University of Michigan Retirement Research Center

How Effective Is Redistribution Under The Social Security Benefit Formula?

Alan L. Gustman and
Thomas L. Steinmeier

IB 2000-005

MRRC Issues in Brief

Project #: UM 99-04

Executive Summary

Conventional wisdom holds that the Social Security benefit formula is highly redistributive by favoring low over high earners. It certainly is true that the structure of the benefit formula is highly progressive as it replaces a much higher share of earnings for *individuals* with low rather than high earnings. The focus on the *individual* may be misplaced, however. From a public policy perspective, the proper accounting unit for evaluating redistribution is the *household*. This *Issue in Brief* will describe an empirical investigation using data from the University of Michigan Health and Retirement Survey (HRS) linked with Social Security records for a cohort of individuals nearing retirement. We address only retirement, spouse, and survivor benefits using current Social Security benefits and formulas.

We provide here a brief overview of the major findings of our investigation. Our aim was to determine the extent of redistribution fostered by the current Social Security System on the basis of each individual's earnings, and then to see how the extent of redistribution changes when we instead look at redistribution on the basis of total household earnings and finally at redistribution on the basis of *potential* household earnings, which is what the household could earn if both partners worked full time.

Our analysis contributes to our understanding of just how much redistribution the current system fosters. This information is required to inform policy makers who are involved in system reform. These calculations also provide a benchmark to help understand the effects of various reforms. Any large change in the system will require an accounting of winners and losers, which in turn depends on the extent of redistribution under the current system.

How the Social Security Benefit Formula Works

For each individual, the Social Security Administration calculates a measure of lifetime earnings, which is an average of the high 35 years of earnings. The earnings measure is typically expressed as a monthly amount, the Average Indexed Monthly Earnings (AIME). A progressive benefit formula is then applied so that those who have low computed lifetime earnings have higher benefits, relative to earnings, than do those with high earnings. Spouses are entitled to roughly half of their partner's benefits, and survivors are entitled to an amount roughly equal to what would have been paid to the deceased.

The Data

The Health and Retirement Study (HRS) is a longitudinal, nationally representative study of older Americans. The survey began in 1992 with an initial cohort of 12,652 individuals from 7,607 households, with at least one household member born from 1931 to 1941. Social Security earnings histories were linked for 9,472 respondents, or about 75 percent of the respondents to the survey. Of the respondents with linked earnings histories, there were 7,370 who were born between 1931 and 1941, for whom the HRS is representative.

Summary of Major Findings

Work and Earnings Patterns

For the purposes of this report, we distinguish individual lifetime earnings from household lifetime earnings. Household lifetime earnings are the combined lifetime earnings of a husband and wife.

- Overall, we find that AIME is a poor indicator of lifetime household earnings. Many individuals in the lowest levels of AIME may not be as poor as their individual AIME suggests.

- Many workers falling in the lowest AIME categories, mostly women, are there because they worked few years, rather than because they have low earning potential.

- The majority of women in this study fall into the lowest AIME brackets and have low *individual* lifetime earnings; however these same women have relatively high lifetime *household* earnings. The same is not true for men. Men in the lowest AIME brackets also tend to have very low lifetime household earnings.

Redistribution at the level of the Individual and the Household

- There is less redistribution among all individuals when individual *and* spouse benefits are taken into account, suggesting that those with high AIMEs benefit disproportionately from spouse and survivor benefits.

- When households are categorized according to lifetime household earnings, and spouse and survivor benefits are accounted for, the extent of redistribution from households with high lifetime earnings to those with low earnings is reduced by half.

Redistribution when Households are Classified by Earning Capacity

- When households are grouped according to the potential household income, or earnings during years when both spouses were engaged in substantial work, there is *very little* redistribution from families with high to low earnings capacity. The remaining redistribution, however, goes primarily to families in the lowest decile and contributes significantly to their benefits.

Most of the redistribution based upon potential household income occurs within AIME groupings. The likely transfer is from families with two earners to families with about the same combined earning power but in which only one spouse is a lifetime worker.

Conclusion

In this cohort of individuals nearing retirement, the current Social Security benefit formula clearly redistributes individual benefits from individual taxes when examined at the level of the individual. Much of the redistribution at the individual level is from men to women. The extent of redistribution is halved, however, when benefits and taxes for both spouses are analyzed at the level of the household. When households are grouped by their potential earnings, there is very little redistribution from high earning to low earning households. The current policy effectively subsidizes households with a spouse who, although working at least ten years to qualify for benefits, remains home for many years rather than working in the market.

It is important to remember that the results presented in this paper pertain only to a single cohort, those born from 1931 to 1941. Further investigation of more recent cohorts is needed to see if these findings are generalizable. Nonetheless, it is clear that the common perception that a great deal of redistribution from the rich to the poor is accomplished by the progressive social security benefit formula is inaccurate

It is often argued that privatization would undermine the redistribution fostered by the progressive Social Security benefit formula. Our findings suggest that for the cohort of Americans nearing retirement, there is actually very little redistribution of Social Security benefits from the rich to the poor. Thus, introduction of a system of privatized accounts that ignores issues of redistribution would have no major effect on the distribution of Social Security benefits among households with different earnings capacities.

Michigan Retirement Research Center
Institute for Social Research
University of Michigan
426 Thompson Street, Room 3026
Ann Arbor, MI 48104-2321

Phone (734) 615-0422
Fax (734) 615-2180

http://www.mrrc.isr.umich.edu
mrrc@umich.edu

The Michigan Retirement Research Center is supported by a grant
from the Social Security Administration (grant number 10-P-98358-5).