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The Effect of Public Pensions on Social Security Benefits

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The "three-legged stool" of retirement security is constructed a little differently for public employees. This article spells out the differences and offers suggestions for retirement planning.

For most Americans, the three-legged stool of retirement security consists of their pension, Social Security benefits, and personal savings. For state and local government employees, the "legs" are constructed a little differently.

Their pensions are funded and paid under statutes, as opposed to qualified pension plans. Their primary savings vehicle is the Section 457 plan (somewhat different from the well-known 401(k) plan). And, they might or might not be covered under the Social Security program for time spent in public employment. When they are not covered by Social Security under public employment, the Social Security benefits they ultimately receive from private employment or their spouse's employment are impacted by their participation in a public pension plan.

This article presents an overview of the impact of public pensions on Social Security benefits and shows detailed examples of how benefits may be affected. This information, combined with related publications readily available from the Social Security Administration, can form the nucleus of a plan by any governmental unit seeking to explain to its members this important and highly misunderstood subject.

Overview

Social Security retirement and Medicare benefits are paid to retired workers based on credits earned by the retiree or the retiree's spouse. A worker needs 40 credits to qualify for benefits. In 2000, one credit was recorded for every $780 earned during a year, with a maximum of four credits if $3,120 or more is earned in that year (these dollar amounts were lower in past years). Essentially, a person needs about ten years of work to qualify for benefits. Because of this fairly low threshold for vesting, most American workers qualify for Social Security benefits even if they have a full career in a profession outside the Social Security system.

Benefits for workers who have primary careers outside Social Security coverage are affected under two provisions:

- The *government pension offset* (SSA Publication 05-10007) affects benefits that retirees might receive from their spouse's earnings record.
- The *formula for work not covered by Social Security* (SSA Publication 05-10045) affects benefits that retirees receive from their own Social Security earnings record if they have earnings from a primary career outside of the Social Security system. This and other Social Security publications are available for immediate download from www.ssa.gov.

For the purpose of examining these provisions further, references to public employees and public retirees are assumed to be references to persons who were not covered by Social Security during their period of public employment. Also, the pronoun "he" stands for "he or she" and the possessive "his" for "his or hers" unless the context indicates otherwise.

The Government Pension Offset

Before discussing this offset, a brief review of benefits payable from a spouse's earnings record will help the reader understand the impact of a public pension on these benefits.

In the larger civilian workforce, a

retiree receives Social Security benefits from either his own earnings record or he receives up to one-half of his spouse's benefit if that will result in a higher payment. Some examples:

Example #1. Peggy's monthly benefit is $1,000. Her husband Al's benefit from his own earnings record is calculated at $400. Al will receive a monthly benefit of $500.

Example #2. Dan's benefit is $1,200. His homemaker wife Kathy's benefit from her own work record is $0; she never earned enough credit for Social Security benefits. Kathy will receive a monthly check of $600, one-half of Dan's benefit.

In the examples cited above, the lower earning (or no-earnings) retiree receives a benefit from the spouse's record that provides him or her with a monthly Social Security payment that is equal to one-half of his spouse's benefit. There is no reduction in the one spouse's benefit because the other is receiving a spouse benefit. In Example #1, Peggy and Al receive a combined $1,500; in Example #2, the couple receives a combined $1,800.

Effect of Public Pensions

If the spouse with lower Social Security covered earnings is the recipient of a public pension, the amount of Social Security benefit he receives from his spouse's record will be offset (i.e., reduced) by 66¢ for every $1 of government pension received. This effectively eliminates the Social Security benefit he might receive from a spouse's earnings record. As an example, consider the situation in which a wife receives a monthly Social Security benefit of $1,400. Her retired police officer husband could conceivably receive up to $700 per month based on her earnings record. But, if he receives a public pension of $1,051 or more, his $700 benefit based on a spouse's record will be completely reduced to zero.

This complete offset of the Social Security benefit gives rise to one of two simple rules that a public employee can generally follow in planning his retirement income.

