72 or over fall into two categories: transitional-insured and transitional-noninsured. The transitional-insured provisions were contained in the 1965 Act, while the transitional-noninsured ones were legislated in 1966. The latter are often referred to as *Prouty benefits*, because Senator Winston L. Prouty initiated the legislation that led to them.[139]

139. Senator Prouty's original proposal as passed by the Senate was much broader than what was finally enacted. It would have had a limiting age of 70, would have been on a permanent basis (instead of phasing out), and would have had no offsets for public assistance or government-employee pensions, but it was cut back by the conference committee. Actually, his first version anomalously (because of a drafting error) had no residence requirement and would have applied to anybody in the world aged 70 or over for all time to come!

Transitional-insured benefits can be qualified for under the same circumstances as old-age benefits (and spouse's, widow's, and widower's benefits can also then arise) for individuals who would meet the fully insured conditions except that they do not have the 6 QC required, although they must have 3 to 5 QC. This provision applies only to men who attained age 72 before 1964 and to women who attained age 72 before 1967. Spouse's benefits of 50 percent of the primary benefit are payable for spouses who attained age 72 before 1969. Widow's and widower's benefits in an amount equal to the full primary benefit are payable for widowed spouses who attained age 72 before 1969 and whose deceased spouses failed to meet the requirements of fully insured status but had 3 to 5 QC.[140]

Transitional-noninsured benefits are available only on an individual basis for persons who either attained age 72 before 1968 or attained age 72 later and had 3 QC for each year after 1967. This provision does not apply for men who attained age 72 after 1971 and before 1992 and for women who attained age 72 after 1969 and before 1992, because for these cases, fully insured status was as easy to meet, and the regular minimum benefit then available was much larger. However, such minimum benefit is not available for persons who attain age 62 after 1981 (except for certain members of religious orders who attain age 62 before 1992, see footnote 78)—for example, attain age 72 after 1991. Such persons would be required to have a sizable number of QC in order to be eligible for the transitional-noninsured benefit—3 QC for each year after 1966 and before the year of attaining age 72.

Thus, those attaining age 72 in 1992, the first year of the apparent likely "resurrection" of this provision, would be required to have 75 QC to be eligible. It is likely that such a person, with almost 20 years of covered employment, would have a larger regular benefit or a larger special-minimum benefit than the transitional-noninsured benefit, but a few persons might not. (Note that the special-minimum benefit in December 1991 through November 1992 is $193.20 for only 18 "years of coverage," or slightly larger than the uniform transitional-noninsured benefit of $173.60.)

This anomaly of the reactivation of the transitional-noninsured benefit resulted from legislative error when the regular-minimum benefit was repealed prospectively in 1981, and no action was taken with regard to the transitional-noninsured benefits. If such repeal

140. Before the 1983 Act, husband's and widower's benefits were not available with respect to transitional-insured status.

had not occurred, the transitional-noninsured benefit would always have been "over-ridden" by the regular-minimum benefit. However, this anomaly was solved by the complete (and permanent) repeal of this benefit for persons attaining age 72 in 1971 or after, by the Omnibus Budget Reconciliation Act of 1990.

To be eligible for these benefits, persons must be residents of the United States (defined here to exclude American Samoa, Guam, Puerto Rico, and the Virgin Islands—on the ground that federal income tax is not payable there) and must also be citizens or lawfully admitted resident aliens with at least five years of continuous residence.

The transitional-noninsured benefits are not payable if the individual is receiving public assistance (including the Supplemental Security Income program, as described in Chapter 11). The benefits are reduced on a dollar-for-dollar basis for any other government pension received (such as a state teacher-retirement pension). Before the 1983 Act, if both husband and wife were eligible for these benefits, the wife's benefit was reduced by 50 percent, but after the husband's death the wife received the full benefit (and was considered a primary beneficiary). Now, each person qualifies as an individual.

The primary benefit amount is a flat figure for both types of special age-72 benefits. This amount initially (1965 for transitional-insured benefits and 1966 for transitional-noninsured benefits) was $35 per month. Subsequently, this amount was increased at the same time that general across-the-board increases were made in the regular benefits. When automatic adjustments of benefit amounts were introduced by the 1972 Act, they were made applicable to the special age-72 benefits. The primary benefit amount after the December 1991 automatic adjustment is $173.60.

The transitional-insured benefits are financed completely from the OASI Trust Fund (i.e., from payroll taxes). Practically all the transitional-noninsured benefits, although paid through this trust fund, are financed out of general revenues; the only exception is for such benefits for persons with at least 3 QC, which are financed from the OASI Trust Fund.

Relatively few beneficiaries qualified for the transitional-insured provisions. At the peak in December 1966, there were only 92,866 primary beneficiaries on the roll (and 8,292 wives and 29,158 widows). In December 1989, these figures had fallen off to 1,439 primary beneficiaries, 4 wives, and 958 widows. On the other hand, the transitional-noninsured provisions affected far more people—a peak of about 705,000 primary beneficiaries and 25,000 wives were on the roll

in 1967.[141] By the end of 1989, these numbers had decreased to 10,290 primary beneficiaries (all wives now being so classified).

Appendix 2-4

Detailed Descriptions of Eligibility Conditions for Auxiliary and Survivor Benefits and Initial and Final Months for Benefit Payments

In order to be eligible for wife's benefits, the wife must have been married to the primary beneficiary for at least a year or else be the mother of his child or have been eligible for widow's, parent's, or disabled-child benefits on another earnings record. Such eligibility can be of a deferred nature—that is, benefits would later have been available upon attainment of age 62.

When a woman is eligible for wife's benefits because of the presence of a child (or is eligible for a larger benefit under such circumstance—for example, is between age 62 and the NRA and receives the full "50 percent of PIA" benefit instead of a reduced one), such child must be "in her care." When the child is under age 16, this means that the mother must exercise parental control and responsibility for the welfare of the child. A child who is serving in the armed forces (and under age 16) is *not* considered to be in the mother's care. When the child is aged 16 or over and was disabled before age 22, the mother must also perform personal services for the child if the child is mentally competent.

Similarly, to be eligible for widow's benefits, the surviving wife must meet any one of the foregoing requirements (only nine months of marriage required instead of one year; no duration required if death was due to accidental causes or while in the uniformed services, or if the couple had previously been married for at least nine months) or an alternative one—legally adopting a child while she was married. If a widow had more than one former husband, she is eligible for widow's benefits on the basis of all such husbands; under the anti-duplication provision, however, she receives only the largest such benefit. A wife (i.e., husband living), however, is not eligible for any widow's benefits based on former marriages, except for remarriage occurring after age 60.

141. The relatively small number of wives is due to both the age requirements and small proportions of married couples at these advanced ages and beyond (especially as the group ages). Before the 1983 Act, when a husband died the widow became a primary beneficiary.

As a result of legislation in 1990, a "deemed" spouse is eligible for both spouse's and widow(er)'s benefits (including also benefits as a divorced spouse or surviving spouse) if she or he was living with the worker at the time of filing for benefits (or at the death of the worker as to widow[er]'s benefits). This is the case regardless of whether the legal spouse is entitled to benefits on the same earnings record (previously, the deemed spouse could receive benefits only while the legal spouse was not receiving benefits). A deemed spouse is one who entered into an invalid marriage in good faith. When both the legal spouse and the deemed spouse are receiving benefits, the benefit for the former is not considered in connection with family maximum-benefit provision.

Corresponding requirements apply for husbands and widowers. (See Appendix 3-2 for more detailed discussion of this matter.)

Eligibility for parent's benefits extends not only to natural parents but also to stepparents and adopting parents when such status was achieved before the worker involved attained age 16. To be eligible for child's benefits, a child must be a natural or legally adopted child of the deceased worker or a stepchild who had such status for at least a year (or, as a result of legislation in 1990, have been adopted by the surviving spouse and was either living with or receiving at least one-half support from the worker at the time of the worker's death).

In those instances where dependency must be proved (parent's benefits), the proof thereof must be filed within two years of the worker's retirement, disability, or death, as the case may be.

Survivor benefits are paid in full for the initial month of entitlement, even though the beneficiary does not meet the eligibility condition during the entire month (e.g., for the month of death of the worker). Old-age and spouse benefits are also paid in full for the initial month of entitlement, except for those first claimed for the month in which age 62 is attained.[142] In the latter case, as a result of legislation in 1981,[143] the benefit is payable for such month only if the person was aged 62 for the entire month (i.e., attained age 62 on the first day of the month); in all other instances, the benefit is first payable for the following month (but with the early-retirement reduction factor then being slightly larger). This means that, in actual practice, very few old-age and spouse claimants who are eligible for benefits in the

142. According to regulations, a given age is attained on the day *before* the particular birthday.

143. This legislation was enacted solely for "general budget" reasons and not for logical, administrative, or benefit-structure reasons. It has a cash-flow effect but no long-range effect (because of the resulting change in the early-retirement reduction factor used).

month they attain age 62 and claim them then can receive them for that month and have the 20-percent and 25-percent reductions commonly thought of as applicable at that age. Rather, the first benefit payment will be made for the next month, with a slightly lower reduction applied. Conversely, benefits are not paid for the month of termination. In other words, whether benefits are paid for a month depends on the person's status at the end of the month (except that, when the benefit is paid on the last day of the month—see p. 129—the beneficiary need be alive only at the beginning of that day). In essence, nonpayment of pro rata benefits is balanced by payment of a full benefit for the initial month and no benefit for the final month.

Benefits terminate not only for death, recovery from disability, and attainment of age 18 for a nondisabled-child beneficiary who is not attending primary or secondary school (or attainment of age 19 for a nondisabled-child beneficiary who is attending such school), but also for other reasons for some beneficiary categories. Remarriage before age 60 is, in general, a terminating cause for widows and widowers, except disabled ones aged 50–59, while a marriage after the worker's death is such a cause for parent's benefits, except as indicated in the next paragraph. Similarly, marriage terminates child's benefits, except as indicated in the next paragraph; subsequent divorce does not restore eligibility (although annulment of the marriage does do so).

Marriage does not, however, terminate a survivor benefit (other than in the case of a child under age 18 or a child aged 18 in school) when the person married is also receiving such a survivor benefit. Also, remarriage after age 60 for a widow or widower (including a divorced one) to another person than described in the previous sentence does not terminate the benefit (before the 1977 Act, however, this reduced the benefit amount to 50 percent of the PIA of the deceased worker). This peculiar provision was adopted to handle the "problem" of an aged widow "living in sin" with an aged man who was not an OASDI beneficiary (as reportedly occurred with some frequency in localities that were havens for the aged!).

School-attendance benefits for a child terminate if he or she ceases full-time attendance at age 18 and before 19 (or later under the provision for continuation until the end of the semester, as described in the main text of this chapter) and is not disabled. Benefits are paid for months during summer vacation if full-time school attendance precedes and follows such months. Adoption of a child beneficiary is not a terminating event (although, before the 1972 Act, it had been a cause for termination except when adoption was by a close relative).

The lump-sum death payment must be claimed within two years of death, although later filing is permitted with a proof of good cause.

Retroactive filing for up to 12 months is permitted for monthly benefits for disabled workers (and their spouses and children) and disabled widows and widowers. The same 12-month retroactivity was previously applicable for all other beneficiaries, except where this would result in a reduction of the lifetime or ongoing benefit rate (i.e., for old-age benefits, spouse's benefits, and widow's and widower's benefits claimed before the NRA), as discussed in detail in footnote 39 of this chapter; however, as a result of legislation in 1980, such period is now only 6 months.

Appendix 2-5

Method of Computing PIA and MFB for Persons Attaining Age 62, Dying, or Becoming Disabled before 1979[144]

The cohort of persons who attain age 62 before 1979 (regardless of whether they become disabled or die after 1978) and persons who die or become disabled before 1979 is completely unaffected by the new procedure of indexing the earnings record, obtaining an AIME, and using such AIME in a new PIA benefit formula that is automatically adjusted for various future cohorts. Instead, this "prior-to-1979" cohort has applicable exactly the same benefit-computation procedures as were present in the law prior to the 1977 Act, without any change and with such automatic adjustments as would have been made under such law. This is so even though the persons involved work for several years beyond 1978 and do not claim benefits until actual retirement.

This complete difference in the treatment of cohorts on a demographic basis (rather than on, say, a date of filing or entitlement basis) is both desirable from an administrative standpoint and equitable to beneficiaries, who will be neither advantaged by knowledge of how the procedures operate nor disadvantaged by ignorance (or, in either case, by haphazard circumstances). In general, the members of this prior-to-1979 cohort make out considerably more favorably by the procedures applicable to them, although in any event they could often have obtained such results by proper filing tactics if another procedure had been followed.[145]

Accordingly, to describe the benefit-computation procedures for

144. For an excellent account of benefit-computation procedures, see Steven F. McKay and Bruce D. Schobel, *Effects of the Various Social Security Benefit Computation Procedures*, Actuarial Study No. 86, Social Security Administration, July 1981.

145. Nonetheless, the author believes (as he testified before Congress) that there were ways to prevent this favoritism (to which, as it happens, he is subject), at least with

the prior-to-1979 cohort, it will suffice merely to set forth the basis in the law as it was prior to the 1977 Act. The vast majority of the computations of PIAs in recent years have been made on the basis of the "new-start" method, using only earnings for 1951 and after.[146] The "old-start" method, using earnings from 1937 on, is described in Appendix 2-6 as it applies to all cohorts.

Determination of Average Monthly Wage

Under the new-start method, an average monthly wage (AMW) is computed. This is done in exactly the same manner as the AIME—for example, with regard to the number of years to be used in the average and the period from which such years are to be selected, *except* that the actual recorded earnings, rather than the indexed ones, are used.

Before the 1960 Act, the AMW was computed on a slightly different basis. The number of years to be used in determining the average was based on the years after 1950 (or the year of attaining age 21, if later) and before the year of entitlement (i.e., the year of filing claim, including the effect of retroactivity after becoming eligible) instead of before the year of first becoming eligible, as under current law. This former procedure could produce anomalous results because of the arbitrariness as to when claims are filed.

The 1960 Act also increased the minimum number of years used in computing the AMW from two years to five years (except when a long disability freeze would produce a lower result than five years). No notch situation was created by this change. For example, a person who attained age 65 in 1953 had only two computation years if becoming entitled in 1953. However, if entitlement were deferred to a later year (in order to use higher earnings after age 65 in the benefit computation), more computation years would have been required under the prior law. Thus, the minimum requirement of five years as established by the 1960 Act was not deleterious to persons who initially had a lesser requirement but wished to use higher earnings after age 65 (and even after 1960).

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respect to benefit computations involving earnings after 1978. However, this would have considerably increased the administrative complexity and would have been somewhat more difficult for the beneficiaries to understand.

146. In 1983, only about 7 percent of all old-age benefits awarded under OASDI utilized the "old-start" method (probably mostly consisting of women who worked in covered employment during the 1940s and then "retired" to being homemakers). Only about 2 percent of disability-benefit awards used this method.

Men who attained age 62 before 1975 were discriminated against compared with women of the same age with the same earnings record, because their closing year for measuring the number of years of earnings to be used in computing the AMW was based on an older age (see footnote 60 of this chapter). For example, for persons who attained age 65 in early 1975 with maximum earnings in all past years, the PIA for a man was $316.30 as compared with $333.70 for a woman.

An extremely illogical situation occurred for young workers in computing the AMW for purposes of disability and survivor benefits, because of the short period that may be used for the averaging (especially when the general trend of earnings has been so sharply upward over the years). For example, consider workers who were 29 or under in 1978 and who died or became disabled at the beginning of the year. Their AMW was $1,325 (the sum of $15,300 and $16,500, divided by 24). However, the AMW of a person who attained age 62 at the beginning of 1978 (and had no period of disability in the past), or of a person who was at least age 26 in 1950 and who died or became disabled at the beginning of 1978, could not exceed $642. Certainly, it does not seem equitable to treat the short-term new entrant so much more favorably than one who has contributed for many years at the maximum taxable earnings. This anomaly has been considerably remedied—completely so in the long run—by the new AIME method.

The AMW as so described is essentially on a career-average basis. In times of rising earnings, such as the United States has had for many years (especially since 1940), questions may be raised as to the use of a career-average wage, as contrasted with a final-average wage computed only over the most recent years preceding the risk of retirement, disability, or death. Under these circumstances, it may be argued, the career-average basis will produce unrealistic results because of utilizing the low wages of long-distant past years.

As a practical matter, however, the manner in which OASDI benefits were adjusted in the past to reflect increases in the CPI, and the manner in which they will be adjusted automatically for changes in the CPI in the future, produced about the same results as if a final-average basis had been used for determining the AMW. The reason for this is that each time benefits were increased in the past, the benefit percentage factors were correspondingly increased for those who would be beneficiaries in the future. This same approach was written into the law by the 1972 Act as being the procedure for the automatic adjustment of benefits to reflect changes in the CPI. In other words, using a career-average wage and dynamic benefit factors can produce

about the same result as using a final-average wage and static benefit factors.[147] In actual experience, however, this procedure resulted in overadjustments of benefits, and thus a change was necessitated—namely, the present decoupled approach using indexed earnings (as discussed in more detail in Chapter 3).

Benefit Formula

In all laws before the 1958 Act, a definite benefit formula was prescribed. For example, in the 1954 Act, the benefit formula applicable to earnings before 1950 was 55 percent of the first $110 of AMW, plus 20 percent of the next $240 of such wage (reflecting the $4,200 earnings base then in effect).

Under the 1958 Act, an apparently considerably different procedure was used. A benefit table gave the PIA for various ranges of AMW (e.g., where the AMW was $114–$118, the PIA was $66). The benefit table also provided for conversion of benefits for those on the roll before January 1959, to result in an increase of about 7 percent in the PIA (or $3, if larger). The benefit table also showed the maximum family benefit applicable for each PIA (e.g., $99 where the AMW was $114–$118). A similar procedure was followed in subsequent legislation. The 1972 Act not only contained a benefit table but also provided complete instructions on how to derive the new benefit table when benefits were automatically adjusted for changes in the CPI.

Actually, the benefit table in the law was based on a definite formula and on definite minimum and maximum benefit provisions, which were built into the table, and there was really no change in the basic principle that had prevailed in the past. Obviously, certain approximations were made because of the grouping involved in rounding the benefits to the nearest dollar.

