The Impact of Social Security Cuts on Retiree Income

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Contents

About the Authors

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Executive Summary

There has been a serious push in policy circles to cut Social Security benefits for near- and/or current retirees. The argument for such cuts has been based on the deficits in the federal budget; the finances of the Social Security program have been at most a secondary consideration.

However, the finances of the current or near-retirees who would be affected by these cuts have also largely been ignored in this discussion. This is striking because this group has been hardest hit by the collapse of the housing bubble and the resulting plunge in stock prices. These workers had accumulated some wealth – mostly in the form of home equity – which they stood to lose as a result of the crisis. Since they are at or near retirement age, they will have little opportunity to replace their lost wealth.

This paper assesses the cuts implied by three common proposals for reducing Social Security benefits:

1) Adopting a "progressive price" indexation (PPI) formula for the basic benefit structure,
2) Accelerating and extending the increase in the normal retirement age, and
3) Reducing the annual cost-of-living adjustment.

It calculates the implied cut in benefits and projected income for various age groups and income quintiles of retirees and near-retirees.

It shows that:

- The most frequently suggested PPI formula would imply cuts in benefits of 6.2 percent for a household in the middle quintile between the ages of 45-49 in 2007. This would translate into a 3.7 percent reduction of income. This would be roughly equivalent to a 3.7 percentage point increase in the tax rate imposed on these middle-income households.
- This PPI formula implies a cut in benefits for middle quintile households between the ages of 40-44 in 2007 of 9.6 percent. This would translate into a reduction in income of 6.4 percent.
- Raising the normal retirement age to 70 in 2036 (compared to age 67 in 2022 under current law) would lead to a 4.0 percent reduction in benefits for workers between the ages of 50-54 in 2007 and a 10 percent reduction in benefits for workers between the ages of 40-44.
- This accelerated increase in the normal retirement age would imply a 3.1 percent reduction in retirement income for workers between the ages of 50-54 in the bottom quintile. It implies a cut in retirement income of 7.9 percent for workers in the bottom quintile between the ages of 40-44.
- Proposals to change the annual cost-of-living adjustment will reduce benefits for both current and future retirees. A 1.0 percentage point reduction in the annual cost-of-living adjustment (as widely advocated in the 90s) would imply a cut of almost 12 percent in benefits for a retiree at age 75 and more than 20 percent for a retiree at age 85 (assuming retirement at age 63).

- This would imply a reduction in income of 14.6 percent for retirees in the bottom quintile at age 85 who were between the ages of 55-59 in 2007. It implies a cut in benefits of 16.5 percent for retirees in the bottom quintile at age 85 between the ages of 40-44.

Since the vast majority of near-retirees will rely on Social Security for the vast majority of their income in retirement, cuts in Social Security imply large cuts in income for a population that is already not especially wealthy. (Median household income for people over age 65 is less than $30,000.) Ironically, the drive for these cuts is being driven by budget problems resulting from the collapse of the housing bubble. This is a disaster for which older workers were the primary victims, since they lost the most equity in their homes.

It is important that any proposals for cutting Social Security benefits examine the impact on the affected workers. This analysis suggests that the cuts most commonly being considered will have a substantial negative impact on low- and middle-income families.

Introduction

There have been bi-partisan calls for cutting Social Security as part of an effort to reduce the country's long-term budget deficit. In principle, Social Security should not affect the budget. Under the law, Social Security is counted as off-budget. It is treated as a separate program with its own designated funding stream primarily in the form of the 12.4 percent payroll tax. According to the latest projections from the Congressional Budget Office, this stream will be sufficient to fund scheduled benefits through the year 2044 and roughly 75 percent of scheduled benefits in subsequent years.

Even though the program is fully funded for the next 34 years, and therefore requires no changes anytime soon, Social Security is counted in the unified budget.[1] This means that it is possible to reduce the unified budget deficit by cutting Social Security, even if it is not necessary given the program's own finances. This is the reason that many politicians have expressed interest in cutting Social Security benefits.

This paper examines the impact of three proposed cuts[2] in Social Security benefits on the projected retirement income of workers who will be retiring in the next two decades:

1) **Replacing the current benefit formula with one based on progressive price indexation.** The formula used in this analysis allows benefits to rise as currently scheduled for workers with average annual earnings of less than $22,300. The benefit would rise in step with inflation for workers who currently have the maximum average earnings of $106,800. For workers with average wages between these two points, benefits will rise at a rate that is between the scheduled benefit and the rate of inflation.