Simple Rule #1. A career public employee will generally not receive a Social Security benefit from his spouse's earnings record other than Medicare.

If this is the case, why not just eliminate the spouse benefit for public plan retirees rather than use a confusing offset formula? The reason is that there are some public employees who receive a very small benefit based on lower wages and lower credited service than would normally be experienced. A substitute school teacher is a good example. His public pension may be only $150 per month. Complete elimination of the spouse benefit would be unfair. But, most public employees are full-time, career employees and Simple Rule #1 is applicable in almost every instance.

Why an Offset?

Social Security retirement benefits are structured progressively. That is, lower income wage earners fare better in proportion to their earnings when compared to higher wage earners. The benefits available from a spouse's record are a good example of this progressive structure. A lower earning spouse's benefit is increased to up to one-half of the higher earner's benefit.

But, the public employee is generally not a low wage earner. He may look like one when his Social Security earnings record is examined, but that is only because his wages as a police officer or teacher do not show on the Social Security history. Is such a person entitled to a higher benefit? People disagree, but the Congress of the United States has spoken. Such a retiree is not entitled to the higher benefit based on the spouse's record.

The Formula for Work Not Covered by Social Security

Public employees encounter different Social Security benefit formulas from those of the general workforce, both for benefits to be earned on a spouse's record and their own earnings record as well. As in the case of the government pension offset, a brief review of benefits payable from a worker's *own earnings record* will help the reader understand the impact of the special formula for work not covered by Social Security.

Public pension benefits are most often calculated using the employee's salary at retirement and multiplying final salary by a percentage figure based on his or her years of service. The percentage figure (e.g., 70% of salary after 30 years of service) is often referred to as the *replacement rate.*

Social Security retirement benefits are calculated by averaging a worker's salary over his working life (and indexing that average forward based on inflation). The average wages are then replaced using a formula with varying replacement rates. The formula for 2001 is shown in Table I.

Table II shows some examples of how three different employees in the larger workforce might fare under the 2001 formula.

Remember, Social Security benefit formulas are weighted in favor of lower income Americans. Table II clearly shows this leaning. The lower a worker's average monthly salary, the higher the percentage of that salary that is replaced by his Social Security benefit.

Effect of Public Pensions

There is a different formula for retirement benefits if the Social Security recipient has a pension from work that was not covered by Social Security. This is referred to as the Formula for a Pension from Work Not Covered by Social Security. For ease of discussion, the phrase "special formula" will be used for the balance of this article.

For 2001, the special formula is shown in Table III.

In the special formula in Table III, the only difference between the benefit calculations for public employees and those for the larger workforce is the treatment of the first $561 of indexed monthly wages. In the larger workforce, the first $561 is replaced at 90%; for public employees, the replacement rate is 40%. All other factors remain unchanged.

Table IV shows examples of how two public employees would fare under the formula in 2001.

Simple Rule #2. If retiring today, most public employees would receive a Social Security benefit from their work record that is $280 less than the benefit that would be calculated using the formula for the larger workforce. This is because the difference between 90% of $561 and 40% of $561 is always $266. Such a “simple rule” calculation can be made in any year in the future as the dollar amounts change. Note that this rule will not apply to persons who earn a very low Social Security benefit. In such instances, the Social Security Administration can provide guidance on the calculation of an individual employee.

Why a Separate Formula for Public Employees?

The fire or police retiree is not a low-income wage earner as envisioned in the Social Security benefit formula. If his benefit is calculated using the standard formula, the higher replacement rate for the public employee will result in what the government calls a “windfall.” Although the use of the term “windfall” may be offensive to some people when discussing somewhat low Social Security benefits, the description is fairly accurate.

The Social Security Administration only has access to the public employee’s Social Security covered employment. Its computers look at the record and see a low wage earner. But the worker is *not* a low-income American; he is a police officer or similar worker who has his primary earnings outside the Social Security system. Use of the standard formula will overpay this retiree. With the special formula, this overpayment does not occur. Use of the special formula ends up treating the public plan retiree in a manner similar to private sector retirees with similar *total* income.

