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REPLACING "WAGE INDEXING" WITH "PRICE INDEXING" WOULD RESULT IN DEEP REDUCTIONS OVER TIME IN SOCIAL SECURITY BENEFITS

by Kilolo Kijakazi and Robert Greenstein

One of the three Social Security plans the President's Social Security Commission endorsed at its final meeting on December 11 includes a major change in the program's benefit formula that would result in large benefit reductions over time. Under this change, starting in 2009, the amount of wages that a worker who is retiring earned over his or her work career would effectively be adjusted by changes in the Consumer Price Index between the year the worker earned the wages and the present time, rather than by the change in average wages over this period.

The Social Security benefit for which a worker qualifies when he or she retires is based on the worker's average monthly earnings over the worker's career. The average monthly earnings figure for any worker is derived by taking the amounts that the worker earned in previous years and adjusting them to reflect the increases in average wages between those years and the present. Since the CPI grows more slowly over time than average wages do, calculating the Social Security benefit level that a worker receives when he or she retires by adjusting past earnings by changes in the CPI instead of by changes in average wages would result in the worker receiving a smaller benefit than under current law. Under the change the Commission has proposed, the benefit reductions would be very substantial and would apply to all beneficiaries, not just to those electing to forgo some of their Social Security benefits in return for an individual account.

- A worker who earned the average wage throughout his or her career and retired in 2040 would receive a benefit 24 percent lower than under the current benefit formula.

- If the worker retired in 2070, his or her benefit would be 43 percent lower than the benefit the worker would receive under current law.[1]

- These benefit reductions would apply to all Social Security beneficiaries, including disabled beneficiaries and widows.

The current approach of using "wage indexing" to compute the benefit an individual receives at retirement is designed to achieve an important goal — to ensure that the percentage of wages that Social Security replaces when workers retire remains constant across generations,

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[1] These benefit reduction figures assume the change from wage indexing to price indexing would be made starting in 2009, as the Commission is proposing. If the change were made sooner, the benefit reductions would be larger.

CPI Grows More Slowly Than Wages

In general, wages rise more rapidly than prices. The result is an increase over time in the standard-of-living. Between 1988 and 1998, average wages rose 49 percent while the Consumer Price Index rose 38 percent.

Over long periods of time, these differences become quite pronounced. From 1960 to 1998, the Consumer Price Index rose 450 percent, while average wages rose 620 percent.[a]

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[a] *Annual Statistical Supplement*, Social Security Administration, Table 2.A8, 2000; and Council of Economic Advisers, *Economic Report of The President*, Table B-60, January 2001.

rather than falling over time. If wage indexing is replaced by price indexing, Social Security benefits will replace a lower proportion of prior wages for each succeeding generation of retirees.

Under the benefit formula in current law, a steady average wage-earner who retires at age 65 in future decades will receive Social Security benefits that replace 37 percent of his or her pre-retirement earnings.[2] If wage indexing is replaced by price indexing, the proportion of wages that Social Security replaces will fall markedly.

- Social Security would replace 28 percent of the wages of a steady average wage-earner who retires in 2040.

- Social Security would replace 21 percent of the wages of a steady average wage-earner who retires in 2070.

These are rather profound changes. They mean that over time, the standard-of-living that Social Security benefits support for elderly retirees would decline significantly, relative to the standard-of-living that the rest of society enjoys, and also relative to the standard-of-living that workers enjoyed before they retired.

Furthermore, these changes would reduce Social Security disability and survivors' benefits as well. Social Security uses a common benefit formula for all categories of beneficiaries, something that is necessary for reasons of equity. (Failure to use a common benefit formula would introduce major anomalies and inequities into the Social Security benefit structure.)

The Commission appears to have adopted this proposal in part because various other potential Social Security benefit cuts are strongly opposed by large majorities of the population, such as increases in the age at which workers can retire and draw full Social Security benefits and reductions in the annual cost-of-living adjustment. Some Commission members reportedly were

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[2] The replacement rate for an average wage-earner is currently 40 percent because the full benefit age (also known as the "normal retirement age") is 65. As the full benefit age rises to 67, the replacement rate will gradually decline to 37 percent for workers who retire early, at age 65.

attracted to the idea of replacing wage indexing with price indexing because this change can save so much money that other, better-understood, highly unpopular benefit cuts may not be needed. Some proponents of this approach evidently believe they can present a move from wage indexing to price indexing as providing a full inflation adjustment and therefore not constituting a benefit reduction. Commission documents make such a presentation.[3] The hope may be that the public will not understand this proposal well and not grasp the fact that it is a benefit cut of substantial magnitude.