The approximate benefit formula underlying the benefit table for months in December 1989 through November 1990 is the sum (in terms of AMW) of:

(1) 295.91% of the first $110
(2) 107.60% of the next $290
(3) 100.57% of the next $150
(4) 118.23% of the next $100
(5) 65.75% of the next $100
(6) 54.79% of the next $250
(7) 49.36% of the next $175
(8) 45.71% of the next $100
(9) 42.96% of the next $100
(10) 40.56% of the next $100

147. For more details, see Robert J. Myers, "New Insight as to the True Basis of Social Security Benefits," *Pension and Welfare News*, August 1971.

(11) 38.09% of the next $435
(12) 34.66% of the next $250
(13) 30.32% of the next $315
(14) 27.27% of the next $225
(15) 25.39% of the next $275
(16) 24.53% of the next $175
(17) 23.70% of the next $150
(18) 22.99% of the next $200
(19) 22.69% of the next $150
(20) 21.78% of the next $100
(21) 20.94% of the next $250

except that, in some cases for AMWs under $95, a slightly higher amount is payable to fit in with the minimum benefit which was applicable under this procedure. The maximum PIA is $2,036.60 based on an AMW of $4,000 (which cannot generally be obtained for many years, except for workers at the very oldest ages).[148] The minimum PIA in the benefit table is $231.90, applicable to AMWs of $76 or less.

The corresponding formula for months in December 1990 through November 1991 is obtained by merely increasing each of the percentage factors by 5.4 percent relatively and by adding the term "20.94 percent of the next $275" at the end of the series. The absolute maximum PIA is $2,204.10, while the minimum PIA is $244.40. Similarly, the formula for months in the period from December 1991 through November 1992 was obtained by increasing each of the percentage factors in the preceding formula by 3.7 percent and adding a term.

One might well ask how such a complicated benefit formula developed and what its underlying basis is. As mentioned previously, whenever the benefit level has been increased following 1954, this has been accomplished by an across-the-board uniform percentage rise. This increase was applied not only to benefits in force at the time but also, for consistency, to the percentage benefit factors in the formula, leaving the dollar bands unchanged.[149] At the same time, a new dollar band is added that is equal to one twelfth of the increase in the maxi-

148. Specifically, to eliminate the low earnings prior to 1979 due to the lower earnings bases then, a number of years after 1979 would have to involve high earnings—thus at ages well beyond 65. At the extreme case consider a man who attained age 65 in 1951 (the same results apply to older men and to women who are three years younger) and who is living (at age 104 at the beginning of 1990 and has had maximum covered earnings in 1985–89 (a minimum of five years being required in the computation of the AMW). His PIA (and benefit too, before rounding and before the SMI premium and subsequent rounding—because he could not receive any delayed-retirement credits, since these were only available for years *after* 1970 and *before* age 72 was attained) is $1,960.20 for January 1990. As an almost impossible case, if such person had at least three disability-freeze years before becoming age 65, the PIA would be $2,010.40. The absolute maximum of $2,036.60 could be obtained only if there were snfficient future years at the $48,000 maximum earnings for 1989 (but future COLAs likely then would increase this "maximum").

149. Note that this is exactly the reverse of what is done to adjust the PIA formula under the AIME wage-indexing procedure. For future cohorts, the percentage factors under the AIME procedure are left unchanged, and the dollar bands are adjusted for changes in the general wage level.

mum taxable earnings base for the year in which the benefit increase occurs over that for the previous year (and this band is extended for any subsequent years when the base increases, but there is no general benefit increase). The benefit percentage applied to this band is 20 percent for the portion of the year before the general benefit increase; the 20 percent is increased by the relative benefit increase for the remainder of the year (and until the next general benefit increase).

Specifically, the 55-percent factor applicable to the first $110 of AMW under the 1954 Act formula was increased successively by 7 percent (1958 Act), 7 percent (1965 Act), 13 percent (1967 Act), 15 percent (1969 Act), 10 percent (Act of March 1971), 20 percent (Act of July 1972), 11 percent (Act of December 1973), and the 15 automatic adjustments applicable for June of 1975–89 (8.0, 6.4, 5.9, 6.5, 9.9, 14.3, 11.2, 7.4, 3.5, 3.5, 3.1, 1.3, 4.2, 4.0, and 4.7 percent respectively) to yield the 295.91 percent factor in the foregoing formula. In the same way, the 20-percent factor applicable to the next $240 of AMW under the 1954 Act formula was increased to 107.60 percent.[150] The remainder of that 21-step formula was developed in the same general manner.[151]

150. This factor was made applicable to the next $290 of AMW (in excess of the first $110) when the maximum creditable AMW was increased to $400 in the 1958 Act.

151. In the 1965 Act, when the maximum AMW was increased by $150 (to $550), the benefit factor applicable to the new band of AMWs at the top of the range was taken at the same percentage (21.4 percent) as had been applicable to AMWs between $110 and $400 in the 1958 Act. This factor was then increased successively by the percentage benefit increases of subsequent legislation, yielding the 100.57-percent factor in the formula shown. Next, in the 1967 Act, when the maximum AMW was increased by $100 (to $650), the benefit factor applicable to the new band of AMWs was taken at a percentage such that the maximum PIA would be the same as if the benefit factor applicable to the second band of AMWs (i.e., $110–$400) had applied to all the AMWs in excess of $110. Specifically, the formula then was 71.16 percent of the first $110 of AMW, plus 25.88 percent of the next $290, plus 24.18 percent of the next $150, plus 28.43 percent of the next $100. This use of a relatively high benefit factor on the new band of AMWs produced the desired result of the maximum PIA of $218 being the same as would have been derived from the "simple formula"—71.16 percent of the first $110 of AMW, plus 25.88 percent of the next $540. In other words, the factor applicable to the newly added band of creditable AMW had to be higher than the preceding one in order to average out at the higher level of the second preceding one. Unfortunately, this was a most inappropriate procedure. The 1969 Act did not increase the maximum AMW, so all benefit factors previously applicable were merely increased by 15 percent. The legislation of March 1971 increased the maximum AMW by $100 and followed the appropriate procedure of applying a 20-percent factor (the same as in the second step of the 1954 Act formula) to such increase, and this was done for all subsequent increases in the earnings base. At the same time, the benefit factors previously applicable were, quite properly, increased by 10 percent. Similarly, the legislation of July 1972 increased the benefit factors applicable to the part of the AMW below $750 by 20 percent, the general benefit increase then legislated. Then, the legislation of December 1973 increased the benefit factors applicable to the part of the

TABLE 2.15. OASDI Benefit Table Applicable when AMW Is Computed for Periods Beginning with 1951, Effective December 1989

Average Monthly Wage	*Primary Insurance Amount*	*Maximum Family Benefit*
$76 or under	$ 231.90	$ 348.00
77–78	235.50	353.40
79–80	241.10	361.60
81	245.30	368.40
306–309	538.90	894.60
310–314	544.50	908.70
315–319	548.90	923.50
986–990	1,102.90	1,930.10
991–995	1,105.70	1,935.00
996–1,000	1,108.60	1,939.60
3,986–3,990	2,033.70	3,559.00
3,991–3,995	2,034.80	3,560.90
3,996–4,000	2,035.80	3,562.70

Table 2.15 gives several fragments of the benefit table as of December 1989 as it relates to the cases where the AMW is computed for periods beginning with 1951. The benefit table as of December 1990 has benefit amounts which are 5.4 percent higher.

Some may question that the benefit factor applicable to the first $110 of AMW exceeds 100 percent (which occurred for the first time in the 1972 Act). Is it appropriate for benefits to exceed previous earnings? The explanation rests on the fact that the AMW is on a career-average basis and almost always will not be indicative of recent earnings prior to retirement but will be significantly lower. Therefore, if the resulting benefits are measured against such recent earnings, the ratio will be much lower (and well below 100 percent for almost all categories of workers). Quite interestingly, because of the counteracting effects of the career-average wage and the automatic

AMW below $1,000 by 11 percent, the general benefit increase then enacted, effective June 1974 (a 7 percent increase being effective for March–May 1974). The two-step approach was adopted because, in the short time available between enactment of the legislation and March 1974, it was not possible to make exact increases for all beneficiary categories (notably those involving more than one type of benefit). Accordingly, the "rough" 7 percent increase effective for March 1974 was to be completely overridden by the 11 percent increase effective for June 1974. In the 16 automatic adjustments of benefits for June of 1975–82 and December of 1983–90, all benefit factors were increased by the applicable percentages.

adjustment of the benefit percentage factors to reflect the COLAs, the PIA actually *exceeds* the AMW in the table for December 1989 at all AMWs up to $1,213!

In the future, each time the Secretary of HHS promulgates the percentage benefit increase for those on the roll, a new PIA benefit table will also be promulgated for the prior-to-1979 cohort, whether then on the roll or applicable upon later retirement (or death). Its values will merely be the PIAs in the previous table multiplied by the percentage benefit increase (and rounded down to the next higher 10 cents, if not already an even multiple of 10 cents), along with another band with a benefit percentage of 20 percent increased by the percentage benefit increase.[152]

Maximum Family Benefit

Before the legislation in 1971, the Maximum Family Benefit (MFB) was, in general, a percentage of the AMW. Specifically, the MFB in the 1969 Act was determined approximately from the following formula: 80 percent of the first $436 of AMW, plus 40 percent of the next $214, except that it could not be less than 1½ times the PIA (which applied for AMWs of $239 or less).[153] This procedure produced anomalies when all benefits were increased by a uniform percentage across the board and, in the case of benefits for a family, were permitted to rise above the stated MFB (done for ease of public understanding, such that it would be stated that all beneficiaries received an x percent increase). As a result, persons coming on the roll shortly afterward who were affected by the MFB could have lower benefits than if they had come on the roll just before the effective date.

For the foregoing reason and, perhaps more important, because of the recognition of the need for dynamic benefit factors to offset the career-average wage basis, the 1971 Act changed the procedure for determining MFBs. The resulting method was to increase the MFBs in the previous benefit table by the same percentage as the PIAs were increased and to make the MFBs for the new band of AMWs that is added at the upper end of the table be 175 percent of the applicable PIAs, which was about the same ratio as the maximum MFB held to the maximum PIA in the 1969 Act table. This procedure was adopted in the automatic-adjustment provisions that were incorporated into the law in 1972, and it will be followed in the future just as the PIA table will be changed.

152. The underlying benefit formula can be similarly derived.

153. This somewhat complex formula developed as a result of several patching-up changes over the years.

TABLE 2.16. Approximate Formula for Maximum Family Benefits, Effective December 1989

Average Monthly Wage	*Primary Insurance Amount*	*Maximum Family Benefit**
$ 76–239	$231.90–464.40	1½ times PIA
240–436	468.80–672.80	289.4% of AMW
437–627	678.20–878.00	$631 plus 144.7% of AMW
628–4,000	882.30–2,035.80	1¾ times PIA

*Percentages are applicable to upper end of AMW band for each PIA in benefit table.

Table 2.16 shows the formula relationship of the MFBs to the AMWs and the PIAs according to the benefit table that went into effect in December 1989. One might well question why, for AMWs of $3,289 and less, the MFB is higher than the AMW. Should benefits paid exceed previous income? The answer to this apparent overliberality is the same as that mentioned before in connection with the PIA—the use of a career-average wage for determining the MFB—so that benefits payable are not likely to be high relative to final earnings.

As in the case of PIAs, each time that future benefits for those on the roll are increased by the automatic-adjustment provisions as the CPI rises, the MFBs in the benefit table applicable to the prior-to-1979 cohort are correspondingly increased by the same percentage. Thus, for the MFB formula effective December 1990, all of the dollar figures applicable to the PIAs in Table 2.16 are 5.4 percent higher.

Appendix 2-6

Alternative Method of Computing PIA for Persons Attaining Age 62 in 1979–1983[154]

Persons who attain age 62 in 1979–83 (and such persons who die in or after the month of attaining age 62) can have their PIAs computed under an alternative transitional-guarantee provision, as well as under the new benefit formula using indexed earnings.[155] Whichever of

154. See also the reference in footnote 144 for an excellent account of benefit-computation procedures.

155. Actually, the law is not too clear on this procedure and, strictly read, could be taken to apply only to the old-age benefit and not to any auxiliary benefits with respect to the retired worker or to any survivor benefits (even those based on death after retirement) with respect to individuals who die in or after the month of attainment of

the resulting two PIAs is the larger will be used. This method is not available for disability benefits, even for persons disabled after attaining age 62 (and before age 65). Those disabled at ages 62–64 can use the transitional-guarantee provision only by taking an early-retirement benefit (with actuarial reduction). However, upon the death of an individual who has chosen to take the unreduced disability benefit under the regular formula (based on the AIME)—rather than an early-retirement benefit based on a higher PIA under the transitional guarantee—the survivor benefits are determined from the transitional guarantee. The same thing is done when the disabled individual attains age 65 and is automatically shifted to old-age benefits.

The purpose of this transitional provision was to protect the benefit rights of persons approaching retirement when the legislation was being enacted and whose retirement plans had taken their anticipated OASDI benefits into account. At the same time, however, it was not applied to deaths under age 62 and to disabilities occurring after 1978, so as to eliminate as rapidly as possible the anomaly of the previous overly large benefit amounts for these categories, particularly at the young ages (see Appendix 2-5).

The guarantee provision continues the application of the method used for calculating the PIA under the law as it was before the 1977 Act (and as continued for persons attaining age 62, dying, or becoming disabled before 1979—see Appendix 2-5), but with two significant restrictions. First, the PIA benefit table is frozen in its form as of December 1978 (i.e., the table promulgated for June 1978); however, automatic CPI increases are applicable for the year of attaining age 62 and all subsequent years. Second, earnings for and after the year of attaining age 62 cannot be used in the computation of the AMW, either for the initial computation or for recomputations for earnings in or after the year of initial claim; such earnings can, however, be used in the computation of the AIME under the new benefit formula.

The alternative guarantee provision will be gradually phased out over the future in the sense that a decreasing proportion of those eligible to use it will find it advantageous. For those attaining age 62 in 1979 and retiring then, this provision will produce exactly the same benefit result as would previous law, except that benefits payable for 1980 and after might not be as large, because any earnings in 1979 cannot be used for recomputation purposes. If such individuals continue in employment after age 62, there will be no effect on their PIAs

age 62. The procedure described here, as practiced by the Social Security Administration, is the most reasonable and logical one, and it certainly follows the underlying intent of the legislation.

as computed under the guarantee provision (other than CPI increases), whereas under previous law, the additional earnings could have produced increases in the PIAs. Under such circumstances, however, recomputations will be made under the new AIME method, and this could yield a larger PIA (even though such method gave a lower PIA than the guarantee provision initially). It seems likely that the vast majority of those attaining age 62 in 1979 and retiring then or in the next few years have had their PIAs computed under the guarantee provision, because the new benefit formula under the AIME method was developed to yield an average of about 6–7 percent less than the AMW method would have done then (as discussed in more detail in Chapter 3).

For those who attained age 62 after 1979, the freezing of the benefit table at its December 1978 level until the year of attainment of age 62 meant that relatively fewer and fewer PIAs were computed under the guarantee provision because of the large increases in wages and prices which occurred since then. It is likely that a far smaller proportion of those attaining age 62 in 1980 used the guarantee provision than those attaining age 62 in 1979 (quite probably well less than half the 1980 cohort).

An illustration of how the guarantee provision operates in a specific case may help the reader understand it better. Consider a person who attained age 62 in 1982 and had always had maximum creditable earnings. The AMW was based on the highest 26 years (which in this case were 1956–81) and was computed at $851. Based on the December 1978 benefit table, this yielded a PIA of $540.50. That amount was applicable for benefits for January–May 1982, while for subsequent months it increased by the CPI increase applicable for benefits for June 1982. If the individual did not retire until January 1988 (at age 68), the AMW remained the same, and the PIA then would be $540.50 increased by the six CPI adjustments intervening (i.e., for June 1982 and for December of each year in 1983–87). Of course, if at any time (either initially or on recomputation to include earnings in 1982 and after) the new AIME method gave a larger PIA, it would be used instead.

The MFB for those whose PIA is computed under the guarantee provision (because this yields a larger amount than AIME method) is determined from the new MFB formula rather than from the MFB column in the December 1978 benefit table based on AMWs. This procedure is followed to produce consistent, logical results. Even though the new MFB formula was intended to produce about the same results in early 1979 as the formula underlying the MFB column

in the December 1978 benefit table (see Appendix 2-4), this was so only *on the average*. Thus, if this were not done, there could have been the anomalous situation where, for a particular PIA arising from the benefit table under the guarantee provision, the MFB was smaller than that with respect to a slightly smaller PIA arising from the AIME benefit formula, as determined from the new MFB formula. Accordingly, it was much more reasonable to use the new MFB formula for all PIAs for the 1979–84 cohort, no matter under which of the two methods the PIA is determined.

Appendix 2-7

Method of Computing PIA Using Wages before 1951

Initially, the computation of the PIA, beginning with the time monthly benefits were first payable in 1940, was based on an AMW involving the career-average concept applicable to wages paid after 1936. The 1950 Act extended coverage to a large number of persons who had not previously been covered. Because of this and because wages had increased so greatly during and following World War II, it was decided to have a new start in determining the AMW for purposes of computing the PIA.[156] In a sense, it may be said that this was based on the belief (unrealized in actual experience) that wage rates would be relatively stable after 1950. However, for equity, an alternative had to be made available for those who had substantial earnings records in 1937–50 and low earnings (or even none) after 1950.[157]

Computation of AMW

The 1950 Act provided for alternative use of such pre-1951 wages in combination with subsequent earnings under what is called the "old-start" method. The general principle is that an AMW is computed in the same manner as the AMW under the "new-start" method (see Appendix 2-5), with two exceptions. First, the starting date for determining the number of years to be used in averaging is 1937 (or

156. The problem of giving adequate treatment as to the AMW for those first covered by the 1954 and 1956 Acts was handled by the five-year dropout provisions.