Table I

First $561 in monthly wages	90%
Next $2,620 in monthly wages	32%
Over $3,381 of taxable wages	15%

Table II

Average Wage	Calculation	Benefit	% Replaced
$ 561	$ 561 @ 90%	$ 505	90%
$1,200	$ 561 @ 90%	$ 709	59%
	$ 639 @ 32%		
$4,000	$ 561 @ 90%	$1,500	37%
	$ 2,820 @ 32%		
	$ 619 @ 15%		

Table III

First $561 in monthly wages	40%
Next $2,820 in monthly wages	32%
Remainder of taxable wages	15%

Table IV

Average Wage	Calculation	Benefit	% Replaced
$ 561	$ 561 @ 40%	$ 224	40%
$1,200	$ 561 @ 40%	$ 429	36%
	$ 639 @ 32%		

Two Retirees Compared

We can see how the formula works to treat public and private workforce retirees equally by comparing the earnings and Social Security benefits of two hypothetical retirees. Ted is a retiring accountant and has average monthly earnings of $4,000. Bob is a retiring firefighter who had an average fire salary of $3,200 and average wages from Social Security covered employment of $800. Each worker’s Social Security benefit at age 65 is shown in Table V.

See the result of the special formula? It equalizes the benefits between government and private workers.

Factors That Lessen the Impact of the Special Formula

The special formula is modified when special circumstances would result in undeserved negative impact on the public employee’s benefits. The modifications are:

- If a public employee has 30 or more years of “substantial earnings” in Social Security, the special formula for public employees does not apply. In 2000, substantial earnings began at $14,175.
- If a public employee has between 20 and 29 years of substantial earnings, the special formula change from 90% to 40% of the first increment of wages is prorated. For example, a public worker with 25 years of substantial Social

Security covered earnings would receive 65% of the first $561 in monthly earnings if he retired in 2001.
- The modified formula does not apply to survivors' or spouses' benefits. Only the benefits that the public plan retiree receives are modified. As an example, assume a public employee is receiving a $320 monthly Social Security benefit. His spouse would be eligible for a benefit of $300, one-half of the $600 benefit that Social Security would have calculated if the primary wage earner would not have had a pension from non-Social Security covered work.

Planning for Retirement

Public plan retirees face confusing half-truths when considering how much of a contribution Social Security benefits will make to their retirement income. In actuality, the tools are readily available to make an accurate estimate.

First, each retiree should realize that he or she will not receive a benefit from their spouse's Social Security record other than Medicare coverage, if needed.

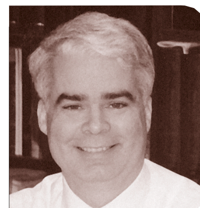
Secondly, the special formula used to calculate benefits from the public employee's record is different from the standard formula used for the general workforce. The special formula only affects the calculation on the first $561 of average wages with a typical resulting reduction of $280 from the use of the standard formula.

When a public employee receives an Earnings and Benefits Statement from Social Security (either unsolicited or by filing Form SSA 7004-SM-O97), he should reduce the estimate provided by Social Security by $280 per month. The only time that the Social Security Administration takes a public pension into consideration is when an application for benefits is filed. If the estimate of benefits is less than $500, the public employee should call Social Security and ask for advice on calculating his estimated benefit.

Thus, a public employee, armed with his benefit estimate from Social Security and the knowledge of how to adjust it for their unique circumstances, can accurately estimate the value of this one leg of the three-legged stool of retirement income. ◆

Table V

Ted the Accountant	$4,000 in Social Security covered wages $0 in other wages $1,500 Social Security benefit 37% of wages replaced
Bob the Firefighter	$800 in Social Security covered wages $3,200 in other wages $301 Social Security benefit 37% of wages replaced



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