The purpose of this paper is to help explain this somewhat complex and potentially confusing proposal.

How the Current Benefit Formula Works

When a worker becomes eligible to receive Social Security benefits, his or her benefit level is determined through a two-stage process. In the first stage, the worker's average monthly lifetime earnings are determined. This is done by taking the worker's annual earnings (up to the maximum amount of earnings covered under Social Security) for each of his or her 35 highest earning years. The amount that the worker earned in each of these years is adjusted by the increase in the average wage level in the U.S. economy between that year and the present. The amounts of earnings for the 35 years, as adjusted in this manner, are then averaged and divided by 12. The result is the worker's average monthly earnings.

The second stage of the process is to apply Social Security's progressive benefit formula to the worker's average monthly earnings. Under this formula, the Social Security benefit for an individual retiring in 2001 at the "normal retirement age" equals:

- 90 percent of the worker's first $561 of average monthly earnings;

- plus 32 percent of any average monthly earnings between $561 and $3,381, and

- plus 15 percent of any average monthly covered earnings above that.

The dollar amount of $561 (at which the 90 percent replacement rate ends and the 32 percent replacement rate begins in 2001) and $3,381 (at which the 32 percent rate ends and the 15 percent rate begins in 2001) are known as the program's "bend points." Consistent with the adjustment of earnings from earlier years to reflect the changes in average wages between those years and the present, the "bend points" are adjusted each year to reflect the change in average wages over the last 12 months.

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[3] Commission leaders have stated that this proposal would merely "slow the rate of of growth in future benefits." (Statement of Richard Parsons, Commission co-chair, at Commission press conference, November 29, 2001.) The Commission documents include similar statements. The documents do not explain that under this proposal, Social Security benefits would replace significantly less of pre-retirement earnings than they do today or that large reductions in benefits would result relative to the benefits that would be provided under the benefit formula in current law.

Once a worker's Social Security benefit level is determined in this manner when the worker retires, the worker's benefit level is subsequently adjusted in each succeeding year by the annual change in the Consumer Price Index. This assures that once an individual retires and starts to draw benefits, his or her benefit level will remain constant in purchasing power as the individual grows older.

Shifting from Wage Indexing to Price Indexing

The draft commission report distributed on December 10 explains how the change from wage indexing to price indexing would be made.

- Each year, a ratio would be computed of the change in the CPI over a preceding 12-month period to the change in average wages over the same period. (For example, if the Consumer Price Index rises three percent in a given 12-month period and average wages rise four percent, the ratio would be 1.03 divided by 1.04, or 0.99.) In most years, this ratio will result in a fraction that is slightly less than one, since the increase in the CPI is generally smaller than the increase in average wages.

- This fraction would be multiplied each year by the 90 percent, 32 percent, and 15 percent replacement-rate factors in the Social Security benefit formula. The result would be a gradual reduction over time in the 90 percent, 32 percent, and 15 percent factors.

Impact on Social Security's Long-term Shortfall

In February 2000, the Office of the Chief Actuary of the Social Security Administration issued an analysis of the impacts this proposal would have on Social Security's long-term financing shortfall.[4] At the time the analysis was conducted, the actuaries estimated that Social Security's shortfall over the next 75 years would equal 2.07 percent of taxable payroll. (This means that additional payroll tax revenues equal to about one percent of covered wages on both employees and employers would close the program's financing gap for the next 75 years.) Currently, the actuaries estimate the shortfall to be 1.86 percent of taxable payroll.

In its analysis, the Office of the Chief Actuary estimated that the change to price indexing would reduce the shortfall by 2.36 percent of taxable payroll, or more than the entire 75-year shortfall. This estimate assumed, however, that price indexing would take effect for beneficiaries retiring in 2001. The Commission is proposing to institute the change in 2009. As a result, the Commission's proposal would have a somewhat smaller effect on the long-term Social Security shortfall than the estimate in the actuaries' analysis.