157. In unusual cases, persons currently retiring can qualify for benefits even though they did not work in covered employment after 1950. For example, a person attaining age 62 in 1991 who worked in covered employment for only 10 full years during and after World War II (at ages 12–21) would have had no creditable earnings after 1950 and yet would qualify.

age 22, if later) rather than 1951 (or age 22, if later). Second, wages back through 1937 are considered in determining the highest years, rather than only wages from 1951 on. The old-start method is restricted to certain persons to eliminate cases that might, by unusual circumstance, find it advantageous and yet have little covered employment before 1951. First, there must be at least 1 QC before 1951. Second, if age 22 was attained after 1950, the number of QC after 1950 must have been less than 6. This latter restriction will result in very few persons (if any) attaining age 62 after 1990 being able to use the old-start method.[158]

Computation of Primary Insurance Benefit

This old-start AMW is then, in principle, applied in the original primary benefit formula established by the 1939 Act. This formula was the sum of 40 percent of the first $50 of AMW and 10 percent of the AMW in excess of $50 (up to the maximum of $250 resulting from the earnings base of $3,000 in 1937–50), with the total increased by 1 percent for each year in which credited wages were at least $200 (maximum of 14 such years due to the period 1937–50). In the unlikely event that the AMW were larger than $250, it would be considered as only $250.

Computation of PIA

The resulting Primary Insurance Benefit (PIB) is then entered in the PIA benefit table, frozen as of December 1978, to yield a PIA (and also a corresponding MFB). As a result of the several increases in the benefit table (due to ad hoc changes and the automatic adjustments in 1975–78), the PIAs derived from the old-start method through the PIBs steadily increased over the years and thus kept up to date with economic conditions. A segment of the benefit table as it converts PIBs to PIAs (and MFBs) as of December 1978 is shown in Table 2.17.

In practice, in part because relatively few persons used the old-start method after the first few years following 1950 and in part for administrative simplicity,[159] approximations to this old-start method were

158. For example, a person attaining age 62 in 1991 would need 40 QC to be fully insured, and at most only 5 of them could be acquired after 1950. Accordingly, the 35 QC needed before 1951 would mean that the person would have had to have worked for almost nine years before age 22.

159. A major reason for simplified procedures with respect to wages in 1937–50 is the manner in which the records have been maintained—namely, only as to the aggre-

TABLE 2.17. OASDI Benefit Table Applicable when AMW Is Computed for Periods Beginning with 1937, Effective December 1978

Primary Insurance Benefit	*Primary Insurance Amount*	*Maximum Family Benefit*
$16.20 or under	$121.80	$182.70
16.21–16.84	123.70	185.60
16.85–17.60	126.60	189.90
32.01–32.60	198.70	298.10
32.61–33.20	201.30	302.90
44.45–44.88	248.70	378.80
44.89–45.60*	251.80	384.90

*Maximum PIB.

legislated over the years. Further simplifications were made in the 1977 Act for persons attaining age 62, dying, or becoming disabled in 1978 or later.

Present Simplified Procedure

At present, the procedure under the old-start method is as follows: This method can be used only for persons who have at least 1 QC before 1951 but cannot be used by those who attained age 22 after 1950 and have 6 or more QC after 1950 (done so as to phase out the method). The wages after 1936 are used in their actual values (i.e., not indexed). The wage credits in 1937–50 are assigned to years within that period by an empirical process prescribed in the law. Such total wage credits are divided by N, the number of years after the year that the person attained age 20 and before 1951 (for a person who attained age 20 in 1949 or after, the divisor is always 1). Then the resulting average annual wage is assigned to 1950 and to each of the immediately preceding $(N - 1)$ years. However, if such average wage exceeds $3,000 (the earnings base during this period), it is taken as $3,000, and the excess of the total wages over $3,000 times N is assigned in $3,000 units (with a last partial unit) in successive years im-

gate wages for that period, not by individual years. Otherwise, it would have been necessary to go back to individual files.

mediately preceding the $(N - 1)$th year before 1950 (but, of course, not in any year before 1937).

After the 1937–50 wages have been so assigned to individual years, they are considered along with the earnings for 1951 and after, but before the year of attaining age 62 or prior death or disability. Then the requisite highest number of years is used in computing the AMW. This figure is then entered into the PIB benefit formula (described previously). The 1 percent increment years in such formula are also derived on an empirical basis; one such year is given (up to a maximum of 14) for the number of full units of $1,650 in the individual's total 1937–50 wages, but with at least four increments given (i.e., if such total wages are less than $6,600).[160]

The resulting PIB is then entered into the PIA benefit table frozen as of December 1978, and then any CPI increases for and after the year of attaining age 62, or prior death or disability, are given. The restrictions of using the frozen benefit table and of not using earnings at age 62 or over (paralleling what is done under the transitional-guarantee provision as it relates to the new-start AMW procedure for the 1979–83 cohorts—see Appendix 2-6) result in even less use of the old-start method.

When the old-start method is applicable for 1979 and later cohorts, the MFB is determined from the new MFB formula used under the AIME method, rather than from the PIA table. This is the same procedure that is followed for the MFB under the transitional-guarantee provision—for the same reasons (see Appendix 2-6).

An example of how the old-start method operates may be of value in understanding it. Consider an individual who attained age 20 in 1945 and who had wages of $13,000 in 1937–50. He is considered to have $2,600 of wages ($13,000 divided by 5) in each of the five years 1946–50 and to have had seven increment years ($13,000 divided by $1,650, with the fractional remainder dropped). When age 62 was attained in 1987, the AMW was computed over the highest 31 years of earnings, considering the foregoing seven years at $2,600 and all years in 1951–86. Suppose that such AMW is $200. Then the PIB is $37.45 (40 percent of $50, plus 10 percent of $150, with the total increased by 7 percent). According to the frozen December 1978 benefit table, this yields a PIA of $219.90, which would be applicable for January–November 1987 (i.e., before the effect of any CPI increase for December 1987).

160. The empirical $1,650 figure and the minimum of four years were derived from sample studies as reproducing reasonably well, on the average, the $200-per-year basis.

If the foregoing person had total wages in 1937–50 amounting to more than $15,000, the allocation procedure would be somewhat different. For example, if such wages were $19,000, then the average annual wage initially calculated would be $3,800. However, the allocation would be $3,000 to each of the five years 1946–50, and the remainder of $4,000 would be assigned as $3,000 in 1945 and $1,000 in 1944.

In 1990, about 4 percent of the awards for old-age benefits (i.e., retirement cases) were computed under the old-start method. It is likely that the vast majority of these cases were women who had worked in covered employment during World War II and shortly thereafter, but not subsequently. The corresponding proportion for disabled-worker benefits was only about 1 percent (much lower because eligibility for such benefits requires recent employment).

Appendix 2-8

Indexing of Earnings Records, Especially as to Earnings Prior to 1978

The method of indexing earnings records that was established by the 1977 Act bases such indexing for 1977 and afterward on average nationwide wages in all employment in the country, both that covered under OASDI and that not so covered. The indexing of the earnings record is done to the second year before the year in which the AIME benefit formula for the particular cohort could first be used. Such a procedure is necessary because of the lag involved in collecting the data. Thus, the promulgation of the new benefit formula is to be made on or before the October 30 preceding the particular year, and at that time the latest available data on the average wage would be for the second preceding year (which must be promulgated on or before the October 30 preceding the year—see Appendix D).

Source of Data

The underlying information, which is to be derived on a 100-percent basis (rather than from a sample, as is the CPI, for example), is to come from income-tax data. The congressional committee reports underlying the 1977 Act stated the intent that, for 1977 and 1978, the basic source would be wages as reported on the personal income tax returns, Form 1040. For 1978 and after, it was stated that such source should be the wages as reported on the Wage and Tax Statements,

Form W-2, furnished by employers to employees.[161] Although the average wages derived for 1978 by the two sources were not expected to be exactly the same, it was thought that it would be possible to link the 1977 average from Form 1040 to the series based on Form W-2 for 1978 and after.[162]

The data reported in the "wages" line of Form 1040 include relatively small amounts of remuneration in the aggregate that are not reported on Form W-2. Examples are tips unreported to the employer by the employee, wages for which there is no Form W-2 (whether or not one was required), certain disability retirement income, and certain strike and lockout benefits. Conversely, Form W-2 includes certain "other compensation" that is not truly "wages." Examples are certain moving expenses and certain prizes for commission sales persons.

Even though, in both Form W-2 and Form 1040 data, there are small amounts of remuneration that are not truly "wages"—so that the average wages derived are somewhat too high—this is not very significant. The whole purpose of the series of average wages is to establish *relative* weights or indexes. As long as the proportion of nonwage remuneration included is small and does not change much, the relatives will be only slightly affected (if at all).

In actual practice, however, administrative difficulties prevented the use of the method involving solely Form W-2. Accordingly, the procedure utilized for obtaining the 1978 index figure was continued until the determination of the average wage for 1985 was made. This is well within the letter of the law, even though it does not strictly follow congressional intent.

The big problem, however, is what data were to be used for years before 1977, because neither Form W-2 data nor Form 1040 data were available. The 1977 Act gave broad authority to the Secretary of HEW to develop average wages for each year in 1951–76.

For the 1979 cohort (attainments of age 62 in 1979 and deaths and disabilities before age 62 in 1979), indexing was to be done to 1977. Thus, initially, the important thing was to obtain a consistent series of average wages for 1951–77.

161. The procedure in obtaining the average wage for any particular year is simply to add all the wages reported on Forms W-2 and then to divide the grand total by the total number of persons represented in such forms (some persons have more than one employer in the course of a year and thus more than one W-2).

162. For example, the 1978 average wage from Form 1040 was $10,840.68, while that for 1977 was $10,043.15. Let us assume that, if it had been administratively possible to carry out this procedure in determining the average indexing wage for 1978, such average from Form W-2 was $10,860 for 1978. Then the 1977 figure comparable to the ongoing series from Form W-2 would be $10,061.05 ($10,860 times the ratio of $10,043.15 to $10,840.68).

Indexing Series

The SSA wage-indexing series for 1951–89 used for the 1979–92 cohorts is shown in Table 2.18. This series for 1951–77 is the average reported taxable wages in the first quarter of the year multiplied by 4 (based on a 100 percent sample for 1973–77 and on various smaller samples for earlier years, with the several series being linked into the 1973 figure).[163] The first-quarter data are used because they are only slightly biased by the effect of the maximum taxable earnings base (because so few individuals have wages in the first quarter that exceed the base).

Although the 1977 Act was not entirely clear as to the basis for the indexing series to be used for the 1980 and later cohorts, it was decided by the Social Security Administration merely (and logically) to build onto the series for the 1979 cohort, which used the 1977 average wage as the indexing base. The problem which was resolved was that the 1978 average wage was on a different basis than the first-quarter average wages used for 1951–77. However, the 1977 average wage which was derived on the same basis as the 1978 one was available, and the percentage increase of the latter over the former (7.941 percent) was applied to the 1977 average from the 1951–77 series to yield the 1978 average for this series.

The indexing series for the 1981 cohort (and then for later cohorts as well) is logically built onto the 1951–78 series, although the law apparently provides for a completely different basis, using the average wages on the basis to be followed in 1979 and after. The percentage increase of the 1979 average wage over the 1978 one (8.748 percent) was merely applied to the 1978 figure to obtain the 1979 one (and the same procedure was followed for subsequent cohorts, and will be followed for future ones as well). Thus, it can properly be said that the indexing series is based on first-quarter wages in covered employment (annualized), assuming that the annual increases in first-quarter wages are essentially the same as increases in the annual nationwide wages without regard to the OASDI maximum taxable earnings base.

Although, under a strict interpretation of the law, there could eventually be two distinct indexing series, with different values for each year in 1951–79, the same relative relationships would be present in

163. For more details on this matter, see the *Federal Register*, December 29, 1978, p. 60877. For the extension of this series back for the period 1937–50 (which is used for the benefit computations under totalization agreements between the United States and other countries), see Appendix 2-14.

TABLE 2.18. Wage-Indexing Series Used for 1979–1992 Cohorts and Indexed Maximum Taxable Earnings for 1951–1992 (by Cohort)

Calendar year	*Indexing Average Wage**		*Indexed Maximum Taxable Earnings†*					
			1979	*1980*	*1981*	*1982*	*1983*	*1984*
1951	$ 2,799.16		$12,577	$13,576	$14,764	$16,094	$17,714	$18,689
1952	2,973.32	(6.2)	11,841	12,781	13,899	15,151	16,676	17,594
1953	3,139.44	(5.6)	11,214	12,105	13,164	14,349	15,794	16,663
1954	3,155.64	(0.5)	11,157	12,042	13,096	14,276	15,713	16,578
1955	3,301.44	(4.6)	12,441	13,429	14,604	15,919	17,522	18,486
1956	3,532.36	(7.0)	11,628	12,551	13,649	14,879	16,376	17,278
1957	3,641.72	(3.1)	11,279	12,174	13,239	14,432	15,885	16,759
1958	3,673.80	(0.9)	11,180	12,068	13,124	14,306	15,746	16,613
1959	3,855.80	(5.0)	12,174	13,141	14,291	15,578	17,146	18,090
1960	4,007.12	(3.9)	11,714	12,645	13,751	14,989	16,498	17,407
1961	4,086.76	(2.0)	11,486	12,398	13,483	14,697	16,177	17,067
1962	4,291.40	(5.0)	10,938	11,807	12,840	13,997	15,405	16,254
1963	4,396.64	(2.5)	10,677	11,524	12,533	13,661	15,037	15,864
1964	4,576.32	(4.1)	10,257	11,072	12,041	13,125	14,446	15,242
1965	4,658.72	(1.8)	10,076	10,876	11,828	12,893	14,191	14,972
1966	4,938.36	(6.0)	13,070	14,108	15,342	16,724	18,407	19,421
1967	5,213.44	(5.6)	12,380	13,363	14,533	15,842	17,436	18,396
1968	5,571.76	(6.9)	13,690	14,778	16,070	17,518	19,281	20,343
1969	5,893.76	(5.8)	12,942	13,970	15,192	16,561	18,228	19,231
1970	6,186.24	(5.0)	12,331	13,310	14,474	15,778	17,366	18,322
1971	6,497.08	(5.0)	11,741	12,673	13,782	15,023	16,535	17,445
1972	7,133.80	(9.8)	12,338	13,317	14,482	15,787	17,376	18,333
1973	7,580.16	(6.3)	13,933	15,040	16,356	17,829	19,624	20,704
1974	8,030.76	(5.9)	16,074	17,351	18,869	20,568	22,639	23,885
1975	8,630.92	(7.5)	15,975	17,245	18,754	20,443	22,501	23,739
1976	9,226.48	(6.9)	16,217	17,505	19,036	20,751	22,840	24,097
1977	9,779.44	(6.0)	16,500	17,810	19,368	21,113	23,238	24,517
1978	10,556.03	(7.9)	17,700	17,700	19,248	20,982	23,094	24,366
1979	11,479.46	(8.7)	22,900	22,900	22,900	24,963	27,476	28,988
1980	12,513.46	(9.0)	25,900	25,900	25,900	25,900	28,507	30,077
1981	13,773.10	(10.1)	29,700	29,700	29,700	29,700	29,700	31,335
1982	14,531.34	(5.5)	32,400	32,400	32,400	32,400	32,400	32,400
1983	15,239.24	(4.9)	35,700	35,700	35,700	35,700	35,700	35,700
1984	16,135.07	(5.9)	37,800	37,800	37,800	37,800	37,800	37,800
1985	16,822.51	(4.3)	39,600	39,600	39,600	39,600	39,600	39,600
1986	17,321.82	(3.0)	42,000	42,000	42,000	42,000	42,000	42,000
1987	18,426.51	(6.4)	43,800	43,800	43,800	43,800	43,800	43,800
1988	19,334.04	(4.9)	45,000	45,000	45,000	45,000	45,000	45,000
1989	20,099.55	(4.0)	48,000	48,000	48,000	48,000	48,000	48,000
1990	21,022.98	(4.6)	51,300	51,300	51,300	51,300	51,300	51,300
1991	21,811.60	(3.7)	53,400	53,400	53,400	53,400	53,400	53,400

*Figures in parentheses are percentage increase from previous year's average wage. See footnote 163 for source of similar figures for 1937–50.

†Shown here rounded to the nearest dollar, although in practice the figures will be carried out to the nearest cent.

Indexed Maximum Taxable Earnings[†]

1985	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
$19,599	$20,751	$21,635	$22,278	$23,698	$24,866	$25,850	$27,044
18,451	19,536	20,368	20,973	22,310	23,409	24,336	25,460
17,475	18,502	19,290	19,863	21,130	22,170	23,048	24,113
17,385	18,407	19,191	19,761	21,021	22,057	22,930	23,989
19,387	20,527	21,401	22,036	23,442	24,596	25,570	26,751
18,120	19,185	20,002	20,596	21,909	22,988	23,899	25,002
17,575	18,609	19,401	19,977	21,251	22,298	23,181	24,252
17,422	18,446	19,232	19,803	21,066	22,103	22,978	24,040
18,971	20,086	20,942	21,564	22,939	24,069	25,021	26,177
18,255	19,328	20,151	20,749	22,073	23,160	24,077	25,189
17,899	18,951	19,758	20,345	21,642	22,708	23,607	24,698
17,045	18,047	18,816	19,375	20,610	21,625	22,482	23,520
16,637	17,615	18,366	18,911	20,117	21,108	21,944	22,957
15,984	16,924	17,645	18,168	19,327	20,279	21,082	22,056
15,701	16,624	17,333	17,847	18,985	19,920	20,709	21,666
20,367	21,564	22,483	23,150	24,627	25,839	26,863	28,103
19,292	20,426	21,297	21,929	23,327	24,476	25,445	26,621
21,334	22,588	23,550	24,249	25,796	27,066	28,138	29,437
20,168	21,354	22,263	22,924	24,386	25,587	26,600	27,829
19,215	20,344	21,211	21,840	23,233	24,378	25,343	26,513
18,295	19,371	20,196	20,796	22,122	23,211	24,130	25,245
19,226	20,356	21,223	21,853	23,247	24,392	25,358	26,529
21,712	22,989	23,968	24,680	26,254	27,547	28,637	29,960
25,048	26,521	27,651	28,472	30,287	31,779	33,037	34,563
24,896	26,359	27,482	28,298	30,103	31,585	32,836	34,353
25,271	26,756	27,896	28,724	30,556	32,061	33,330	34,870
25,712	27,223	28,383	29,226	31,089	32,621	33,912	35,479
25,553	27,055	28,207	29,045	30,897	32,419	33,702	35,259
30,400	32,187	33,559	34,555	36,758	38,569	40,096	41,948
31,542	33,396	34,819	35,852	38,139	40,017	41,601	43,523
32,862	34,793	36,276	37,352	39,735	41,691	43,342	45,344
33,978	35,976	37,509	38,622	41,085	43,108	44,815	46,885
35,700	37,799	39,409	40,579	43,167	45,293	47,086	49,261
37,800	37,800	39,410	40,580	43,168	45,294	47,088	49,263
39,600	39,600	39,600	40,775	43,376	45,512	47,314	49,500
42,000	42,000	42,000	42,000	44,679	46,879	48,735	50,986
43,800	43,800	43,800	43,800	43,800	45,957	47,777	49,984
45,000	45,000	45,000	45,000	45,000	45,000	46,782	48,943
48,000	48,000	48,000	48,000	48,000	48,000	48,000	50,217
51,300	51,300	51,300	51,300	51,300	51,300	51,300	51,300
53,400	53,400	53,400	53,400	53,400	53,400	53,400	53,400

both series. Thus, for example, the ratio of the indexing wage for 1951 to that for 1977 would have the same value for both series.

