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Social Security price indexing proposal means benefit cuts for workers

By William E. Spriggs and David Ratner

Much has been made of the recent Social Security proposal put forth by Robert Pozen, a member of Bush's President's Commission to Strengthen Social Security, and endorsed by President Bush. Pozen's suggested changes to Social Security include blending the current wage indexing of benefits with price indexing, a shift that will reduce Social Security benefits for middle-income workers by 22% in 2055 and by 28% in 2085. Indeed, the Pozen proposal will lead to substantial and ever increasing benefit cuts for well over 70% of Social Security beneficiaries, including retirees, widows, and surviving children.

Earlier projections discussing implications of the effects of Pozen's proposal concern only workers who are either very young or not yet born. As a result, the cost of price indexing for current workers has been missing from the debate. These new estimates focus on current workers and, while remaining consistent with the proposal's long-run projections, show substantial benefits cuts under the Pozen plan for them as well. These expanded numbers also include estimates for each state for different ages and national estimates for race, gender, and marital status.

Wage indexing versus price indexing

The Pozen proposal cuts projected Social Security benefits by taking advantage of the fact that average wages have grown (and will continue to grow) faster than prices. Because the gap between wages and prices grows over time, the benefit cuts under the Pozen plan deepen over time. Thus, the cuts for those currently employed will not be as large as for those not yet old enough to be employed.

The cuts in benefits for current American workers should be put in the context of other changes in sources of retirement income. [Retirement Income: The Crucial Role of Social Security](#), a recent Economic Policy Institute study by Christian Weller and Edward Wolff, highlighted the declining share of Americans with access to traditional retirement accounts and the dramatic growth of Social Security as a share of middle-class retirement wealth. For instance, for those ages 47 to 55, Weller and Wolff show that about 26% of workers have neither a defined benefit nor a defined contribution pension plan. And, for workers in that age group, the mean value of their private pension plans was less than the wealth they held in Social Security benefits. In that context, the cuts from the Pozen plan would be devastating.¹

The tables below use data on workers gathered by the U.S. Census Bureau on annual income for the three most recent years of data (2001 to 2003). By creating such a large sample of current American workers, we can project the loss of Social Security retirement benefits that specific groups of current workers can expect to receive (see the [Technical Appendix](#) for a full explanation of the data and methods). The tables present the proposal's effects for workers currently married and the expected benefit cuts by state, race, gender, and age.

Under the Pozen proposal, about 6% of workers who earn enough to get the maximum Social Security benefit will have their future benefits calculated using pure price indexing (currently those earning more than \$90,000 a year would receive the maximum benefit). The benefit cuts are largest for these workers with the highest earnings. Roughly the bottom 30% of earners—but, importantly, not the bottom 30% of Social Security *beneficiaries*—will have their benefits calculated using the current method of wage indexing. And the remaining workers—the roughly 64% of those between the bottom and the top of the earning scale—will have their benefits cut, with those at the lower end facing smaller cuts than those at the higher end.

Pozen plan will slash benefits for many current workers

According to testimony by the director of the Congressional Budget Office on May 25, the Social Security trust fund should be able to pay full benefits another 39 years, through 2044.² Thus, under the current Social Security framework, workers now in their early 40s should receive full benefits in

retirement for their expected lifetimes. Anyone younger than that would unambiguously suffer from a cut in benefits if Congress passes Social Security reform with the Pozen proposal for indexing benefits.

But while older workers will be hit with reductions in benefits under the Pozen plan, younger workers will take the biggest cuts in benefits. As shown in [Table 1](#), the average cut for today's 26-year-old workers will be 14.6% compared to current law, and will amount to a reduction in retirement income over their expected retired lives of \$71,236 in today's dollars. Today's 40-year-old workers will suffer a cut of 7.3%, amounting to a cut of \$28,148 in benefits in today's dollars. Given that under current law, and with current projections, Social Security should be sufficiently solvent to pay full current law benefits, these are substantial and unnecessary cuts.

It is important that policy makers approach any cuts in benefits to current workers with caution. In 1997, the Social Security Trustees reported that the projected 75-year shortfall in Social Security's finances were equivalent to 2.23% of taxable payroll for the United States. Yet, no changes were made in the program. Over the last eight years, the shortfall estimated by the Trustees' report has narrowed by 14% to 1.92% of payroll, mostly because the economy performed better than predicted.³ So, if cuts in benefits had been implemented to eliminate the shortfall projected by the Social Security trustees in 1997, those cuts would have been far deeper than necessary, based on what we know about the projections made today.