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[4] Stephen C. Goss, then Deputy Chief Actuary of the Social Security Administration, "Estimated Long-Range OASDI Financial Effects of Provisions to Change the Calculation of OASDI Benefits," Memorandum to Harry C. Ballantyne, Chief Actuary, February 4, 2000, p. 3.

Even so, this change should eliminate the entire long-term deficit and might produce a small long-term surplus. In other words, this proposal produces very large savings. It does so because it constitutes a very substantial reduction in benefits.

Impact on Benefits[5]

The benefit reductions that would result would be larger for those who retire farther in the future than for those who retire sooner. A few examples help illustrate the size of the benefit changes.

- Suppose Mr. Conway works as an average wage-earner throughout his work life and retires in 2040. Mr. Conway would receive a Social Security benefit 24 percent lower than the amount he would receive under the benefit formula in current law.

- Looked at another way, under the current-law formula, the Social Security benefits that Mr. Conway would receive would replace 37 percent of his pre-retirement earnings, not an overly generous percentage. Under the change the Commission is proposing, Mr. Conway's Social Security benefits would replace 28 percent of his previous earnings.

The magnitude of the reduction in Social Security benefits would grow larger over time. Suppose Mr. Conway had a son or daughter who also is a steady average wage-earner and who retires in 2070.

- The younger Conway's Social Security benefits would be 43 percent below the level he or she would receive under the benefit formula in current law.

- Social Security benefits would replace just 21 percent of pre-retirement earnings, rather than 37 percent as under current law. (Calculations by the Social Security actuaries yield very similar figures.[6])

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[5] The estimates of benefit reductions and replacement rates cited here were computed by Peter Orszag, a Senior Fellow at the Brookings Institution. These estimates use the intermediate projections of the Social Security actuaries regarding wages and prices over the next 75 years. The actuaries project that, on average, wages will rise faster than prices by about one percent per year.

[6] In February 2000, the Social Security actuaries estimated the effects of this option. The actuaries assumed the option would start to take effect with beneficiaries who retire in 2001, however, while the Commission proposal would take effect in 2009. In addition, at the time the actuaries issued their analysis, they assumed that wages would rise an average of 0.9 percent per year faster than prices. They have since changed that to an assumption that wages will rise an average of one percent per year faster than prices. The changes in assumptions in these two areas roughly offset each other. As a result, the actuaries estimated that for an average wage-earner retiring in 2070, this option would result in a benefit reduction of 43.5 percent compared to current-law benefits, and in a replacement rate of 21 percent. These estimates are nearly identical to those shown here. The actuaries' estimates shows a modestly larger benefit reduction for average wage-earners who retire in 2040 than we show here. See Stephen C. Goss, then Deputy Chief Actuary, "Estimated Long Range OASDI Financial Effects of Provisions to Change The Calculation of OASDI Benefits," Memorandum to Harry C. Ballantyne, Chief Actuary, February 4, 2000.

Impact of Changing from Wage Indexing to Price Indexing				
Year of Retirement	Current-law Formula		Adjusting the Replacement-rate Factors	
	Benefit Cut	Replacement Rate	Benefit Cut	Replacement Rate
2040	—	37%	24%	28%
2070	—	37%	43%	21%

As these figures indicate, shifting to price indexing results in a significant decline in the percentage of pre-retirement wages that Social Security benefits replace. As a result, future retirees would experience a larger decline in their standard-of-living upon retiring than retirees experience today. Shifting from wage to price indexing also would significantly reduce the standard-of-living that Social Security beneficiaries experience relative to the average standard-of-living of the rest of society. In addition, by themselves, Social Security benefit reductions of this magnitude would lead to higher levels of elderly poverty than the nation otherwise would experience.