Such a potential change in the 1951–79 series shown in Table 2.18 could have been easily avoided—without any effect on the benefit computations, because of the series being used only as a relative one—if the law had been changed so that the 1951–79 figures would always be used and figures for subsequent years would be derived from the percentage changes shown by the nationwide average wages for 1978 and subsequent years. In practice, the Social Security Administration has issued only one series, just as if the law had been so changed.

Two significant changes in the indexing procedure occurred as a result of legislation in 1989. First, under the Medicare Catastrophic Coverage Act of 1988 (which, as discussed in Chapter 7, was repealed in 1989, prospectively for 1990 and after), cash payments were made by employers who had post-retirement health benefit plans for their former employees. Such payments represented the value of the benefits not paid for 1989 as a result of the new legislated provisions (which were solely with respect to HI benefit coverage). The payments, which were generally $50–60, were to be reported as wages (and OASDI-HI taxes paid thereon), with the required W-2 form to be submitted. This would have significantly biased the 1989 average wage in the indexing series, because about 2 million individuals were involved. However, to avoid this occurring, the Omnibus Budget Reconciliation Act of 1989 provided that such payments were to be considered as pension payments, not wages.

Second, the 1983 Act had provided that certain deferred-compensation payments should be subject to OASDI-HI taxes at the time when the services underlying them are rendered, rather than when the payments are received (see Appendix 2-13). However, such taxable earnings for OASDI purposes were not reportable on the W-2 or 1040 forms for income-tax purposes. If these earnings had been increasing after 1983 at the same rate as earnings in general, no distortion in the indexing series would have occurred. However, this was not the case, because such earnings were rising relatively more rapidly.

As a result, corrective steps were taken in the Omnibus Budget Reconciliation Act of 1989. These were of a complicated, transitional nature. The procedures for using the indexing series were modified for 1990–92 as they related to the determination of the maximum taxable earnings base (and also the old-law base). For the 1990 base, the 1989 base was multiplied by the sum of (1) the ratio of the nationwide

Unadjusted Average Wage (UAW) from the IRS Forms W-2 (i.e., unadjusted for deferred-compensation payments) for 1988 to the UAW for 1987 and (2) 2.0 percentage points (to allow for the cumulative effect of the trend in deferred-compensation payments as compared with other wage payments). Thus because of the 2.0-percent factor the earnings base for 1990 became $51,300, instead of the $50,400 which would otherwise have resulted under the procedure in prior law.

For purposes of determining the earning bases in 1991 and 1992, two nationwide average wages were derived for 1990, the UAW and the Adjusted Average Wage (AAW), which included the deferred-compensation payments. Thus, 1990 served as a "bridge" year between the UAW and the AAW, the two average wages. For the 1991 base, the same procedure was followed as for the 1990 base (but, of course, with the years involved being advanced one year—and the 2.0-percent factor being used). (As it turned out, the increase of the AAW over the UAW was only 1.49 percent—not 2.0 percent.) For the 1992 base, the 1991 base was multiplied by the ratio of the AAW for 1990 to the UAW for 1989—and thus a proper "catch-up" was achieved, and the fact that the AAW/UAW differential was not 2.0 percent was taken into account. The bases for years after 1992 will all be determined from the increases in the AAWs.

Details as to the modification of the procedure for determining the maximum taxable earnings base can be found in the *Federal Register*, December 29, 1989 (54FR53751), reproduced on page 119 of the 1990 OASDI Trustees Report.

The following table shows nationwide average wages as determined from the IRS Forms W-2 (both unadjusted for deferred-compensation payments and adjusted therefor) and the indexing average wages for recent years. The fact that the indexing average wage is larger than the nationwide average wage is explained, in large part, by the former being a "first-quarter" average (annualized) and the latter being an "annual" average. Thus, the former shows a higher amount for workers who work in less than all four quarters of the year.

	Nationwide Average Wage		
Year	*Unadjusted*	*Adjusted*	*Indexing Average Wage*
1988	$18,274.38	n.a.	$19,334.04
1989	18,997.93	n.a.	20,009.55
1990	19,875.47	$20,172.11	21,027.98

The modification in the nationwide average wages which are used in determining the indexing series as it affects the benefit provisions (namely, the earnings requirements for QC and the bend points in the PIA and MFB formulas, and exempt amounts in the retirement test) is deferred until the determinations for 1993. Specifically, for the determinations for 1991 and 1992, only the UAWs are used to calculate the percentage increase in the indexing average wage, while for years after 1992, only the AAWs are used for such purpose. For example, for the 1992 determinations, the 1990 indexing average wage (which was determined in 1991) was calculated from the 1989 indexing average wage and from the UAWs for 1989 and 1990 (because the AAW for 1989 is not available). Then, in the 1993 determinations, the AAWs for 1990 and 1991 will be used (because the UAW will no longer be available after 1990).

The procedure for the benefit provisions was adopted primarily for reasons involving the General Budget of the United States (see Chapter 4 for a discussion of the relationship between Social Security and the General Budget). Otherwise, if the transition had been made immediately—as was done for the earnings base—significantly increased benefit outgo would have resulted. Also, a "notch" would have occurred between those first becoming eligible in 1990 as against 1989 eligibles; however, this could have been avoided by a gradual phase-in, over a period of two or three years, as to the bend points in the PIA and MFB formulas.

Thus, as it turned out, the shift from one series of average wages to another in 1990 did *not* restore the amounts in the factors for benefit purposes to the level that they would have been if the new AAW series had always been in effect. However, future differences in trend due to using the series which includes the effect of deferred-compensation payments will be recognized. The effect on the long-range actuarial balance of the OASDI program by this change in the indexing series would be relatively negligible.

It is significant to note the relationship between the average wage and the maximum taxable earnings, both in the past and in the future, under the provisions of present law. In the late 1930s, the maximum earnings base averaged about 270 percent of the average wage. This ratio fell during the 1940s and was only 118 percent in 1950. During the 1950s, the ratio fluctuated between 114 percent and 129 percent, but thereafter it decreased to a low of 103 percent in 1965. Then, in 1966–73, the ratio fluctuated between 120 and 142 percent and thereafter rose to a level of about 165 percent during 1974–78 and further each subsequent year until reaching a level of about 235

percent in 1983–89. In 1990 and after, the ratio is (and will be) about 240 percent.

The wage-indexing series has been extended back to 1937 (and is used for computing benefits under the totalization agreements—see Appendix 2-14), and is as follows for 1937–50:

Year	*Average Wage*	*Year*	*Average Wage*	*Year*	*Average Wage*
1937	$1,150.45	1942	$1,454.27	1947	$2,175.32
1938	1,053.23	1943	1,713.52	1948	2,361.66
1939	1,142.35	1944	1,936.32	1949	2,483.19
1940	1,195.01	1945	2,021.39	1950	2,543.95
1941	1,276.03	1946	1,891.76		

Application of Indexing Series

Table 2.18 also shows the effect of indexing the earnings record for persons with maximum earnings in each year who are in the various possible cohorts in 1979–92. When the highest years of such a person's earnings were chosen under the AMW method, they were naturally the most recent ones. However, under the AIME method, some of the earliest years turn out to be among the highest. For example, for the 1979 cohort, 1968 is the sixth highest, 1951 is the ninth highest, and 1955 is the tenth highest. The five lowest years are, in reverse order, 1954 and 1962–65.

A person attaining age 62 in 1979 who had not had a disability-freeze period must use 23 years in the computation of the AIME (and also the AMW, when applicable). If this person retired in 1979 and had maximum taxable earnings in 1951–78 (earnings in 1979 not being counted until benefits for 1980 were recomputed), the AIME would be based on the highest 23 years of indexed earnings. These would include the $17,700 in 1978 (unindexed) and the indexed earnings in all but the five lowest years in 1951–77, the total being $302,425; this, when divided by 276 months, results in an AIME of $1,095 (with the cents being dropped). Similarly, the AMW was derived on the basis of the highest 23 years of actual earnings (1956–78), the total being $187,200 and the AMW being $678.

The recomputation of the AIME for benefits after 1979 used the earnings in 1979. If in this case such earnings were not more than $11,180 (the indexed earnings for 1958, the 23rd lowest year in 1951–78), the AIME remained unchanged. If the 1979 earnings had

exceeded $11,180, the AIME was recomputed and a higher result obtained. For example, if the maximum of $22,900 was earned in 1978, the AIME became $1,138 (as a result of $22,900 replacing $11,180 in the total).

Appendix 2-9

Comparison of PIAs for Adjacent Cohorts and for Other Variables

This appendix presents several detailed analyses of PIA benefit computations to show the effects of the new method of determining benefits through the wage-indexing approach. The several subjects to be dealt with in turn are as follows:

1. The use of the AIME method compared with the transitional-guarantee provision (see Appendix 2-5) in the years after 1978.
2. The effect of the AIME method for those attaining age 62 after 1978 compared with the benefits arising for those attaining age 62 in 1978.
3. The different benefit results for persons dying or becoming disabled at young ages after 1978 compared with those doing so before 1979.
4. Comparison of the benefits computed under the AIME method for those attaining age 62 in 1980 and 1981 with those for persons attaining age 62 in 1979.
5. The effects of different types of earnings histories in the computation of retirement benefits.
6. The effects of retiring at various ages beyond 62.
7. The effects of different economic assumptions.

Relative Use of AIME Method as against Transitional Guarantee

The benefit formula that is used in connection with the AIME, as derived from the indexed earnings record, was designed to produce lower *relative* benefits over both the long run and the short run than the computation procedure in previous law.[164] The differential is about 5 percent for those retiring at age 62 and as much as 10 percent for those retiring at age 65 or over.

As a result, for the vast majority of workers who have been more or

164. Such procedure, it should be remembered, continues to be applicable for persons who attained age 62 before 1979 (or died or became disabled before then); see Appendix 2-4.

less steadily employed since 1951, with their earnings keeping up to date with changing economic conditions, the PIA under the transitional guarantee was larger than that under the AIME formula for those attaining age 62 in 1979 *and retiring then*. For example, for such a person with maximum creditable earnings in all years back through 1951, the PIA in early 1979 under the AIME formula (based on an AIME of $1,107) was $454.90, whereas under the transitional guarantee it was $486.10 (based on an AMW of $678), or 6.9 percent higher. Similarly, for a person with average earnings,[165] the PIA under the AIME formula was $365.90 (based on an AIME of $817), as against $383.10 under the transitional guarantee (based on an AMW of $492, or 4.7 percent higher).

If such a person in the 1979 cohort continued working after age 62, the situation could change, and the AIME formula would produce a more favorable result. If the maximum-earnings individual continued in employment until age 67 in early 1984, the PIA under the transitional guarantee would be $755.00 (the initial $486.10 increased only by the CPI increases for 1979–83, because earnings for and after the years of attaining age 62 cannot be used). The PIA under the AIME formula would be larger—$779.40 (based on the increased AIME of $1,421 due to taking into account the higher earnings in 1979 and after, especially those under the expanded earnings bases, and the CPI increases in 1979–83).

The corresponding figures for the average-earnings case are $601.90 under the AIME formula (based on an AIME of $885, which is not much larger than the AIME as of 1979 because the higher earnings bases have no effect) as against $595.10 under the transitional guarantee.

Accordingly, for the steady-worker category in the 1979 cohort there is a crossover at points between age 62 at retirement and age 67 at retirement, where the transitional-guarantee procedure ceases to be more favorable than the AIME formula. This is due to the latter utilizing earnings in and after the year of attaining age 62.

Under the actual economic conditions after 1977, which were much worse than those which were assumed in the 1978 OASDI Trustees Report (see Table 2.19), the AIME formula produced more favorable

165. Defined as the average wages on which the indexing is based (see Appendix 2-8, especially Table 2.18), with years after 1977 estimated on the basis of the intermediate assumptions in the 1979 OASDI Trustees Report (see Table 2.19). Such assumptions are used in all subsequent examples in this appendix unless otherwise indicated. This approach after 1977 of using estimated wage figures rather than actual ones (which are now available) is used to see what results were anticipated when the legislation was adopted.

TABLE 2.19. Wage Trends and OASDI Benefit Increases under Automatic-Adjustment Provisions; Intermediate Assumptions of 1978, 1979, and 1980 OASDI Trustees Reports* and Actual Experience

	Increases in Wages in Covered Employment				*Benefit Increase under Automatic-Adjustment Provisions*			
Year	*1978 Report*	*1979 Report*	*1980 Report*	*Actual Experience*	*1978 Report*	*1979 Report*	*1980 Report*	*Actual Experience*
1978	7.2%	8.5%	8.1%	9.7%	6.5%	6.5%	6.5%	6.5%
1979	7.9	8.3	8.4	9.8	6.1	9.8	9.9	9.9
1980	7.9	8.0	9.6	9.0	5.9	7.8	14.3	14.3
1981	7.4	9.1	9.5	9.7	5.4	7.1	11.3	11.2
1982	7.4	7.4	10.9	6.5	5.0	5.9	9.0	7.4
1983	7.1	6.0	9.9	5.0	4.9	4.9	8.8	3.5
1984	6.1	5.4	9.4	7.2	7.2	4.1	8.3	3.5
1985	6.0	5.3	9.1	4.3	4.0	4.0	7.9	3.1
Ultimate†	5.75	5.75	5.75	n.a.	4.0	4.0	4.0	n.a.

*The 1978 report is House Document No. 95-336; the 1979 report is House Document No. 96-101; and the 1980 report is House Document No. 96-332.

†The ultimate year for the wage increase is 2000 for the 1978 and 1979 reports and 2005 for the 1980 report.

results than the transitional guarantee for the vast majority of the 1981 and later cohorts who had been steadily employed in the past. This rapid phasing-out (which was even more rapid than had been anticipated in 1977, because of the unfavorable economic conditions) occurred because of the frozen nature of the PIA formula under the transitional guarantee (see Appendix 2-6). This occurred even more rapidly with respect to those who continued employment beyond age 62 (as was shown previously for the 1979 cohort)—for example, for the 1980 cohort if retirement was deferred until age 65.

For those who have not been steady workers in the past, the situation is somewhat different. Those who had their highest earnings some years ago are much more likely to find the new AIME formula more advantageous than the transitional guarantee. On the other hand, those whose recent earnings are the highest will have the reverse situation. Consider two rather unlikely examples to illustrate this.

Suppose that an individual who attained age 62 at the beginning of 1979 had earnings of $3,600 in every year during 1951–73 (an unlikely situation in view of the trend of wages in the past). The PIA then (with 23 computation years being required) was $294.20 under the AIME formula (based on an AIME of $593), or well in excess of the $251.80 under the transitional guarantee (based on an AMW of $250 and the December 1978 PIA benefit table).

Next, consider a person who attained age 62 at the beginning of 1983 (the last cohort that can use the transitional guarantee) and had earnings of $1,000 per year in 1956–78 and maximum creditable earnings in 1979–82. The PIA under the AIME formula (based on an AIME of $516) is $312.40, or well below the $343.50 based on the transitional guarantee (based on an AMW of $413 and the frozen December 1978 benefit table).

The transitional-guarantee provision applied to only a relatively small number of persons retiring in 1983—or in later years if they attained age 62 before 1984. Thus, the unavailability of this provision for the 1984 and later cohorts probably has had a disadvantageous effect in only rare cases.

Effect of AIME Method versus Old Method Applicable to Cohorts before 1979

Persons who attained age 62 before 1979 and do not retire until after 1978 continue to have their PIAs computed according to the method prescribed by the law as it was before the 1977 Act. To the

extent that such procedure was faulty (and overgenerous), such persons have significant advantages over those who attain age 62 after 1978, although only on a gradual basis. This situation is augmented, too, by the lowering of the general benefit level by 5–10 percent under the new, permanent computation method based on the AIME.

In passing, it should be noted that such undue advantage could have been avoided—and, in fact, this was proposed by the author at congressional hearings.[166] The procedure for persons who attained age 62 before 1979, if they had a significant amount of earnings after 1978 (say, sufficient to be credited with 4 QC), could have been to use both the new benefit-computation method based on the AIME and the old AMW method but not permitting earnings after 1978 to be used, with the larger result being payable. Another possible procedure would be to base increases in the PIA for earnings at age 62 and over on the increases that would arise under the new benefit-computation method; this procedure is discussed in more detail later in this section.

Persons who attained age 62 in 1979 and retired then will, because of the transitional-guarantee provision (using the frozen benefit table of December 1978), receive benefits quite comparable with those of persons who attained age 62 in 1978 and retired then. However, if each of these two cohorts do *not* retire at age 62 but work beyond then, a "notch" or "cliff" problem arises—namely, that the initial benefits at the time of retirement for the 1978 cohort become increasingly larger than those of the 1979 cohort.[167] The problem is much smaller for the 1980 cohort as compared with the 1979 cohort and is largely nonexistent for the 1981 and later cohorts as compared with the immediately preceding year's cohort, because the transitional-guarantee provision will usually not have any effect on them.

The problem can be clearly seen from Table 2.20, which shows, for present law, the benefit for the initial month of retirement for persons retiring in January of various years who were born in adjacent months (one at the end of a year and the other at the beginning of the next year). Figures are shown both for persons with maximum creditable

166. See "Decoupling the Social Security Benefit Structure," Hearings before the Subcommittee on Social Security, Committee on Ways and Means, House of Representatives, June 18–July 26, 1976, pp. 137 and 138.