Marital status and gender under the Pozen plan

Because men have been earning more than women, men will face a greater cut in benefits than women. Young men ages 26-31 can expect cuts in benefits of 13.8%, amounting to a drop in expected retirement income over their lives of \$62,686 in today's dollars (see [Table 2](#)). It will be difficult for these men to earn back enough by retirement to offset a cut that large, even with the most generous assumptions about how private accounts might perform.

Married couples will take a bigger cut in benefits than single workers. This is primarily because married men tend to earn more than single men or women. Wives are allowed to claim either their own benefit, based on their work record, or half their husband's benefit, based on his work record. So, some women who appear to be low wage, actually will take a larger benefit cut. For married couples age 42-54, the cut will be 3.9% each, and will average a cut of \$14,373 each in retirement income (as shown in [Table 3](#)). Against the backdrop that Social Security would be able to pay these benefits in full, that is a large cut. And, watching the private pension plans of Enron, United, and others vaporize in the wake of the stock markets downturn, those cuts will be difficult to make up from other resources before these workers retire.

Social Security cuts by state

Examining the Pozen proposal through the lens of its impact on individual states yields further evidence of the proposal's negative effect on Social Security benefits. As [Table 3](#) showed, married couples take a bigger cut than singles. And, as the logic of the Pozen plan protects the bottom third of earners, states with more low earners will have lower cuts than states with more high earners. Part of the reason that some states have deeper cuts than others comes from differences in marriage rates, as well as in incomes.

Projected cuts for states reflect average income for workers, and the share of workers in each state who are married (see [Table 4](#)). Among states, current workers in Massachusetts, New Jersey, Connecticut, and Delaware will take the greatest loss in Social Security income, though Virginia and Pennsylvania also rank high.

Racial differences in benefit cuts

Again, because the Pozen plan cuts benefits more for workers who make more, racial differences in the size of cuts will depend on racial differences in income. Racial differences in cuts reflect the higher earnings of whites and Asian Americans than of Hispanics and African Americans ([Table 5](#)). Despite a smaller cut for African Americans and Hispanics—an average of 2.8% for 42- to 54-year-olds compared to 3.8% for whites and 3.7% for Asian Americans in that age group—the greater share of African Americans and Hispanics who rely solely on Social Security for their retirement income will make these cuts appear larger relative to their total retirement income. (The amount of lost retirement income is projected to be slightly higher for African Americans because a higher share of African Americans are women than is true for Hispanics, and women have longer life expectancies than men.) It bears repeating that the Pozen plan would impose cuts on 42-54 year olds even though projections show that Social Security will have sufficient funds to pay full benefits throughout the expected life of this age group.

Given the certainty that the current work force will face benefit cuts under the Pozen plan, a careful

analysis must be made of the impact of those cuts. For instance, 42-to 54-year-olds will face smaller cuts than younger workers, but their cuts are not the direct outcome of Social Security projections showing insufficient funds to cover their benefits. And, cuts for 42- to 54-year-olds will take place when many have been surprised by the sudden drop in their private pension plans and have little time to recover the losses in retirement income that will stem from private plans or cuts in Social Security. Using cuts to balance the Social Security Trustees projections must be weighed carefully in light of the fluctuations in the Trustees' projections over time. Had cuts been made in 1997 to close the 75-year actuarial shortfall projected at that time, they would have been deeper than what would be required to close that shortfall today.

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Endnotes

1. Christian Weller and Edward N. Wolff, *Retirement Income: The Crucial Role of Social Security* (Washington, DC: EPI, 2005).
2. Douglas Holtz-Eakin, "Options for Social Security: Budgetary and Distributional Impacts," statement, U.S. Congress, Senate, 109th Congress, 1st Session, Committee on Finance, Hearings: Social Security: Achieving Sustainable Solvency, May 25, 2005 at <http://finance.senate.gov/hearings/testimony/2005test/dhetest052505.pdf>.
3. U.S. Congress, House of Representatives, 109th Congress, 1st Session, Committee on Ways and Means, The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, (Washington, DC: U.S. Government Printing Office, 2005): Table VI.B1.—Long-Range OASDI Actuarial Balances as Shown in the Trustees Reports for 1982-2005at <http://www.ssa.gov/OACT/TR/TR05/tr05.pdf>.