To be sure, benefit levels would keep pace with changes in prices. But beneficiaries would be precluded from partaking in the general increase in the standard-of-living that the society as a whole experiences from one generation to the next. Upon retiring, workers would essentially drop back to a standard-of-living prevalent in an earlier generation. As one recent analysis notes: "This is like saying retirees who could afford indoor plumbing when they were working should, in retirement, not be able to afford indoor plumbing because their parents' generation could not afford it."[7]

Impact on Survivors and People with Disabilities

Switching from wage indexing to price indexing would result in an across-the-board reduction in the benefits of all new beneficiaries, including people with disabilities and survivors. The Social Security benefit formula applies to *all* categories of beneficiaries. As a result, changing the formula so it relies on price indexing rather than wage indexing would affect all

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[7] "Price-Indexing the Social Security Benefit Formula Is a Substantial Benefit Cut," prepared by the minority staff of the Social Security Subcommittee, House Committee on Ways and Means, November 30, 2001.

beneficiaries, not just retirees.[8] New Commission documents acknowledge that this proposal would apply to disabled beneficiaries and reduce their benefits.[9]

The Commission also has proposed to improve the benefits for elderly survivors by setting the benefit for a surviving spouse at 75 percent of what the couple would have received if both spouses were still alive. Under present law, a surviving spouse receives a benefit that equals 50 percent to 67 percent of the combined benefit the couple would have received. This change also was recommended by the majority of members of the 1994-1996 Advisory Council on Social Security.

Combining this change with a shift from wage to price indexing, however, alters the impact. Because of the change to price indexing, the combined benefit that a retired couple would receive in future decades would be significantly lower than what the couple's benefit would be under current law. As a consequence, the proposal to set the survivor's benefit at 75 percent of the couple's benefit would place the survivors benefit at 75 percent of a smaller amount. For many survivors, a benefit that is 75 percent of a substantially reduced amount would result in a lower guaranteed Social Security benefit than these survivors would receive under the current benefit structure.

The President's executive order establishing the Commission charged that body with preserving the disability and survivors components of the program. The executive order does not, however, preclude reducing benefits for new beneficiaries in these two components of the Social Security program. Substituting use of the CPI in the Social Security benefit formula for changes in average wages would substantially reduce the benefits of disabled workers and survivors. These are two groups that can ill afford to have their incomes diminished.

Are Benefit Deductions of this Magnitude Necessary?

The Commission's interest in moving from wage indexing to price indexing appears to be driven in part by several factors: 1) the fact that the President's charge to the Commission ruled out changes that would boost payroll tax revenue; 2) the fact that the Commission apparently was not willing to consider approaches that would scale back the large tax cut enacted earlier this year (the costs of which will reach $4 trillion by the second decade it is in effect) and dedicate some of the preserved revenue to Social Security; and 3) the fact that diverting a portion of Social

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[8] People with disabilities receive benefits from all of the programs within the Social Security system, not just the Disability Insurance program. For example, a child with a disability who remains disabled as an adult (known in Social Security parlance as a "a disabled adult child") receives Social Security retirement benefits when the child's parent retires. When the parent dies, the adult disabled child receives Social Security survivors benefits. Similarly, surviving spouses who are disabled receive survivors benefits. In addition, disabled workers who receive disability insurance benefits are switched to Social Security retirement benefits when they reach the "normal retirement age." (Their benefit levels do not change.) As a result, reductions in any of these types of Social Security benefits would result in benefit reductions for some people with disabilities (unless complex changes are made in the Social Security benefit structure that would result in significant inequities in the provision of benefits).

[9] Staff draft of "Strengthening Social Security and Creating Personal Wealth for All Americans," Report of the President's Commission, December 11, 2001.

Security payroll tax revenues to individual accounts would make Social Security's funding gap still larger and consequently would require deeper Social Security benefit reductions. These constraints appear to be part of the reason the Commission has proposed changes that constitute such large reductions in future Social Security benefit levels.[10]

These constraints, however, are not written in stone. Different approaches can be considered.

For example, if a portion of the tax cut that has not yet taken effect and that would benefit only the wealthiest of Americans were cancelled — and the revenues preserved by such an action were dedicated on an ongoing basis to the Social Security trust fund — the program's long-term financing shortfall could be materially reduced. That would appreciably lessen the magnitude of the changes in the Social Security benefit and tax structure that would need to be considered.