167. This situation has received widespread recognition and demands for "rectification" in recent years. This was especially the case when the widely read columnist Dear Abby brought up the matter (somewhat erroneously) in the fall of 1983. The so-called notch-year babies, those born in 1917–21, are *not*—as was alleged—worse off than those born later. Rather, they can be somewhat better off, because they can use the transitional-guarantee method of benefit computation if it produces a better result.

TABLE 2.20. Benefit for Month of Retirement for Persons Attaining Age 62 at Various Times in 1978–1980 and Retiring at Various Dates (all figures rounded to next lower even dollar)

Month of Retirement	*Person Attaining Age 62 in*			
	December 1978	*January 1979*	*December 1979*	*January 1980*
With maximum earnings in all past years				
January 1979	$ 395	$ 388	*	*
January 1980	493	463	$430	$402
January 1981	635	570	532	498
January 1982	789	679	637	604
January 1983	900	755	735	709
January 1984	990	826	804	773
January 1985	1,084	904	881	844
January 1986	1,178	985	961	918
January 1987†	1,255	1,056	1,031	982
January 1988†	1,363	1,136	1,136	1,080
January 1989†	1,473	1,218	1,218	1,155
January 1990†	1,600	1,318	1,318	1,245
With average earnings in all past years				
January 1979	312	306	*	*
January 1980	388	365	339	316
January 1981	500	449	419	393
January 1982	623	532	502	475
January 1983	716	592	576	553
January 1984	773	638	621	596
January 1985	833	691	674	645
January 1986	894	747	729	696
January 1987†	937	794	775	737
January 1988†	1,005	848	848	804
January 1989†	1,075	905	905	855
January 1990†	1,158	973	973	917

*Not eligible for benefits at this time.

†Despite the fact that retirement occurred after age 70, benefits (at a lower rate) had been payable from the month of attaining age 70 to the month of actual retirement.

earnings in all past years and for persons with average earnings. Comparisons should be made primarily between the first and second and the third and fourth columns. The figures take into account the effects of the reduction in benefits for early retirement and of the DRC.

The notch, or significant difference, that occurs between virtually similar persons is quite evident. For example, for persons who have always had maximum covered earnings and who retire at age 65, the

one reaching such age at the end of 1981 has a benefit of $789, whereas the one reaching such age at the beginning of 1982 has a benefit of only $679—or $110 less (and 14 percent lower relatively). These differences are less for retirement at ages before 65 and greater for retirement at ages after 65. On the other hand, no significant notch is present between those retiring at age 65 who attained age 62 at the end of 1979 and those retiring at age 65 who were born one month later (only $26). There will tend to be *small* notches between adjacent cohorts, such as the last-mentioned one (as will be discussed in the second following section), but these can be in either direction, depending upon recent economic elements (CPI and wage changes).

Another way of analyzing the notch problem is to consider replacement rates for steady workers who retire at age 65 at the beginning of various years. The replacement rate is the annualized monthly retirement benefit, exclusive of any auxiliary benefits, as a percentage of the previous year's earnings. Such rates are shown for the average-wage case, for selected years, in the middle section of Table 2.10. The rate increased steadily from about 39 percent for 1973 to a peak of 51 percent for 1981 (those born in 1916) and then decreased to 47 percent for 1982 and to the ultimate level of about 43 percent for 1984 and after; the rates for 1985–89 showed an accidental, small trough (varying from 40.8 percent to 41.5 percent for those years).

Thus, although those born in 1917–21 (the notch babies) had lower replacement rates for retirement at age 65 than those born in 1916 and several earlier years, they generally had the same (or even higher) rates than those born after 1921 and those born before 1910. Accordingly, this analysis makes it quite clear that the notch babies do receive equitable benefit treatment as against most other beneficiaries, but that the bonanza babies (births of 1910–16) receive undue windfalls as compared with those born in both earlier and later years. (Note the special treatment for those born on a January 1.)

Still further evidence that the notch babies have been fairly treated as compared with other beneficiaries is obtained by considering replacement rates for retirement at age 62. The PIAs are considered, and not the actuarially reduced benefits for early retirement; the use of the latter instead would show the same general relative results. These rates for retirement in 1978 (year of birth 1916) and later are as follows for the average-wage case. It is quite evident that the rates for those born in 1917–21 are about the same or only slightly lower than those for persons born in both earlier and later years. So no serious or significant notch occurred.

Year of Birth	*Replacement Rate*	*Year of Birth*	*Replacement Rate*
1916	43.3%	1923	43.3%
1917	43.6	1924	43.0
1918	41.3	1925	43.6
1919	41.2	1926	42.2
1920	40.8	1927	42.7
1921	42.6	1928	43.1
1922	42.8	1929	42.9

One solution of this notch problem would have been to raise the benefit level for those attaining age 62 in 1979 and after who retire at ages beyond 62.[168] This could have been done by making earnings at ages 62 and over usable in the transitional-minimum-guarantee procedure. In other words, the notch (or precipice) would have been diminished by pulling up the lower end.

Such a change would have substantially eliminated the notch for the two groups most affected. But two effects would have been created that may be considered undesirable. First, the unduly (and perhaps inequitably) high benefits of those attaining age 62 before 1979 who go on working for a number of years after 1978 would have been *retained*, and the benefits of later-born retirees would have been *brought up* toward that level. Second, as a result, rather sizable costs would have arisen (small initially, but increasingly large for a few years—although tapering off eventually because only a closed group is involved).

Another solution would have been to approach the problem from the other direction—namely, to have a smaller increase in the benefits accruing for *future* earnings for those attaining age 62 before 1979 than is provided under present law. This would have been done only prospectively, and thus benefit rights that had been acquired to date would not have been taken away. The computation procedure for persons who attain age 62 in 1979 or after would not have been affected, so the administrative problems of such a change would have been minimized.

The procedure applicable to persons who attained age 62 before 1979 who are living on January 1, 1980, would have been as follows: Any recomputation of benefits to allow for earnings after 1978 for

168. This procedure was suggested in a memorandum by the author which is appended to the first report of the National Commission on Social Security, May 11, 1979.

this category would have been based on the *increase* in the PIA for including such earnings under the AIME method *over* a PIA computed under the AIME method only on the basis of earnings before 1979 (even though such PIA was not able to be used in the computation of the initial benefit). The DRC under current law is 1 percent per year for all years for those attaining age 65 before 1982, but 3 percent for later attainments. It would have been made a uniform 3 percent for all persons for all periods after 1981.

It might be argued by some that this change would have been undesirable because it represented a deliberalization of benefits. However, it would have been only fair to do this, because the present law provides unduly large benefit increases for work after 1978. Certainly, nobody in this group would have had any reduction in benefits based on earnings credits before 1979. Moreover, persons in this group would have received substantial increases in benefits from earnings in 1979 and later years.

Let us consider how the proposed procedure would have worked for a person who attained age 65 in late 1981, retired then, and had maximum earnings in all past years. The PIA as of January 1979 was $491. If no further work were done, this would have been increased to $686 as of January 1982. The PIA under the AIME method as of January 1982 based on earnings before 1979 would have been $578, while that based on earnings through 1981 would have been $610, or $32 higher. This would have been added to the $686 to yield a total benefit of $718, which is a reduction from the $789 in present law, but is more in line with the $667 benefit for the person who attains age 65 a few months later.

The proposed procedure would have resulted in a far better transition than present law between those attaining age 62 in 1979 and retiring some years hence and those attaining age 62 earlier. It would have had a cost-reduction effect for the OASDI program. The reduction would have been about $60 million in 1980, increasing over the years to about $1.5 billion for 1988 but ultimately phasing down and eventually out. The total reduction in cost for 1980–89 would have been about $8 billion.

Unlike the first solution (which, to be operable, would have had to be enacted by early 1980), the enactment of the second solution could have been delayed for a year without losing all the effect of lessening the notch problem. In other words, under such delayed enactment, for persons who attained age 62 before 1979 who were living on January 1, 1981, the description previously would have been applicable if every year mentioned were increased by 1. Thus, enactment by about the middle of 1981 would have done much to alleviate this illogical

situation (although not eliminate it completely), because it could then have been made applicable to 1980 earnings (which were not posted completely and used for benefit recomputations until the fall of 1981). The Reagan administration had this change as part of its legislative package in 1981, but (as described in Chapter 3) this did not go anywhere—for other reasons than the notch partial solution. Later enactment of such a change could be applicable to the year of enactment and subsequent earnings and, although desirable, would not be as effective in lessening the notch.

This change would not really be a deliberalization but rather a correction of inconsistent, overgenerous treatment of one category of persons. Such a correction would be only of a prospective nature and would not at all affect any past rights accrued. However, as a practical matter, it now seems too late to do anything about this admittedly inequitable and illogical situation. To increase the benefits for those on the "wrong" side of the notch (who are already receiving sizable amounts relative to what they "purchased actuarially") would have serious cost effects on the program. And that might also merely create new notches further down the line. To reduce the benefits for those on the "right" side of the notch who have unduly benefited (primarily those who worked for several years beyond age 62) is probably also impossible. This is the case for both political and humane reasons and from the standpoint of administrative feasibility (i.e., locating those born before 1917 who were unduly advantaged—because not all born then did have such windfalls).

In the mid-1980s, the "notch-baby" issue heated up considerably as a result of several active groups of persons born in 1917–21 who felt unfairly discriminated against. Also, James Roosevelt, a son of President Franklin D. Roosevelt, took up this cause through his National Committee to Preserve Social Security and Medicare. As a result of these widespread and vigorous pressures, many members of Congress introduced bills to increase benefits for the notch-baby group and some cohorts of persons born in the next few years after 1921.

Some notch-baby advocates asserted that their birth cohort is being unfairly treated as against those born after 1921. This is not the case, because, if anything, they are being treated more favorably by having two benefit-computation methods available (whichever is more favorable) rather than only one of them (as is the case for those born after 1921).

That no notch occurs between the 1917–21 group and those born later can be seen by considering a person born at the end of 1921 as against one born at the beginning of 1922, with both of them retiring at the beginning of 1987 (at almost exact age 65). For persons with

maximum earnings in all past years, the monthly benefit is $785 for the 1921 person, or only slightly less than the $789 for the 1922 person. The corresponding figures for the average-wage case are $589 and $593 respectively.

Several congressional committees held hearings on the proposed bills to increase benefits for the notch-baby group. Opposition came from various quarters—some senior-citizen groups, business and labor organizations, and the Reagan administration. Such opposition was based both on cost grounds (and as the unified budget would be affected) and, more important, on the logic that the notch-baby group was not receiving benefits that were too small (or less than intended), but rather that those who were born before 1917 and who worked well beyond age 62 were receiving undue windfalls. Further, three authoritative, expert studies were made—by the General Accounting Office, the Congressional Research Service, and the National Academy of Social Insurance (see Bibliography)—that concluded that no unfair discrimination against the notch babies was present. Legislation enacted in October 1992 provided for the establishment of a Commission on the Social Security "Notch" Issue to study the subject.

Different Benefit Results for Persons Dying or Becoming Disabled at Young Ages in Early 1979 as against Late 1978

As was brought out in the main portion of this chapter, a sharp difference in benefit-computation procedure was introduced in 1979 for death and disability cases before age 62. The new AIME method was made applicable to those cases, whereas for death or disability before 1979, the old coupled method was applicable. As discussed in Appendix 2-5, the latter was particularly (although inequitably) advantageous to young workers (see Table 2.11).

Let us consider the extreme case of death or disability for a person who was aged 29 or under and who died or became disabled alternatively (1) at the end of 1978 and (2) at the beginning of 1979. If earnings had been at the maximum creditable in 1977–78, the PIA for the late-1978 case was $684.70, while that for the early-1979 case was $502.60. The corresponding figures for average-earnings cases were $538.90 and $375.50, respectively. In both earnings cases, there was a sharp decrease in the benefit amounts as between the late-1978 and early-1979 cases, about 30 percent.

Such differentials as those between late-1978 and early-1979 cases decreased for older ages at death or disability. For example, for age-60 cases with maximum-earnings records back to 1951, the PIA for the late-1978 case was $491.20, while that for the early-1979 case was

$453.10, a difference of only 8 percent. The corresponding differential for the average-earnings case was 6 percent.

In some respects, these sharp differences as between persons dying or becoming disabled within a few days of each other were undesirable. However, the situation as to the excessively large benefits for young persons who had contributed only a short time as against older persons who had contributed many years called for immediate action. Even so, this differential was not entirely eliminated. Thus, for the maximum-earnings case, the benefit for the late-1978 case was $193.50 higher at age 29 or under than at age 60 (or 39 percent relatively), whereas for the early-1979 case, the differential was $49.50 (or 11 percent).

Comparison of Benefits Computed under AIME Method for Adjacent Current Cohorts

As discussed previously, the AIME method of computing PIAs based on indexed earnings involves decoupling. Each year's cohort of persons attaining age 62 or becoming disabled or dying before age 62 has a different benefit-computation method, involving a different year to which earnings are indexed, a different benefit formula (with regard to the dollar bands), and, for retirement cases, different years for which automatic CPI adjustments apply. There arises, therefore, the question of how smooth a junction exists for persons who are close to the borderline of two cohorts—for example, those attaining age 62 at the end of one year compared with those who do so at the beginning of the next year.

This section examines first the situation of the PIA for early 1980 for two almost identical persons—one who attained age 62 at the end of December 1979 and another who attained such age at the beginning of January 1980. The PIA benefit formulas for the two individuals are shown in Table 2.5. For the first individual—but not the second one—the resulting PIA is increased by the 9.9 percent automatic adjustment made for June 1979.

Individuals at four earnings levels are considered. The resulting PIAs are shown in Table 2.21. The AIMEs for the 1980 cohort are about 7–8 percent larger than those for the 1979 cohort, primarily due to the indexing being done to 1978 rather than to 1977. The PIAs for the 1980 cohort, however, are about 2 percent lower than those payable to the 1979 cohort in early 1980. This arises because the effect of the 9.9 percent benefit increase applicable to the PIAs of the 1979 cohort (but not to those of the 1980 cohort) somewhat more than offsets the use of higher AIMEs for the 1980 cohort in the re-

TABLE 2.21. Comparison of PIAs Based on AIME Method for Early 1980 for Individuals Attaining Age 62 at End of 1979 and at Beginning of 1980

*Earnings Category**	*AIME for Individual Attaining Age 62 in*		*PIA in January 1980 for Individual Attaining Age 62 in*		*Ratio of PIA for Attainment in 1980 to That for Attainment in 1979*
	Dec. 1979	*Jan. 1980*	*Dec. 1979*	*Jan. 1980*	
Very low	$ 208	$ 223	$188.00	$183.90	97.8%
Low	416	446	261.20	255.30	97.7
Average	823	883	404.30	395.10	97.7
Maximum	1,138	1,208	505.20	492.80	97.5

*The earnings record for the low-earnings individual is $5,300 for 1978 (the minimum hourly wage of $2.65 according to federal law, multiplied by 2,000 hours); for other years, it is the same proportion of the earnings of the average-earnings individual as prevailed in 1978 (namely 50.5 percent). The earnings record for the very-low-earnings individual is arbitrarily assumed to be 50 percent of that of the low-earnings individual in all years.

vised PIA benefit formula applicable to it. Nonetheless, there is a reasonably smooth junction in the PIAs for these two cohorts.

The situation as to the borderline cases of persons attaining age 62 at the end of one year as against those doing so at the beginning of the next year can be similarly demonstrated, using only the AIME method (so as to have proper comparability). The following table does this for the PIAs for the maximum-earnings case for retirement just after the end of the specified year. The variations between the two

Year	*Attainment of Age 62 at*		*Ratio of Beginning-of-Year Case to End-of-Year Case*
	End of Year	*Beginning of Next Year*	
1979	$505.20	$492.80	97.5%
1980	571.50	540.00	94.5
1981	609.90	593.40	97.3
1982	646.60	658.00	103.3
1983	690.40	699.30	101.1
1984	733.60	739.20	100.8
1985	772.00	788.20	102.1
1986	808.40	827.70	102.4
1987	872.70	858.40	98.4
1988	902.80	917.60	101.6
1989	971.40	968.30	99.7

very similar cases are relatively small—and of a random-variation nature, depending upon the trends in the recent past of wages and prices. Under "normal" circumstances, when wages rise somewhat more rapidly than prices (as for the 1983 and later situations), a relatively smooth junction between the two cases will occur.

Effects of Different Types of Earnings Histories

Up to this point, almost all of the computations of replacement rates have been made by assuming that the year-by-year earnings of the retirees followed a smooth trend, either in proportion to the nationwide average or at the maximum creditable amount. This section considers the situation for current new entrants for several different hypothetical earnings trends, with the assumption that the general trend of earnings and prices is the same as assumed in the 1979 and 1980 Trustees Reports for the ultimate situation (i.e., annual rates of increase of 5¾ percent and 4 percent, respectively). The corresponding figures in the next four Trustees Reports were 5½ and 4 percent, respectively, while in the 1990 report and several preceding ones, they were 5.3 and 4.0 percent, respectively. Nonetheless, the analysis can reasonably be made on the basis of the former set of rates.

A common pattern of earnings for steadily employed persons (ignoring the offset of general inflation of earnings) is a rapidly rising trend for workers in their twenties, followed by a leveling-off until their fifties, and then a slow decline. This is typical of blue-collar workers. Assume that Mr. A begins work at age 20 at 50 percent of the nationwide average wage and by age 30 is at 110 percent of such average wage and continues to be until age 55, after which his wage decreases to 80 percent of the average at age 64. Over his lifetime, his average wage was 99.0 percent of the nationwide average (based on the arithmetic average of his 45 earnings ratios to the nationwide average wage).

Mr. A's PIA at age 65 is 53.0 percent of his earnings at age 64 (which can also be expressed as 49.3 percent of his average earnings at ages 60–64, indexed to the general earnings level when he was age 64).[169] If his earnings relative to the nationwide average had been uniform at 99.0 percent, his gross replacement rate relative to his last year's earnings (or, equally, relative to his last five years' earnings, indexed to the last year) would have been only 40.9 percent.

169. His AIME was determined from his 35 highest years after indexing. These were ages 28–59 and 62–64.

Thus, the AIME benefit-computation method produces relatively larger benefits for the increasing-level–decreasing-earnings pattern than for a level one. This may be a socially desirable result and in accord with the social-adequacy principles of OASDI.