**Table 1: Pozen plan's effect on Social Security benefits:
Average benefit cuts by age**

Age	Percent cut in benefits	Cumulative cut in benefits*
54	0.13%	352
53	0.77%	2,629
52	1.34%	4,630
51	1.92%	6,706
50	2.50%	8,881
49	3.03%	10,894
48	3.49%	12,611
47	3.89%	14,194
46	4.36%	15,988
45	4.91%	18,279
44	5.45%	20,459
43	5.77%	21,146
42	6.31%	23,496
41	6.80%	25,696
40	7.30%	28,148
39	7.74%	30,177
38	8.21%	32,429
37	8.72%	35,217
36	9.11%	36,905
35	9.97%	41,429
34	10.13%	42,390
33	10.69%	45,599
32	11.04%	48,022
31	11.50%	50,351
30	11.87%	53,196
29	12.52%	56,932
28	13.13%	61,080
27	13.70%	65,060
26	14.57%	71,236

*Cumulative benefit cut in 2005 dollars. See Technical Appendix.

Source: Economic Policy Institute analysis of CPS and SSA.

Table 2: Pozen plan's effect on Social Security benefits:

Average benefit cuts by sex and age group

	Age 26-31		Age 32-41		Age 42-54	
	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*
Male	13.8%	62,686	10.0%	40,855	4.1%	15,018
Female	11.7%	55,641	7.7%	31,101	3.0%	10,923

*Cumulative benefit cut in 2005 dollars. See Technical Appendix.

Source: Economic Policy Institute analysis of CPS and SSA.

**Table 3: Pozen plan's effect on Social Security benefits:
Average benefit cuts by marital status and age group**

	Age 26-31		Age 32-41		Age 42-54	
	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*
Single	11.6%	54,287	7.1%	29,180	2.7%	10,124
Married	14.2%	64,844	9.9%	40,375	3.9%	14,373

*Cumulative benefit cut in 2005 dollars. See Technical Appendix.
Source: Economic Policy Institute analysis of CPS and SSA.

**Table 4: Pozen plan's effect on Social Security benefits:
Average benefit cuts by state and age group**

	Age 26-31		Age 32-41		Age 42-54	
	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*
Alabama	11.3%	50,358	8.1%	31,533	3.4%	12,237
Alaska	12.6%	56,088	9.2%	36,694	3.8%	13,962
Arizona	12.6%	57,402	8.6%	34,838	3.3%	12,204
Arkansas	11.0%	47,891	7.5%	28,675	2.7%	9,198
California	13.0%	61,344	9.2%	38,973	3.8%	14,315
Colorado	13.6%	62,940	10.0%	41,699	3.9%	14,466
Connecticut	14.6%	71,159	10.5%	44,720	4.4%	16,790
DC	15.7%	80,271	10.4%	47,224	3.8%	15,331
Delaware	14.3%	67,074	9.3%	38,080	3.8%	13,829
Florida	12.3%	56,269	8.1%	32,221	3.4%	12,361
Georgia	13.1%	59,907	8.9%	35,918	3.3%	11,996
Hawaii	12.3%	55,339	8.3%	32,890	3.4%	12,127
Idaho	10.9%	45,664	7.5%	27,964	3.1%	10,571
Illinois	13.7%	64,199	9.6%	39,498	3.6%	13,160
Indiana	12.6%	55,735	8.9%	35,747	3.4%	12,069
Iowa	12.4%	53,905	8.1%	30,878	3.3%	11,350
Kansas	12.4%	55,768	8.9%	35,437	3.5%	12,269
Kentucky	12.2%	55,064	8.2%	31,976	3.3%	11,489
Louisiana	12.0%	52,743	8.5%	33,026	3.0%	10,525
Maine	12.3%	53,975	7.9%	29,890	3.1%	10,697
Maryland	14.7%	70,854	10.3%	43,155	4.1%	15,690
Massachusetts	14.9%	72,930	10.2%	43,342	4.0%	15,334
Michigan	13.1%	60,832	9.7%	39,588	3.8%	13,845
Minnesota	14.5%	68,806	10.0%	41,265	3.8%	13,962
Mississippi	10.7%	47,164	7.2%	27,561	2.9%	10,083
Missouri	13.3%	62,189	9.0%	36,213	3.3%	11,821
Montana	9.1%	37,830	7.0%	25,143	2.6%	8,546
Nebraska	13.4%	61,001	8.6%	33,856	3.3%	11,415
Nevada	12.6%	57,081	8.5%	33,837	3.4%	12,274
New Hampshire	14.3%	65,503	10.1%	41,557	4.0%	14,708
New Jersey	14.6%	70,970	10.2%	43,238	4.1%	15,886
New Mexico	10.7%	44,603	6.9%	26,387	2.8%	9,889
New York	13.1%	62,555	9.1%	37,703	3.6%	13,529
North Carolina	11.9%	53,109	8.0%	31,223	3.2%	11,352
North Dakota	12.0%	51,176	7.3%	26,274	2.9%	9,651
Ohio	12.9%	58,820	9.0%	36,001	3.6%	13,022
Oklahoma	11.7%	50,690	7.3%	27,631	3.3%	11,656
Oregon	11.8%	52,942	8.5%	33,510	3.3%	11,920
Pennsylvania	13.6%	63,082	9.1%	37,015	3.5%	12,652
Rhode Island	13.1%	61,786	9.0%	36,515	3.7%	13,746
South Carolina	11.8%	52,815	8.2%	31,881	3.4%	11,671
South Dakota	12.0%	52,373	7.7%	28,420	3.0%	10,011
Tennessee	12.0%	53,576	8.0%	31,058	3.2%	11,396
Texas	12.1%	55,824	8.2%	32,938	3.4%	12,540
Utah	11.6%	49,866	8.7%	34,242	3.5%	12,325
Vermont	11.6%	51,881	8.2%	32,012	3.3%	11,593
Virginia	13.9%	66,801	9.8%	40,824	4.1%	15,255
W. Virginia	10.4%	44,564	7.2%	27,405	2.9%	9,776
Washington	11.9%	54,243	8.9%	35,861	3.8%	14,262
Wisconsin	13.7%	61,916	8.9%	34,905	3.6%	12,512
Wyoming	11.9%	51,293	7.8%	29,240	3.2%	11,125