As an earlier Center analysis has documented, the revenue loss that will result from the tax cut over the next 75 years if the tax cut takes full effect and becomes permanent law *is more than twice* the size of the entire Social Security shortfall over this period.[11] As a result, relatively modest changes in the tax cut can produce revenues that significantly shrink the Social Security shortfall — and thereby significantly reduce the scope of any benefit reductions or payroll tax increases that may be needed.

For example, if some of the changes in the estate tax that were included in the tax legislation enacted in June were retained but other changes in the estate tax (including estate tax repeal) were cancelled before they took effect — and the revenues that continued to be collected were transferred to the Social Security trust fund — a significant portion of the Social Security financing gap could be eliminated. If the estate tax were effectively cut in half and the remaining revenues dedicated to Social Security, about one-quarter of Social Security's long-term financial gap could be closed.[12]

If this were done, the estate tax would be limited to approximately the largest one percent of estates, and the estates that continued to owe estate tax would receive very large reductions in the amount of estate tax owed, compared to the amounts these estates would have owed under the law in effect prior to passage of this year's tax legislation. Rejecting a course such as this and proceeding with estate tax repeal would essentially represent a decision to subject millions of

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[10] Still another constraint was the President's charge to the Commission ruling out investing a portion of the Social Security Trust Fund's revenues in assets that provide higher average returns over time, such as equities. As analyses by the Social Security actuaries have shown, investing a portion of Trust Fund reserves in higher-yielding assets closes some of the long-term Social Security financing shortfall and reduces the magnitude of the changes needed in the Social Security benefit-and-tax structure to restore long-term solvency.

[11] Peter Orszag, Richard Kogan, and Robert Greenstein, "Social Security and the Tax Cut," Center on Budget and Policy Priorities, August 3, 2001.

[12] This option assumes that increases in the estate tax exemption, reductions in the estate tax rate, and provisions to shield more farms and businesses for estate tax would reduce estate tax collections by half, compared to the estate tax collections that would have occurred if this year's tax legislation had not been enacted. This option also assumes the cancellation of the provision of this year's tax legislation that repeals the state estate tax credit.

elderly people of modest means to deeper Social Security benefit reductions so that the estates of the wealthiest people in the nation can secure tax cuts that can only be described as massive. (These tax cuts would average several million dollars per estate.)

Similarly, in a recent op-ed article in the *Washington Post*, former National Economic Council director Gene Sperling, now a guest scholar at the Brookings Institution, proposed cancelling tax-rate reductions enacted in June but not yet in effect for the top two income-tax brackets and also cancelling estate-tax repeal, and dedicating the preserved revenue to Social Security. Under this approach, all reductions in the estate tax scheduled to take effect through 2008 would be implemented, with the result that the estate tax exemption would rise to $2 million per individual (effectively $4 million per couple). In addition, estate tax rates would be lowered. Only the further increases in the estate tax exemption scheduled for 2009 and the repeal of the estate tax scheduled for 2010 would be cancelled. Sperling's proposal to cancel future reductions in the top two income tax rates would affect only the top two percent of tax filers. His proposal to rescind estate tax changes scheduled for years after 2008 would affect the estates of substantially fewer than one percent of people who die. Those who would be affected would still receive large tax cuts from other provisions of this year's tax legislation. Yet this proposal would save $1.2 trillion over the next 20 years and erase *more than half* of Social Security's long-term financing gap.[13]

Conclusion

The change the Commission is considering to replace wage indexing with price indexing in the Social Security benefit formula would lead to large reductions in Social Security benefits that grow deeper over time. It would constitute an across-the-board reduction in benefits and would affect all beneficiaries, including people with disabilities and survivors.

This proposal is not readily understood by the public and is complicated to explain. That may be one of its attractions to those who favor it. It can be presented in a manner that sounds highly technical and does not make evident the magnitude of the benefit reductions that would occur if the proposal were adopted. Yet it would represent a very large change. The public should understand what the proposal entails, and also that there are alternatives to restoring Social Security solvency that do not require benefit reductions of this magnitude.

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[13] Gene Sperling, "Fiscal Chutzpah," *Washington Post*, July 31, 2001.