Another common pattern of earnings for steadily employed persons is a rising trend until the 40s and a level one thereafter. This is typical of clerical, lower management, and sales personnel. Assume that Ms. B began work at age 20 at 70 percent of the nationwide average wage and by age 45 is at 120 percent of such wage and continues to be through age 64. Over her lifetime, her average earnings would be 105.6 percent of the nationwide average (based on the arithmetic average of her 45 earnings ratios to the nationwide average wage).

Ms. B's PIA at age 65 is 37.2 percent of her earnings at age 64.[170] If her earnings relative to the nationwide average had been uniform at 105.6 percent, her gross replacement rate relative to her last year's earnings would have been significantly higher—40.2 percent.

Upper management and professional employees often have continuously rising earnings patterns. Assume that Ms. C begins work at age 23 at 90 percent of the nationwide average earnings and that her earnings increase steadily each year by four percentage points, until at age 58 she has reached 230 percent thereof, which is the first year that she had the maximum taxable earnings. Then, at ages 59–64, her earnings equal the earnings base.[171] Over her lifetime, her average earnings were 170 percent of the nationwide average (based on the arithmetic average of her 45 earnings ratios to the nationwide average).

Ms. C's PIA at age 65 is 24.6 percent of her earnings at age 64 (i.e., the earnings base in that year). If her earnings relative to the nationwide average had been uniform at 170 percent, her gross replacement rate relative to her last year's earnings would have been 32.5 percent, or very much higher.

Thus, the AIME benefit-computation method produces relatively low benefits compared with final earnings for the steadily increasing earnings pattern. A substantial need in such cases for supplementation through the private sector, either on an individual-savings basis or through employer-sponsored plans, is thus indicated.

When it comes to workers who are not steadily employed through-

170. Her AIME was determined from her 35 highest years after indexing. These were ages 30–64.

171. Cases with more rapidly rising earnings then assumed here would, of course, reach the maximum taxable earnings base sooner and would thus tend to approach the situation for the person with maximum earnings in all years.

out their entire potential working careers, the situation is quite different. For those with level relative earnings while employed, the situation for the gross replacement rate based on earnings just prior to the time when old-age benefits are first claimed (or when not working then, the last earnings indexed up until then) does not differ greatly depending upon when the employment occurred. For example, if two persons worked for only 10 years and had the same relative level of earnings (e.g., the nationwide average, or some multiple thereof), the PIA would be the same regardless of the fact that one worked at ages 21–30 and the other at ages 51–60.[172]

Before the 1977 Act, under the coupled procedure then in effect, the late-age entrant (such as career government employees who are not covered by OASDI in such employment and who take early retirement and then enter OASDI employment) received much larger benefits than did similar early-age entrants who dropped out of the paid labor market after some time and did not return later (such as some female workers). Thus, the change in the indexing procedure had some tendency to reduce the windfalls previously available for late-age entrants to OASDI.

Finally, consider those who have OASDI coverage during their younger ages, then have a gap, and later return to covered work in the middle ages (as do many female workers who cease paid employment for some years to raise a family). Under these circumstances, if their earnings while employed are relatively level (compared with the nationwide average), the only effect is the diminishment of the AIME because of years of zero earnings (although the provision of five dropout years and the possibility of substituting high years of earnings at age 62 or over for low or zero years before then tends to be offsetting). Such decrease, however, is not proportionately reflected in the PIA because of the weighted benefit formula.

Suppose that Mrs. D is covered at the nationwide average wage at ages 20–29 and again at ages 45–64. Her PIA will be only 10.1 percent lower than if she had been employed for the entire period from age 20 to age 65. In fact, if she had been out of the paid labor market for only 10 years in that period (e.g., at ages 30–39) instead of 15 years, her PIA would not have been affected at all.[173] Proposals to provide more dropout years for those taking care of young children

172. However, the PIA would be slightly lower for a similar person who worked from, say, ages 55–64 (due to the fact that earnings after age 60 are not indexed).

173. This is because of the five-year dropout and the substitution of the two "good years" before age 22 and of the three "good years" at ages 62–64 for "zero years" between ages 21 and 62.

would, of course, further ameliorate (or even eliminate) the reduction in benefits for such periods of noncoverage.

Effects of Retiring at Various Ages beyond 62

As indicated in the discussion of Table 2.10, the gross replacement rate of the PIA for a steady worker with uniform earnings relative to the nationwide average decreases slightly as retirement is delayed beyond age 62. For delay beyond age 65, the drop is more than offset by the effect of the delayed-retirement increment (under likely economic conditions). The extent of the decrease will depend on the relative future trends of wages and prices—and, in fact, under some circumstances, no decrease will occur.

At a cursory glance, one might say that it is unfair for individuals who work longer (beyond age 62) to have *lower* replacement rates. Actually, such persons will have *larger* benefit amounts (and they will have had the advantage of larger earnings than the benefit amounts which they would have received if they had retired earlier), but these are measured against the higher earnings after age 62 (according to the economic assumptions underlying the benefit projections). The basic cause of this is that earnings before age 60 are only indexed to that age, and all subsequent earnings are used in their absolute amounts (i.e., unindexed). As discussed in the main text, this procedure is logical and is necessary for reasons of administration and public understanding.

Let us consider the case of Mr. E, who attained age 62 in early 1979 and had average earnings in all previous years. The analysis will be only under the AIME method, because this is the only method available to those who attain age 62 after 1983, and thus this approach is indicative of future situations. The same general results will occur for other earnings levels over the long run and for persons who attain age 62 in years after 1979. Similarly, it will be assumed that the ultimate intermediate assumptions of the 1979 and 1980 Trustees Reports as to future wage and price increases (5¾ percent and 4 percent, respectively) will apply for all years after 1977; this approach is followed, rather than using the actual wage increases and COLAs, solely to indicate the general principle involved over the long run (as would similarly occur if other wage/price increases were used).

If Mr. E ceased employment in early 1979, his PIA was $365.60, yielding a gross replacement rate of 42.8 percent. This is the amount payable at age 65 in early 1982, exclusive of the automatic adjustments in 1979–81. However, the amount actually payable at age 65, including the effect of the COLAs, if Mr. E deferred receipt of bene-

fits until then, is $411.50. If Mr. E continued to work until age 65, his PIA would be $418.50, yielding a lower gross replacement rate (41.1 percent) but an amount that is 1.7 percent higher.

If Mr. E continued to work until age 70 in 1987, however, his PIA (inclusive of COLAs) will be $547.10, yielding a replacement rate of 40.6 percent, which is also lower than the rate at age 62 (42.8 percent). This PIA of $547.10, though, is well above the age-62 PIA adjusted for CPI increases to 1987 ($501.00). Moreover, the benefit for retirement at age 70 is the PIA increased by 15 percent for the DRC; if this were considered, the replacement rate would be 46.7 percent.

Effects of Different Economic Assumptions

Up to this point, the economic assumptions about future wage and price trends used to illustrate various principles over the long run have been only those utilized in the intermediate-cost estimate of the 1979 and 1980 Trustees Reports. Let us now see what effect different economic assumptions have on replacement rates. The procedure is to begin with the PIA formula for the 1979 cohort and to study how it would change, and what gross replacement rates would result for workers with average earnings, under different economic assumptions for years after 1977. If workers at other earnings levels were considered, the relative results would be the same, except for the maximum-earnings case, when the earnings base has, at times, been increased proportionately more than the general wage level rose.

If the general nationwide wage level increases at the assumed ultimate rate of 5¾ percent per year, the PIA formula for, say, the 1985 cohort would be:

90 percent of the first $252 of AIME, plus
32 percent of the next $1,265 of AIME, plus
15 percent of the AIME in excess of $1,517

However, if such wage increases were 10 percent, the formula would be:

90 percent of the first $319 of AIME, plus
32 percent of the next $1,603 of AIME, plus
15 percent of the excess of the AIME over $1,922

At first glance, these two formulas appear quite different and might be expected to yield quite different results for replacement rates.

However, at the same time that the dollar factors in the formulas are changing, so too are the indexing wages (which are the 1983 average wage for these formulas). For the first formula the indexing wage is $13,678, whereas for the second one it is $17,324. Thus, the AIMEs are much larger than for the 1979 cohort, and more so for the second formula—as are also, of course, individual earnings. The net effect tends to be counterbalancing, and would be exactly so if it were not for the influence of the two-year lag in indexing. As a result of this factor, the earnings used for the computation of the replacement rate are affected in a different manner, and thus different results occur.

Considering an individual in the 1985 cohort with average earnings, the replacement rate of the PIA for retirement at age 62 is 42.4 percent under the 5¾ percent wage assumption and 40.8 percent under the 10 percent assumption. These same *rates* would be obtained for all other future cohorts. Moreover, if the replacement rates were to be determined from the earnings in the *second* year before retirement, instead of the immediately preceding one, they would both be 44.9 percent. Such a figure would also result under the assumption of wages not increasing after 1977 (in which case the 1979-cohort PIA formula would apply to all future cohorts).

It will be noted that, in the foregoing discussion, CPI changes did not enter in. The result of stable replacement levels over time—although at somewhat different levels when measured against the last year's earnings, but not when measured against the penultimate year—was the intent of the decoupling procedure adopted in the 1977 Act.

Although the CPI has no effect on replacement rates for those retiring at age 62, it does have some small effect for later retirements. Let us consider the same situation as above, but using only the 5¾-percent wage-increase assumption and combining it with several CPI assumptions, for the case of a person in the 1985 cohort with average earnings who retires at age 65 (in early 1988). If the CPI rises at the rate of 4 percent per year, the replacement rate would be 40.9 percent, or well below the age-62 rate of 42.4 percent. On the other hand, if the CPI rises at the same pace as wages, the replacement rate would be 43.0 percent or slightly higher (due to the effect of the higher earnings at ages 62–64, which slightly exceed the average of the indexed earnings up through age 60).

Thus, as the excess of the annual wage increase over the CPI increase becomes larger, the replacement rates for those retiring after age 62 decrease (although the dollar amounts of the PIAs rise compared with those payable if retirement had taken place at age 62). This effect occurs because of the indexing being fixed to age 60, and only the CPI increases being recognized at age 62 and after.

Appendix 2-10

Net Replacement Rates for Persons Retiring at Age 65 and for Young Workers Becoming Disabled or Dying

The general practice in measuring the relative size of OASDI benefits over the years has been to compare them with the gross earnings in the year before the assumed claim for benefits occurred. It is, of course, realized that the resulting replacement rates can—because of income taxes, OASDI-HI taxes, and work expenses—be well below 100 percent and yet indicate substantial (or even full) maintenance of previous living standards. The taxability of OASDI benefits, introduced by the 1983 Act, also can have an effect (in the opposite direction).

Concept of Net Replacement Rates

A much more scientific and meaningful procedure is to develop net replacement rates by comparing net income after the receipt of benefits (after taxes, if any) with that immediately prior to the claim of benefits (after all taxes and work expenses).[174] Such comparison could also be made with some sort of an average earnings over recent years prior to the claim. However, if the hypothetical example assumes that the individual's earnings moved smoothly in the past in line with general wage trends, the results of using such an average (especially if indexed earnings are used) will be little different from the results of using the last year's earnings.

The difficulty with using net replacement rates is that precise assumptions are not possible about income taxes and work expenses. Federal income taxes are, of course, known at any time, but there is a question of what rates to use for long-term analysis. As to state income taxes, the procedure to be used here is to select a "typical" state—in this case, Maryland.[175] For both income taxes, there is a question of

174. Some studies also take into account the believed reduced savings needs of beneficiaries as against those of active workers; this, however, seems to be too nebulous an element to consider. Other studies consider health-care expenses, which tend to increase with age; here again, the consideration is blurred by the existence or nonexistence of private health insurance (of varying scope) before age 65 and of Medicare after age 65.

175. Maryland has one of the highest state income taxes (including, in 1990, a 50-percent "piggy-back" county tax for almost all of its counties). After personal exemptions and itemized or standard deductions, the tax rate is essentially 7½ percent. In 1988, according to the Tax Foundation, Washington, D.C., the per-capita state and local income taxes in Maryland were the second highest in the nation.

whether the family involved has income in addition to the earnings of the individual under consideration (i.e., nonearned income or earned income of a second worker) and of what the deductions are. In these analyses, only one-worker families and standard deductions are considered (although the effect of other circumstances will be noted).

Appropriate work expenses is an element even more difficult to assign precise values to, because there is so much variation among individuals. Most studies on this subject have used what amounts to virtually a uniform percentage of gross income as work expenses.[176] However, in this analysis a somewhat different concept of work expenses is used—namely, "minimum necessary work expenses." This involves considering only the smallest costs that would be necessary for work that would be in excess of what would otherwise have been spent for everyday living; this excludes luxury items such as expensive lunches and more costly means of commuting than public transportation. Accordingly, the assumption used here is a flat amount of $300 per year, plus 2 percent of earnings, with a $700 maximum.

The net replacement rates are developed only for steady workers. The past earnings trends are assumed to follow those of the prevailing average wages (as used in the indexing process). The OASDI benefit amounts are determined from the AIME method. Although reductions in nominal federal income taxes have been made since 1981, with indexing of the tax brackets over the long run, the net effect is not large from a *relative* standpoint.[177]

Under no circumstances will an individual with no other income for 1990 than OASDI benefits pay federal income taxes thereon. In fact, for a single person who is receiving the maximum benefit available to a person who retired at age 65, in early 1989 (and who had not had a period of disability), no federal income tax will be payable on the benefits for 1990 until other income is at least $19,355 (the early-1990 retirement case is not used, because such a person receives benefits *for* all 12 months of the year but only 11 benefit checks are received *during* the year and are subject to income tax). For a married one-

176. For example, Howard E. Winklevoss and Dan M. McGill used the basis of $100 per year, plus 5 percent of earnings [in *Public Pension Plans—Standards of Design, Funding, and Reporting* (Homewood, Ill.: Dow Jones-Irwin, 1979)]; Jane L. Ross (Department of HEW) used varying percentages, ranging only between 6.1 and 7.6 percent; and the Department of HEW, in testimony before the House Committee on Ways and Means on March 20, 1979, used a uniform 6 percent. It may also be noted that some studies have used a uniform figure of 13.6 percent to represent the combination of the lower consumption resulting from retirement (see Peter Henle, "Recent Trends in Retirement Benefits Related to Earnings," *Monthly Labor Review*, June 1972, table 7).

177. For a demonstration of this tendency, for the past, see Bruce D. Schobel, "A Comparison of Social Security and Federal Income Taxes," Actuarial Note No. 102, Social Security Administration, April 1981.

earner couple, the corresponding figure is $23,721 (if both are maximum earners, $20,710).

In the long run, because the threshold amounts are not indexed, more and more beneficiaries will have to include up to 50 percent of their OASDI benefits in their taxable income. This does not mean, however, that they will have to pay any income taxes thereon, because of the personal exemptions and the standard deduction given when itemized deductions are not used. For example, based on the 1990 tax provisions, a single person aged 65 or over can have up to $6,100 of taxable income and yet have no tax liability (for a married couple, both aged 65 or more, filing jointly, $10,200). In mid-1990, the average OASDI retirement benefit for single persons was at an annual rate of about $6,670 (for a married couple, $11,690). Thus, probably, *in the absence of any other income*, about 40 percent of all beneficiaries would have had no income-tax liability on their OASDI benefits if there had been no thresholds (and thus if 50 percent of their benefits had been considered as taxable income).

It is likely that this same situation will prevail in the future even though the threshold amounts remain unchanged—as was the underlying intent of the proposal to tax OASDI benefits. The reason that the situation will probably prevail under these circumstances is that the personal exemptions and standard deductions are scheduled by law to be updated as income levels rise.

Accordingly, the following derivation and presentation of net replacements will *not* consider the effect of possible income taxation of benefits. This is done because it is very likely that a large proportion of beneficiaries, primarily those with little other income and with below-average benefit rates, will have no income-tax liability—and thus the net replacement rates would be unaffected by this factor. For others, it is impossible to hypothesize what the level of their other income will be. Nonetheless, some analysis will be presented as to the effect of income taxes on net replacement rates for the extreme case of persons in the top tax brackets.

Net Replacement Rates for Single Persons

Table 2.22 presents net replacement rates for single persons (or married persons whose spouse is not eligible either by reason of age or because of eligibility on his or her own earnings record) retiring at age 65 in early 1990. It is assumed that earnings before 1989 were equal to the 1989 earning projected backward by the wage-indexing series (see Table 2.18). It was also assumed that the maximum taxable earnings bases before 1989 were those derived from the 1989 base of

TABLE 2.22. Net Replacement Rates for Single Persons Retiring at Age 65 in Early 1990*

Earnings in 1989	*Federal Income Tax*	*State Income Tax*	*Social Security Tax*	*Work Expenses*	*Net Take-Home Pay*	*Annualized OASDI Benefit*	*Net Replacement Rate*
$ 5,000	—	—	$ 375	$400	$ 4,225	$ 3,792	89.8%
8,000	$ 437	$ 316	601	460	6,186	4,680	75.7
10,000	739	466	751	500	7,544	5,256	69.7
15,000	1,489	804	1,126	600	10,981	6,720	61.2
20,000	2,239	1,179	1,502	700	14,380	8,184	56.9
25,000	3,168	1,554	1,877	700	17,701	9,648	54.5
30,000	4,568	1,929	2,253	700	20,550	10,584	51.5
35,000	5,968	2,304	2,628	700	23,400	11,280	48.2
40,000	7,368	2,679	3,004	700	26,249	11,964	45.6
45,000	8,768	3,054	3,379	700	29,099	12,648	43.5
48,000	9,608	3,279	3,605	700	30,808	13,056	42.4

*See text for description of assumptions and methodology.

$48,000 in a similar manner. The latter assumption was made so as to eliminate the distortion that would otherwise have occurred because the actual earnings bases for 1980 and earlier were relatively significantly lower than the 1982 and later bases (because of the ad hoc increases in 1979–81 and 1972–74). By eliminating the distortion we can properly show the long-run tendencies.

The net replacement rate is as high as 75–90 percent for very low earners (who have both low earnings rates and, very likely, not full employment). Workers with average earnings (about $20,000 for 1989) have rates of about 55 percent, and even those with earnings that are 150 percent of the average have rates of about 50 percent. The rate for those with exactly the maximum covered amount in 1989 ($48,000) is 42 percent.