*Cumulative benefit cut in 2005 dollars. See Technical Appendix.
Source: Economic Policy Institute analysis of CPS and SSA.

**Table 5: Pozen plan's effect on Social Security benefits:
Average benefit cuts by race and age group**

	Age 26-31		Age 32-41		Age 42-54	
	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*	Percent cut	Cumulative cut*
White	13.7%	63,969	9.6%	39,144	3.8%	13,852
Black	10.5%	46,971	7.2%	28,232	2.8%	9,651
Hispanic	10.3%	45,694	6.6%	25,761	2.8%	9,596
Asian	14.9%	74,002	10.1%	44,143	3.7%	14,011
Other	11.4%	52,033	7.9%	31,452	3.3%	11,957

*Cumulative benefit cut in 2005 dollars. See Technical Appendix.

Source: Economic Policy Institute analysis of CPS and SSA.

Technical appendix

Phase I. Generate earnings profiles

Estimates are generated by pooling earnings data for 2001, 2002, and 2003 from the Current Population Survey of the following year. For each individual aged 26-54, earnings are calculated as the sum of wage earnings and earnings from self-employment. Earnings in 2001 and 2002 are inflation adjusted to 2003 dollars using the CPI-U. Data for 2001 and 2002 are treated as if collected for 2003 so that a 28 year old in the March 2002 survey is included as if she were a 28 year old in 2003.

To construct earnings profiles, we use stylized scale factors created by the SSA to model a typical worker's age-earnings profile¹. For each worker, we construct lifetime earnings from age 21 to 64. Given current reported earnings levels, we backcast and forecast reported income by the growth in the average wage index to account for increases in overall wages and the growth in the scale factors to generate an age-appropriate level of earnings. For example, if person A is 25 in 2003 (the March, 2004 CPS), we will create an earnings history of 43 years for this worker, backcasting 4 years and forecasting 39 years. To calculate earnings for this worker when he/she is 24, the following calculation is performed:

$$E_{2002,24} = E_{2003,25} \cdot \left(\frac{1}{SC_{25}} \right) \left(\frac{1}{AWI_{2002}} \right),$$

where $E_{2002,24}$ is earnings in 2002 at age 24, SC_{25} is the scale factor for age 25, and AWI_{2003} is the average wage index in 2003. To forecast earnings for 2004 when the worker will be 26 compute

$$E_{2004,26} = E_{2003,25} \cdot \left(\frac{SC_{26}}{SC_{25}} \right) \left(\frac{AWI_{2004}}{AWI_{2003}} \right).$$

More generally, to calculate any year i 's earnings from year j 's earnings, solve:

$$E_{i,age+(i-2003)} = E_{j,age+(j-2003)} \cdot \left(\frac{SC_i}{SC_j} \right) \left(\frac{AWI_i}{AWI_j} \right).$$

Phase II: Compute Social Security benefits

After each individual has been assigned an age-earnings profile based on their current reported wage, salary, and self-employment earnings, we compute a worker's AIME—average indexed monthly earnings—that is necessary in computing monthly social security benefits. This is done by taking each year's estimated earnings and indexing it

¹ Clingman, Michael and Orlo Nichols. 2004. "Scaled Factors for Hypothetical Earnings Examples Under the 2004 Trustees Report Assumptions." Baltimore, MD: Social Security Administration, Office of the Chief Actuary.

by the change in the average wage index from that year until the worker is 60. Earnings from 61-64 are taken at face value. The AIME is computed by taking the highest 35 years of earnings and taking a monthly average.