For persons with substantial other income—and for any above-average benefit level ultimately—the replacement rates shown would be lower when account is taken of the income taxation of benefits. At the extreme, the replacement rates could be reduced by as much as 20 percent relatively (based on 50 percent of the benefits being taxable at the maximum federal rate of 33 percent and a state rate of 7½ percent). On this basis, the replacement rate for the maximum earner would be reduced from 42 percent to 34 percent.

Net Replacement Rates for Married Persons

Table 2.23 similarly considers a married person retiring at age 65 in early 1990, with a spouse the same age. This is not typical for a married man, because the wife is usually several years younger. In the case of the wife being age 62, the net replacement rates would be 8⅓ percent lower than those shown in the table.[178] Also, in the long run, the case of a married couple is not typical, because in most families each spouse will have a benefit based on his or her own earnings, and thus no spouse's benefit, or else a significantly reduced one, will be payable.

The net replacement rates for the couple are well over 100 percent for very low earners and about 80 percent for average earners. For those with earnings of about 150 percent of the average, the rates are about 70 percent, while for the maximum-earnings case, the rate is 59 percent. The latter rate would be reduced to 47 percent for the maximum-income-tax case.

178. The respective benefit rates relative to the PIA for the 65/65 and 65/62 cases are 150 percent and 137½ percent, respectively.

TABLE 2.23. Net Replacement Rates for Married Persons with Spouse of Equal Age Retiring at Age 65 in Early 1990*

Earnings in 1989	*Federal Income Tax*	*State Income Tax*	*Social Security Tax*	*Work Expenses*	*Net Take-Home Pay*	*Annualized OASDI Benefit*	*Net Replacement Rate*
$ 5,000	—	—	$ 375	$400	$ 4,225	$ 5,668	134.6%
8,000	$ 122	$ 124	601	460	6,693	7,020	104.9
10,000	422	271	751	500	8,056	7,884	97.9
15,000	1,174	646	1,126	600	11,454	10,080	88.0
20,000	1,924	966	1,502	700	14,908	12,276	82.3
25,000	2,674	1,321	1,877	700	18,428	14,472	78.5
30,000	3,424	1,696	2,253	700	21,927	15,876	72.4
35,000	4,174	2,071	2,628	700	25,427	16,920	66.5
40,000	5,168	2,446	3,004	700	28,682	17,940	62.5
45,000	6,568	2,821	3,379	700	31,532	18,972	60.2
48,000	7,408	3,046	3,605	700	33,241	19,584	58.9

*See text for description of assumptions and methodology.

General Conclusions Drawn from Analyses of Net Replacement Rates

When work expenses are higher than the so-defined minimum necessary ones used in the foregoing analysis or when the individual has larger income-tax deductions than the standard ones, the net replacement rates will be somewhat higher than those presented.

In summary, this analysis of net replacement rates has shown that, for retirement cases, the OASDI benefits take care of the full economic needs of very low earners reasonably well. At the same time, these benefits provide substantially for average earners (who, nonetheless, have some need for additional protection), and they yield a floor of protection for upper-middle and high earners (above which there is ample room, and need, for further protection).

The disability benefits when eligible dependents are present and the young-survivor benefits are at a relatively high level for all incomes and thus leave little room for supplementation, except for high earners. In fact, in two-earner families, the benefits in combination with the earnings of the worker who is not disabled or who survives the deceased insured worker are often excessive (due to the benefits not generally being subject to income tax).

Appendix 2-11

Detailed Description of Actual Method of Operation of Earnings Test

Chapter 2 has described the general basis of the operation of the OASDI earnings test. This appendix gives a more detailed account of this subject, describing both the actual administrative procedures and the results when more than one beneficiary is involved in the same earnings record or when a beneficiary is receiving more than one type of benefit. Only the operation of the annual test is considered because the monthly test frequently is not applicable (and, even so, the same procedures are involved in withholding the amount of benefits prescribed by the earnings test).

The Social Security Administration encourages beneficiaries to report to it, at the beginning of the year, the amount of anticipated earnings for the year. This is done so that benefits can be withheld for sufficient months in an amount that will closely approximate what the actual operation of the earnings test will call for after the year has been completed. As a result, the individual will not have a "dry spell" the next year, when neither benefits nor earnings will be available for some months. If benefits were not withheld in the current year, they

would have to be withheld in the next year when the actual results of the earnings test had been determined. The procedure is thus somewhat similar to that for the federal income tax; there is withholding or advance payment of tax in the current year, but final determination and balancing only after the end of the year.

Only One Person Eligible for Benefits

First, consider the case when only one individual is entitled to benefits on an earnings record. Under such circumstances, the amount to be withheld is charged against benefits beginning with the first month of the individual's taxable year (in almost all cases, January) and proceeding with such subsequent months as are necessary. For example, if Mr. A, age 65, had an old-age benefit of $600 per month for January–November 1990 and $630 for December 1990 and had earnings of $19,920 equally distributed throughout all months of 1990, the $3,520 loss of benefits (33⅓ percent of the excess of $19,920 over the exempt amount of $9,360) would technically mean that his benefits of $3,000 for January–May would be completely withheld, and the remaining $520 would be withheld from the June benefit.

For an individual entitled to benefits for all months of the year, there is really no difference, on balance, as to which months' benefits are withheld. However, if the individual is not entitled in every month of the year, the situation can be different. Thus, if Mr. A became age 65 in June and did not become entitled (by filing a claim) until then, his entire earnings for 1990 would be used in determining the $3,520 reduction in benefits due to the earnings test applicable to the benefits for June–December, which would be somewhat in excess of $4,530 (because the small actuarial reduction for receipt of benefits before age 65 would not have applied). Note that the monthly earnings test would not help Mr. A, because he had substantial earnings (above the monthly exempt amount) in all months of 1990. Mr. A could have avoided this loss by having filed claim in January, in which case he would have lost all of his benefits for January–May and $520 of his June benefit; at the same time, he would have completely "worked off" the actuarial reduction for early retirement, and full-rate benefits would have been paid for June 1990 and after. Under the law as it was before legislation was enacted in 1990 that prevents retroactive filing when reduced benefits are involved, Mr. A could have obtained the same result by filing in June retroactive to January.[179]

179. This was not prevented by the provision prohibiting retroactive benefits being paid if a reduced benefit results, because the reduction would be wiped out by the nonpayment for January–May. If annual earnings were somewhat lower than $19,920

Several Persons Eligible for Benefits

When more than one person besides the insured worker is entitled to receive benefits for a month, and a reduction must be made for that month under the earnings test because of the earnings of the worker, a complex apportionment procedure is used when the reduction is less than the family benefit otherwise payable. The resulting reduced total benefit payable is apportioned to each beneficiary in accordance with the ratio of the beneficiary's benefit rate (not considering reductions applicable for early retirement or the antiduplication provision) to the total benefit rates of all family members (but with the overriding provision that the benefit payable can be no more than what it had normally been reduced to under the MFB provision). For example, for a retired worker aged 65 with a wife and two children under age 18, the total benefit rate is 250 percent (100 percent for the worker and 50 percent for the others); if a reduced benefit of $500 (which is less than the benefit normally payable) is to be made, $200 of it is paid to the worker and $100 to each of the other beneficiaries, but the net result cannot be larger benefits than would otherwise be payable to such other beneficiaries after the effect of only the MFB provision.[180]

In the multiple-beneficiary case, as in the single-beneficiary case, the deductions are made beginning with the first month of the taxable year and going on through the year until the total amount of reduction has been accounted for. Thus, an auxiliary beneficiary first coming on the rolls during the year may not have his or her benefits affected.

When both the insured worker and an auxiliary beneficiary have a deduction to be made against benefits because of earnings, this is first done for the worker's earnings and then on the remaining bene-

(but still spread equally throughout 1990), the month to which retroactive filing would be made would possibly have to be later than January. For example, for $17,400 of earnings in 1990 and filing claim in June, without retroactivity the benefit loss would be $2,680. But benefits could be claimed beginning with February, so that benefits would be lost in full for February–May, and the only reduction of benefits for June–December would be $280.

180. For example, if the PIA were $440 and the MFB were $800, the benefits normally payable would be $440 for the retired worker and $120 for each of the others (because the MFB provision does not reduce the worker's benefit), as against $220 for each of the others before the MFB. A total earnings-test reduction of $100 (yielding a total family benefit of $700) would give a benefit of $140 for each auxiliary beneficiary. However, because this is more than the normal $120 benefit, only the latter is payable, and the entire $100 is assessed against the worker's benefit. If the total reduction were $500, the benefit of each auxiliary beneficiary would be $60 (and $120 for the retired worker, making a total family benefit of $300—i.e., $800 minus $500).

fits of the auxiliary beneficiary (including any benefits based on his or her own earnings record) for his or her earnings.[181] Note, however, that the earnings of an auxiliary beneficiary reduce only his or her benefit and not that of the insured worker or any other auxiliary beneficiaries.

Finally, in a family where all beneficiaries are auxiliaries (e.g., widowed mother and children), the earnings of one beneficiary do not affect the benefits of the others. Also, the MFB is applied *after* the deductions due to the earnings test have been made from the full benefits prior to the effect of the MFB. The result is that substantial employment of one beneficiary may not affect the total payable to the family if the MFB would be operative when only the remaining beneficiaries are considered—for example, in a family consisting of a mother and three or more children, if the mother (and no others) works substantially in the paid labor market. This result is logical, because the mother need not have filed for benefits (in which case the children would have had the MFB) and so should not be disadvantaged by such action.

Appendix 2-12

Automatic-Adjustment Procedures Applicable to Maximum Taxable Earnings Base

The 1972 Act established provisions for the automatic adjustment of the maximum taxable earnings base so that it would be kept up to date with changes in the general level of earnings. Such adjustments were first to be made for 1975, with the bases for 1973–74 being established by legislation. The base is changed only for years after there have been automatic CPI benefit increases effective in the pre-

181. For example, assume that Mr. B has a benefit of $400 based on his own earnings, and Mrs. B has no benefits based on her own earnings but has a benefit of $200 from Mr. B's earnings record. Assume also that deductions in the year because of the earnings test must be made in the amounts of $870 due to Mr. B's earnings and of $350 due to Mrs. B's earnings. Mr. B's $870 would be collected by withholding their January checks and reducing the February checks by $270 (so that they would be $220 and $110, respectively). Mrs. B's $350 would be collected by withholding the $110 residual for February, her normal $200 for March, and $40 from her April check. On the other hand, if Mrs. B has a benefit of $150 based on her own earnings record, her residual wife's benefit is $50. Then Mr. B's deduction of $870 for the year is made by withholding the January checks of $400 for him and $50 for Mrs. B and by withholding $420 from the February checks ($380 from Mr. B and $40 from Mrs. B). Mrs. B's deduction of $350 is made by withholding her $150 benefits for January and February, her $10 wife's benefit for February, and $40 from her combined primary and wife's benefit of $200 for March.

ceding year, and only then if the base would be *increased.* The automatic increases are, of course, negated if legislation providing ad hoc changes in the base is enacted (as occurred for 1979–81 as a result of the 1977 Act). The same procedure is applicable to both the OASDI and HI bases (which are different after 1990).

The data used for measuring changes in the general level of earnings originally were the annualized average first-quarter reported wage in covered employment (per worker with such wages). The first-quarter wage was utilized because it was only slightly affected by the earnings base (few workers attain such level of cumulative taxable wages before April). Wages of farm workers were excluded because they were reported only on an annual basis (as is self-employment income). These data for the first quarter of a particular year were available by fall, so that the computations of the earnings base for a particular year could be (and were) based on the change from the second preceding year to the preceding one (i.e., the year in which the computation was made). For example, in determining the base for 1975, the increase from 1973 to 1974 was used. These average wages are also used in the indexing of the earnings record (see Table 2.18).

Under the initial procedure, the percentage increase was applied to the earnings base for the year preceding the one for which the determination was being made (i.e., the year in which the determination is being made). The resulting figure, if it was an increase, was rounded to the nearest exact multiple of $300. For example, the 1975 base of $14,100 was derived by increasing the 1974 base of $13,200 by 5.9445 percent (yielding $13,985).

If the procedure does not result in an increase in the base, then it remains unchanged, and the determination for the next year is made on the basis of the original average wage. For example, if the computation for 1975 had not yielded an increase in the base over the $13,200 for 1974, the determination for 1976 would have been based on the increase in the average wage for 1975 compared with that for 1973.

When annual reporting of wages was instituted effective for 1978, the method of determining the change in average wages had to be revised. It was then necessary to use annual wage data. For this purpose, total wages in the country (as obtained from income tax Forms W-2) were preferable to OASDI wages, because the latter are significantly affected by the maximum taxable earnings. However, using annual wage data requires an additional year of lag. Thus, the earnings base for 1982 was determined from the 1981 base of $29,700 and the change in the average wage from 1979 to 1980.

The change to the two-year-lag basis was made effective for the de-

termination of the 1977 base. As a result, the increase of 7.4733 percent for 1975 as against 1974 was used twice—for the 1976 and 1977 bases.

For each year after 1978, the law provides that the Secretary of HHS will determine what the earnings base would have been if the three ad hoc increases in the base provided by the 1977 Act had not been made. These old-law bases are utilized for three purposes: (1) determination of the earnings requirements for a year of coverage for purposes of the special-minimum benefit, (2) the maximum earnings base for the second tier of the Railroad Retirement system (see Chapter 12), and (3) determination of changes in the amount of the maximum pension insurable by the Pension Benefit Guaranty Corporation under ERISA. Such base promulgated with respect to 1979 was $18,900 (based on $17,700 increased by 5.9932 percent—the increase in the average wage from 1976 to 1977). The subsequent old-law bases were determined in a similar manner (and are shown in Table 2.5).

The adjustment for the earnings base (and the earnings test as well) follows a slightly different procedure than is done for the PIA and MFB formulas under the AIME method (and the determination of the earnings requirement for QC after 1978). For the former, the percentage increase in wages from year to year is applied to the current factor to yield the next year's one. For the latter, the percentage increase in wages from 1977 to the preceding year is applied to the 1979 factor to yield the next year's one (1976 and 1978, respectively, as to the QC requirement). This latter procedure is preferable, because it results in less bias due to rounding from year to year.[182]

Appendix 2-13

Coverage of Noncash Remuneration, Special Types of Payments, Deferred Compensation, and Salary Reductions as Wages

Certain special situations occur for OASDI taxes and benefit credits for certain types of noncash remuneration of employees. These relate

182. For example, the unrounded result for 1982 was $32,375.20, which was rounded up to $32,400. Then, for 1983, the unrounded result derived from using the 1982 base of $32,400 was $35,661.47, which was rounded up to $35,700. Finally, for 1984, the unrounded result derived from using the 1983 base of $35,700 was $37,665.36, which was rounded up to $37,800. On the other hand, if the foundation for all future years had been the $29,700 for 1981, the base for 1984 would, somewhat more logically, have been $37,500 (by rounding the figure of $37,595.91, based on $29,700 times the ratio of the 1982 average wage of $14,531.34 to the 1979 average

to payments in kind, business expenses for certain categories of employment that are deemed to be employment as an employee, sickness benefit plans, various types of fringe benefits, and the payment by the employer of the employee OASDI-HI tax. Also, special rules apply to certain types of deferred compensation and to salary reductions that are made for the purpose of providing fringe benefits.

Payments in Kind

In general, payments in kind (such as goods, clothing, board, and lodging) are considered wages. This is not the case for farm, domestic, and casual workers or for tips. However, when the payment in kind is made solely for the benefit of the employer (such as when the job is in a remote area and the employer provides housing), it is not taxable.[183] Persons in military service are covered only on the basis of their cash base pay, but additional noncontributory credits at the rate of $1,200 per year (with the cost thereof being met by the federal government) are granted to recognize, in part, payments in kind or as allowances in lieu thereof.

In actual practice, it is likely that many small payments in kind are not reported as wages for OASDI purposes.

Business Expenses of Certain Employees

Certain categories of workers in the sales field who are not employees under the common-law definition are deemed by the law to be employees for OASDI purposes. These include full-time life insurance agents (see Appendix 2-1), agent-drivers and commission drivers distributing certain items,[184] and other full-time traveling or city salespersons.

Quite often, such persons do not have any significant work expenses. However, in some cases they do, and then their OASDI taxes

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wage of $11,479.46). It should be noted that, although under the actual circumstances, the less logical actual procedure produced too high a base for 1984, the reverse situation could just as readily occur in the future.

183. Until a decision of the Supreme court [*Rowan Companies, Inc. v. United States*, 452 U.S. 247 (1981)], such payment in kind was ruled by the Internal Revenue Service to be taxable for OASDI-HI purposes although not for income-tax purposes. The 1983 Act codified the *Rowan* decision but specified that, with the exception of meals and lodging provided for the convenience of the employer, the determination of whether or not amounts are taxable for OASDI-HI purposes is to be made without regard as to whether such amounts are treated as wages for income-tax purposes.

184. Meat or meat products, vegetables or vegetable products, fruit or fruit products, bakery products, beverages (other than milk), and laundry or dry-cleaning services.

and benefits are, nonetheless, based on their gross income from the "employing" organization and not on their net income (as would be the case if they were self-employed). For example, such a life insurance agent might have unreimbursed automobile expenses or office expenses and yet would pay OASDI taxes on total commissions received, rather than on net income from his or her operations.

Sickness Benefit Plans

Until legislation in 1981, payments on account of "sickness or accident disability" which were made under a plan established by the employer (whether insured or self-administered) were not considered wages for OASDI purposes. If such payments were made not under a plan, but rather on an ad hoc basis, they were considered wages for the first six months of disability only.

This provision created some problems. Many employers with sick-leave plans did not bother to exclude the wage continuation for short spells of illness from the reporting of OASDI wages. This occurred largely because the employee was paid the full salary for the pay period, and the payroll system was geared to deduct full income-tax and OASDI-tax withholding. Also, many state and local governments, although actually paying sick-leave benefits, did not have the explicit legal authority to make such payments and to establish a plan to do so.

A simple solution to this problem—and one with much logic—was adopted by legislation in 1981. All payments for sickness under employer plans were made subject to OASDI coverage during the first six months. Of course, in the case of those who have wages while working in excess of the maximum taxable earnings base, such a change has no effect. Temporary disability insurance (TDI) benefits under state plans are included as such covered sick pay.

Other Types of Fringe Benefits

Payments by employers for other types of fringe benefits (e.g., pensions under a qualified plan, limited amounts of life insurance, and health insurance) are not counted as wages for OASDI purposes. Payments under certain supplemental retirement plans that provide COLAs are also not counted as wages. The employer premium on group term life insurance in excess of $50,000 is counted as wages (for former employers who have such benefits, the employee share of the tax is paid through the income-tax system). Dismissal pay and bonuses also count as wages. Special treatment applies to deferred-

compensation plans and to nonqualified or selective pensions—as will be described in the following two sections. Payments under a profit-sharing plan are counted as wages if immediately distributed but not if deferred (so as to serve as a retirement benefit). Before the 1983 Act, retainer (or stand-by) pay made after the individual was aged 62 was considered the same as a pension under a plan if no work was actually being performed (and it was not for vacation or sick pay), but now it is considered to be covered wages if made in the expectation that the individual will subsequently render services.

Deferred-Compensation Payments[185]

Deferred compensation can take many forms. Here, only some simplified cases will be considered—namely, when service in a particular year produces a lump-sum payment some years hence.

Before the 1983 Act, such payments were considered both taxable and creditable for benefit purposes at the time received. However, such payments did *not* affect the earnings test applicable to beneficiaries (because the payment was not earned on the basis of services in the year received).

The 1983 Act significantly changed the situation by making such payments for services rendered after 1983 be considered wages when the services with respect thereto occurred, unless the future payment of the deferred compensation was subject to a "substantial risk of forfeiture." In the latter case, the deferred compensation is considered wages when such risk is no longer present (at the latest, of course, when the payment is made). Any deferred-compensation payments based on service before 1984 will continue to be treated under the basis of the prior law. Unfortunately, as of mid-1992 the Internal Revenue Service had not yet issued regulations on the treatment of deferred compensation, which is very complex because of the many forms that it can take. The following descriptions are based on the author's views as to what the legislation apparently provides.

It is not clear, under all circumstances, when a substantial risk of forfeiture is present. Such risk obviously is not present if the payment is funded in a place not under the control of the employer. Previous IRS rulings stated that, even though the payment might not be made if the individual died before it was due, such risk was not considered to be "present." Likewise, if the employer self-funded for the future payment (rather than its being separately, independently funded),

185. Lump-sum severance or termination pay is really only a special case of deferred compensation. It is taxable at the time of receipt, but does not count for purposes of the earnings test.

the possibility of bankruptcy of the employer did not constitute such a risk. On the other hand, such risk is present under such circumstances as the payment being available only if the individual does not, after separation from the service of the particular employer, work for another employer in the same field of activity or go into such business of his or her own.

The amount to be considered as wages for OASDI-HI purposes in connection with a deferred payment (not subject to substantial risk of forfeiture) is determined on a present-value basis. At times in the past, for such present values, the IRS used a 10 percent interest rate and, when the mortality contingency is applicable, the U.S. Total Persons Life Table for 1969–71. On this basis, a deferred-compensation payment of $10,000 due 10 years from now would have a present value of $3,487, which would be considered the wages for OASDI-HI purposes.

However, if the individual already had received cash salary of more than the earnings base in the particular year, such present value of the deferred compensation would *not* be taxable. This represents more favorable tax treatment than under the former basis of taxing the deferred compensation when received. Before the HI earnings base was increased to much more than the OASDI one—in 1991 and thereafter—it is likely that the vast majority of those receiving deferred compensation and similar nonregular payments were above the OASDI-HI earnings base on the basis of their regular salary payments alone; this is no longer as much the case now with regard to the HI tax. On the other hand, if the individual were not over the OASDI earnings base on the basis of cash salary received in the year, the OASDI-HI tax would be paid sooner, but it would probably have a beneficial effect on his or her benefit amount (by concentrating earnings in one year, which might well be a "high" year).

The often sizable fees paid to corporate directors are considered, by statute, to be self-employment income. In general, such income was originally—for purposes of the OASDI-HI taxes, the computation of OASDI benefits, and the OASDI retirement earnings test—considered to be taxable and creditable when received (rather than when earned). Also, if any income of a self-employed person includes an interest adjustment because of deferred payment, that too is considered as self-employment income.

In some cases corporate directors could obtain substantial gains by appropriate, but legal, arrangement of their fee remuneration. A typical case was that of an executive who retired at age 65 with a substantial pension, and who then became a corporate director. Assume that he or she deferred the director fees (or, at least, that portion of

them in excess of the annual exempt amount under the retirement earnings test) until the year after attaining age 70 (or even, under some circumstances, the year of attainment of age 70, if this occurred in the early part of the year). Then, full OASDI retirement benefits could be obtained at ages 65–69.

At the same time, the OASDI-HI taxes on the fees (as well as the interest adjustments thereon) would be deferred (as well as the income taxes), and might even be lower in the aggregate if the total fees payable after attaining age 70 exceeded the maximum taxable earnings base then applicable. Also, the larger amount of earnings which was then creditable in one year (instead of smaller, yet sizable amounts spread out over 5 or 6 years) could result in a larger OASDI benefit, on recomputation, which would not otherwise have resulted.

This loophole was closed by the Omnibus Budget Reconciliation Act of 1987. Under it, director fees, beginning in 1988, are taxable for OASDI-HI purposes (but not for income-tax purposes) and are counted for purposes of the retirement earnings test when earned, rather than when received. However, OBRA of 1990 reversed this situation back to the pre-1988 basis insofar as OASDI-HI taxes are concerned, effective in 1991—but no change was made as far as the retirement earnings test is concerned.

Nonqualified or Selective Pensions

Frequently, employers give certain employees what will be referred to here as "special pensions" (not under a qualified pension plan, but generally in addition to a pension thereunder). Before the 1983 Act, such special pensions were not counted for OASDI-HI purposes (in the same manner as was the case for qualified pensions).

The 1983 Act changed this situation significantly. Such special pensions are considered to be deferred-compensation payments (even though the first payment may be deferred for only one day from when the pension is granted). Accordingly, whenever the "no substantial risk of forfeiture" test is satisfied, the present-value basis is applied to determine the amount to be considered wages for OASDI-HI purposes, other than for the earnings test. With regard to the latter, a special provision states that, as under previous law, the special-pension payments (and their present value) are not to be considered under the earnings test, which reduces (or even eliminates) benefits for eligible persons who have substantial earnings from employment.

If the special pension is "guaranteed" for life with no "strings" attached, its present value is considered wages for OASDI-HI tax and benefit-computation purposes. This is done, for such pensions which

begin after 1983 and are based on service after 1983, presumably as of the time of the first pension payment or, if earlier, when fully vested with no substantial risk of forfeiture. (The foregoing statement is based on the author's understanding of the law and the legislative history, but of course eventually this will be subject to IRS regulations, which had not yet been issued as of mid-1992.)

For example, suppose that a special pension of $300 per month at age 65, with no death-benefit, has a present value of $25,570. OASDI-HI taxes would be applied to this amount as of the time of the first pension payment (and it would be used for benefit-computation purposes) *unless* in that year the individual already had cash salary in excess of the earnings base (or to the extent thereof needed to equal the difference between the base and the cash salary).

The foregoing situation highlights the possible importance of the timing of the first payment of the special pension if it is not vested with no substantial risk of forfeiture until then. Assume that the person retires at the end of a calendar year and has already had salary of more than the earnings base. Then, if the first special-pension payment is made in January, there will be an OASDI-HI tax liability for that year based on the present value of the special pension (and also such amount, if sufficiently large, will be used for benefit-computation purposes for the following year and thereafter—which, in some cases, could be significantly advantageous for the employee). The individual would, nonetheless, receive OASDI benefits for such January. On the other hand, if the first special-pension payment were made on the December 31 of the year of retirement, the special pension would have no effect for *any* OASDI-HI purposes.

An administrative problem arises for employers when the present value of the special pension is considered for OASDI-HI tax purposes. The employer is immediately liable for the combined employer-employee tax, but how is the employee tax to be obtained from the retiree? The employer could withhold the pension until it equals the amount of the employee tax (which could take up to six months of pension payments) or could stretch out the recoupment for a longer period. If the employer were to waive the payment thereof by the retiree, this would constitute additional "wages" and thus OASDI-HI tax liability, unless the earnings base had already been exceeded by cash salary and the present value of the special pension.

If the special pension is payable *with* a substantial risk of forfeiture (which is unlikely), all payments over the years would be subject to OASDI-HI taxes (and could be used for benefit-computation purposes, but would not affect receipt of benefits under the earnings-test rules). A substantial risk of forfeiture might occur if the payment

of the pension depends on willingness to furnish consulting services when requested or on noncompetition.

Bonuses

Bonuses are taxable for OASDI-HI purposes in just the same manner as are regular salary payments. The point of taxation is when the bonus is declared—and not when it was earned, or when it was paid (including voluntary deferral thereof, if applicable). Thus, for example, a bonus for 1990 which was announced as to its amount in February 1991 (and was paid then) is subject to the OASDI-HI tax at that time, regardless of the fact that anticipated regular salary payments for 1991 will exceed the OASDI and HI earnings bases.

Stock Options

Employers provide many different types of stock options to their employees—under Employee Stock Purchase Plans, Incentive Stock Options, and individual arrangements. The taxation of such options for OASDI-HI purposes (and for credits toward benefits) was affected by the 1983 Amendments and bears some similarity to the treatment of "regular" deferred compensation. Although the Internal Revenue Service has not yet issued any regulations on this subject, a logical method of treatment can be envisaged.

As with deferred compensation, the point of taxation would be the later of the date when the option was granted or the date when no significant risk of forfeiture was present. The amount taxable (and creditable) would be the value (if any) of the option if it were exercised on such date. It is true that, if the individual held on to the option and never realized any gain from it, OASDI-HI taxes would have been paid on an amount that the individual never received. However, the same situation can occur under deferred-compensation arrangements (e.g., the employer goes into bankruptcy before the payment is due, or the employee dies before the payment is to be made).

Payment by Employer of Employee OASDI-HI Tax

The original Social Security Act provided that, if the employer paid the employee tax (as well as the employer tax), this would not be considered additional wages for OASDI-tax purposes (but would be for income-tax purposes). This provision was little used, except with regard to domestic workers, until the late 1970s. Then, some manage-

ment firms sold their services on the basis of the savings that an employer could make by reducing employees' wages by the amount of the employee OASDI-HI tax, thus leaving the employee with the same take-home pay (and so apparently satisfied with the situation). This procedure was sometimes referred to as FICA II.

Here is how this scheme worked for a $10,000 worker in 1979. In the absence of this procedure, the employee tax was $613, so that the take-home pay was $9,387 and the employer's total compensation cost was $10,613. If the employee's pay had been reduced to $9,387 and the employer took on the liability for the combined employer-employee tax, the employee would have had the same take-home pay. At the same time, the employer paid an OASDI-HI tax of $1,150.85 (12.26 percent of $9,387), as contrasted with the combined employer-employee tax of $1,226 on the customary basis. As a result, the employer's total compensation cost was $10,537.85, or $75.15 less. Furthermore, the employee had a slightly larger net income after taxes, because income tax was payable on only $9,962.42 ($9,387 of take-home pay, plus $575.42 of OASDI-HI employee tax paid by the employer); the income tax was thus lower by about $8.

So, what is the catch? It is merely, but importantly, that OASDI earnings credits (and, thus, likely eventual benefits) are lower—as will be also potential Unemployment Insurance, Temporary Disability Insurance, and Workers' Compensation benefits, as well as employer-sponsored benefits based on salary level (unless adjustments are made). When this was recognized, the management firms advised sharing the "profit" with the employees. In some instances, this would more than offset the value of the diminished future social insurance benefits, but in other cases it would not do so. In the aggregate, however, there would be a "savings" to employers and their employees if this procedure were used (largely because of the weighted nature of the OASDI benefit formula and its effect on the upper portion of the wages which are so "creamed off").

But where does this leave the OASDI-HI system? If all employers were to adopt this procedure, tax receipts (on the 1979 basis) would be about $6 billion less. Although future OASDI liabilities would be somewhat reduced, the program—with its close current balance of income and outgo—would need more funds. Accordingly, if this were accomplished by higher tax rates, employers would find that their anticipated savings would largely (or even entirely) vanish.

From a long-range standpoint, the situation for employers could have been even worse if this procedure of "employer pay all" had been universally adopted. Then, with the plan being noncontributory, employees would have pressed for ever-higher benefits on the

ground that it would not cost them anything. The result would then have been much higher employer tax rates and costs.

It is not possible to know from OASDI data how widespread this procedure was. Several state and local governments and some private organizations used it. More advantage accrued to government and nonprofit employers than to other private employers, because the "profit" represented a full savings to the former but was subject to income tax for the latter. There are several reasons that employers did not adopt the procedure besides the basic one of its being a rip-off of the employees (unless the savings are shared)—namely, the educational job required on the employees, the changing of the payroll system, difficulties involved with minimum wage and overtime laws, and the likelihood that Congress would repeal the pertinent provision.

The House Ways and Means Committee held hearings on this matter in late 1979, and all who testified recommended the elimination of this loophole. Also, the Advisory Council on Social Security, the National Commission on Social Security, and President Carter in his budget address in January 1980 recommended this change (except as applicable to domestic workers). In early 1980, the Senate Finance Committee added such a provision to a pending bill, but on the Senate floor the exclusion was broadened from being applicable only to domestic workers to also applying to employees of nonprofit organizations, state and local governments, and small employers (under a very broad definition). The conference committee between the House and the Senate deleted the provision on the grounds that "its enactment would lend countenance to expanded utilization of the remaining exclusion" and that there should be "further study and consideration by the Congress."

Finally, in December 1980, legislation was enacted that eliminated this practice for all workers except domestic and farm workers (effective in 1981, except that state and local governments which had been using it on October 1, 1980, could continue to do so for 1981–83).

Salary-Reduction Plans

Employees of nonprofit charitable, educational, and religious organizations and state and local government employees may receive income-tax advantages (under Section 403[b] of the Internal Revenue Code) by taking a voluntary reduction in salary (either directly of a certain amount or in an amount equal to any "required" employee contribution to a retirement system) and having the employer then put an equal amount into a so-called tax-sheltered or tax-deferred

annuity. The result is that the employee pays income tax on only the reduced salary (although subsequently on the full retirement benefit when received). For OASDI-HI purposes, however, the original unreduced salary is considered wages. Ministers, however, who are statutory self-employed persons (even though usually common-law employees), have their self-employment income reduced by the amount of such contributions to a tax-deferred annuity. Any employer contribution to a 403(b) plan is, of course, tax exempt for both OASDI-HI tax and income-tax purposes.

Other employees can elect salary reductions and have the funds accumulate in investment accounts under Section 401(k) of the Internal Revenue Code. These amounts are exempt from income tax (until the proceeds are actually received) but not from OASDI-HI taxes. Any employer contributions to 401(k) plans are exempt from both taxes.

Flexible Spending Accounts (i.e., reimbursement accounts) may be established by employees whose employer provides this mechanism (under Section 125 of the Internal Revenue Code). The employee annually reduces salary by a selected amount, and the resulting funds can be used to pay out-of-pocket costs for dependent-child day-care expenses, personal legal expenses, and medical expenses (such as noncovered ones and cost sharing under the employer health insurance plan). If the amount put into the account in the year is not used in the year, it is lost. Such salary reductions also reduce the amount of wages subject to the OASDI-HI tax and the earnings for income-tax purposes. In the author's view, such reduction for OASDI-HI tax purposes should not be allowed, but rather the treatment should parallel that for 401(k) and 403(b) salary reductions.

Appendix 2-14

Special Method for Computing PIA for Individuals Who Qualify for Benefits Solely Because of a Totalization Agreement

A special method of computing the PIA applies to individuals who qualify for OASDI benefits solely because of using some coverage under the social security system of a foreign country with which the United States has a totalization agreement. In essence, the PIA is computed from the average earnings under OASDI during the period covered thereunder, and it is then reduced by the proportion that such years under OASDI are to the number of years that are normally

used to compute average earnings (e.g., 35 years for those attaining age 62 after 1990).

Specifically, for the AIME method (which applies to virtually all new claimants currently and in the future), the individual's "Earnings Position" (EP) is computed for each year after 1950 in which there are OASDI earnings. The EP is merely the ratio of the actual earnings (only up to the maximum taxable earnings base) to the indexing wage for the year (see Table 2.18 for years after 1950); in the few instances where the individual has less than 4 QC in the year, the actual earnings are first multiplied by four and then divided by the number of QC (but with the result not being allowed to exceed the earnings base). The table below shows the indexing wages for 1937–50 (from the *Federal Register*, July 24, 1984, p. 29776).

Year	*Indexing Wage*	*Year*	*Indexing Wage*
1937	$1,137.96	1944	$1,936.32
1938	1,053.24	1945	2,021.40
1939	1,142.36	1946	1,891.76
1940	1,195.00	1947	2,175.32
1941	1,276.04	1948	2,361.64
1942	1,454.28	1949	2,483.20
1943	1,713.52	1950	2,543.96

Next the "Relative Earnings Position" (REP) is computed. This is done by a simple arithmetic average of the various computed EPs. Then an "artificial earnings record" is created for the individual for each year in the past, except for years before the year of attainment of age 22, for the year of first benefit eligibility and all subsequent years, and for any year during a period of disability (any actual earnings in such years are, naturally, made part of the earnings record). The "artificial earnings" for a year are merely the product of the REP and the indexing wage for the year.

A PIA is then computed from this artificial earnings record, using the standard procedures (as described previously). This amount is then multiplied by the ratio of (1) the individual's actual number of QC to (2) four times the number of years in the computation procedure for determining the individual's PIA, in order to determine the PIA actually to be used in determining the individual's benefits. This complicated procedure is necessary so as to recognize the weighted nature of the OASDI-PIA benefit formula, which gives relatively larger benefits to those who have low lifetime average earnings.

Each foreign country has a somewhat similar, often simpler, basis for determining benefits when U.S. earnings are used for qualification purposes. In the special circumstances when the individual has fully insured status from the actual OASDI earnings record, but has disability-insured status only because of the totalization provisions, the amount of the disability benefits is the *smaller* of the amount computed under the special totalization provisions or the amount computed under the "regular" provisions.