Based on the AIME for each worker and their spouse (if present), we compute the monthly Social Security benefit that any given worker will receive upon retirement². In order to calculate the primary insurance amount (PIA), we use the bend points and bend point factors that are predicted in the 2004 Social Security Trustees' report (as used in the Pozen memo³). The PIA formula is as follows:

- (1) 90% of all income up to the first bend point, BP1.
- (2) 32% of income between the first and second bend point, BP2.
- (3) 15% of all income above the second bend point.

The .9, .32, and .15 slopes are the bend point factors that would be subject to price indexing. Bend points and bend point factors are used at age 62, the first year of eligibility. PIA's are adjusted for inflation from 62 until the normal age of retirement.

In order to calculate PIA's under progressive price indexing, we use SSA's estimates for the new bend points and bend point factors. Progressive price indexing works as follows.

- 1) Calculate the reduction imposed on the maximum wage earner under pure price indexation. For the maximum earner, this results in a reduction of $\left(\frac{\% \Delta CPI}{\% \Delta AWI}\right)^t$, where t is the number of years that price indexation is in effect (from 2012 until the year of eligibility).
- 2) Generate a new bend point at the 30th percentile of individual wage earners in each year. Call this BP-PPI for the progressive price indexing bend point.
- 3) Reduce the .32 factor that applies between BP-PPI and BP2 and the .15 factor that applies for all earnings after BP2 by a new reduction factor that will preserve the benefit cut of pure pricing indexation for the maximum earner. This results in a phased in, "sliding scale," price indexing.

Now, the PIA-PPI is calculated as follows:

- (1) 90% of all income up to the first bend point, BP1
- (2) 32% of income between BP1 and the new BP-PPI
- (3) 32% · x of income between BP-PPI and BP2
- (4) 15% · x for all income above BP2,

where x is the new reduction factor. For our purposes, we have used the bend points and bend point factors used by the SSA solvency memorandum to Robert Pozen.

Once the PIA under current law and the PIA-PPI are calculated, we index these amounts by projected growth in prices in the 2004/2005 Social Security Trustee's report to when the worker will reach the normal retirement age.

In order to determine spousal benefits, we follow current Social Security provisions and assign the higher of two values. If the wife's (husband's) benefit is less

² We have assumed that each worker will retire at the normal retirement age. The normal retirement age is currently 65, but is notched up over several years until it reaches 67.

³ Goss, Stephen C. 2005 "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing." Baltimore, MD: Social Security Administration, Office of the Chief Actuary.

than one-half of the husband's (wife's) benefit, then we give the wife (husband) half her (his) husband's (wife's) benefit. If not, the wife (husband) receives her (his) estimated benefit. For couples who retire in different years, we use the CPI to correct the benefit to reflect one-half of the real value of the projected benefits.

The President has not specified what to do with married couples of different ages. So, we have omitted the spouse of workers age 54 or younger, if the spouse is age 55 or over.

We calculate a cumulative benefit cut by deflating a worker's benefit at retirement into real 2005 dollars. Using gender specific life expectancy at retirement as projected by the Social Security Trustee's report, we calculate an expected cumulative loss in benefits as

$$(PIA_{2005\$} - PIA_{PPI_{2005\$}}) \cdot \text{Life expectancy at NRA} = \text{Cumulative Benefit loss}$$

Phase III: Comparing estimates

Estimates from the Social Security Administration rely on internal data not available for public use. To check for the robustness of our state-by-state analysis, we compare SSA data⁴ to the CPS data used for our study. We calculate each state's average income as a percent of the national average and use the Spearman Rank Correlation test to compare the rank orders of both datasets. The Spearman statistic is .9430 and the significance level is less than .001. Therefore, the distributions of incomes by state for SSA data and the CPS are not statistically different.

The SSA memo on the Pozen plan includes estimates for benefit cuts for medium workers in ten year intervals starting in 2015. In order to benchmark our estimates, we provide the closest matching years from our analysis.

Year	SSA estimates for medium worker	EPI estimates for average worker	EPI estimates for average of middle quintile
2015	0.7	0.1%	0.3%
2025	6.4	5.5%	6.7%
2035	11.5	10.0%	12.4%
2044	--	14.6%	19.7%
2045	16.4	--	--

⁴ SSA data available from: 2004 Annual Statistical Supplement of the OASDI program. www.ssa.gov/policy. Table 4.B.10.