2) **Raising the normal retirement age to 70 by 2036.** Currently, the normal retirement age is 66. Under current law, it will rise at the rate of two months per year beginning in 2017, until it reaches 67 for workers who turn 62 in 2022 and later. This proposal would have the age start to move up at the rate of two months per year beginning in 2013 and continuing until it hit 70 for workers reaching age 62 after 2035.

3) **Reducing the cost-of-living adjustment (COLA) by 1.0 percentage point below the rate of inflation shown by the CPI-U.** This was a measure that enjoyed wide support in the mid-90s based in part on the recommendations of the Boskin Commission that was created by the Senate Finance Committee.[3] More recently, there have been many advocates of switching the basis for the annual COLA to the Chained Consumer Price Index for All Urban Consumers (C-CPI-U). This would reduce the size of the annual adjustment by approximately 0.3 percentage points.

This paper examines the impact of each of these benefit cuts on workers in five-year age cohorts. That is, in 2007, workers between the ages of 40-44, 45-49, 50-54, and 55-59. This calculation is

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1   For an explanation of the unified budget, see "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011." http://www.whitehouse.gov/omb/budget/fy2011/assets/concepts.pdf
2   See http://www.ssa.gov/OACT/solvency/advisoryboard_20050810.pdf for additional information.
3   Former Senator Alan Simpson, a co-chair of President Obama's National Commission on Fiscal Responsibility and Reform, was a prominent proponent of this cut.

done for each income quintile. It also projects the cuts as a percentage of retirement income. The calculation of retirement income is based on current wealth as calculated from the Federal Reserve Board's Survey of Consumer Finance. It also includes projections of income from defined benefit pensions. (See the appendix for a full explanation.) The projections show the impact of each cut for workers at ages 65, 75, and 85.

The Impact of Progressive Price Indexation

In principle, progressive price indexation makes Social Security more progressive since it protects the bottom half of earners from any cut in benefits. However, the most commonly proposed formula implies substantial cuts for workers who are still middle-income by any reasonable measure.

The formula used in this analysis is taken from the Social Security Administration.[4] Benefits rise in step with average wage growth, following current law, for workers with average indexed earnings of less than the 30th percentile (around $22,300). They are held constant in real terms for maximum wage earners. Those between the cutoff and the maximum benefit will see some increase in benefits while receiving a decreasing share of the scheduled increase as they get closer to the maximum covered wage for Social Security.

This structure of benefit cuts is progressive in the sense that it protects workers earning less than the 30th percentile. However, it does imply substantial cuts in benefits measured against those currently scheduled for workers who are far from affluent by any measure. For example, the middle quintile of the cohort that was between the ages of 45 and 49 in 2007 would see an average cut in their benefits of 6.2 percent under this progressive indexation formula. The cuts relative to scheduled benefits accumulate through time so that the middle quintile of the cohort between the ages of 40-44 in 2007 would see a 9.6 percent cut in benefits.

Because most workers near the middle of the income distribution can expect to have relatively little income in retirement other than their Social Security, these reductions in benefits imply substantial reductions in income. The 9.6 percent cut in benefits for a worker in the middle quintile in the 40-44 age cohort translates into a 6.4 percent reduction in income. This is equivalent to a 6.4 percentage-point increase in the tax rate for these households. The 6.2 percent reduction in benefits for a worker in the middle quintile in the 45-49 age cohort would translate into a 3.7 percent reduction in income. This is equivalent to a 3.7 percentage-point increase in the tax rate for these households.[5]

Figure 1A shows the percentage decline in Social Security's Old-Age and Survivors Insurance (OASI) benefits and retirement income by quintile for the cohort that was between the ages of 40-44 in 2007. **Figure 1B** shows the same information for the cohort that was between the ages of 45-49, and **Figure 1C** shows this information for the cohort between the ages of 50-54. The cohort between the ages of 55-59 is excluded since the proposed schedule of cuts would not affect their benefits.

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4   See http://ssa.gov/OACT/solvency/RPozen_20050210.pdf for a fuller explanation of this indexation formula.

5   It is important to realize that this benefit cut would be equivalent to an additional 3.7 percent tax on the household's entire income. This would have a much larger impact than simply increasing the marginal tax rate by 3.7 percentage points, since the latter would only be applicable to the income above the threshold.

FIGURE 1A
Percentage Change in Benefits and Income from Progressive Price Indexation, by Income Quintile, 40-44 Age Cohort
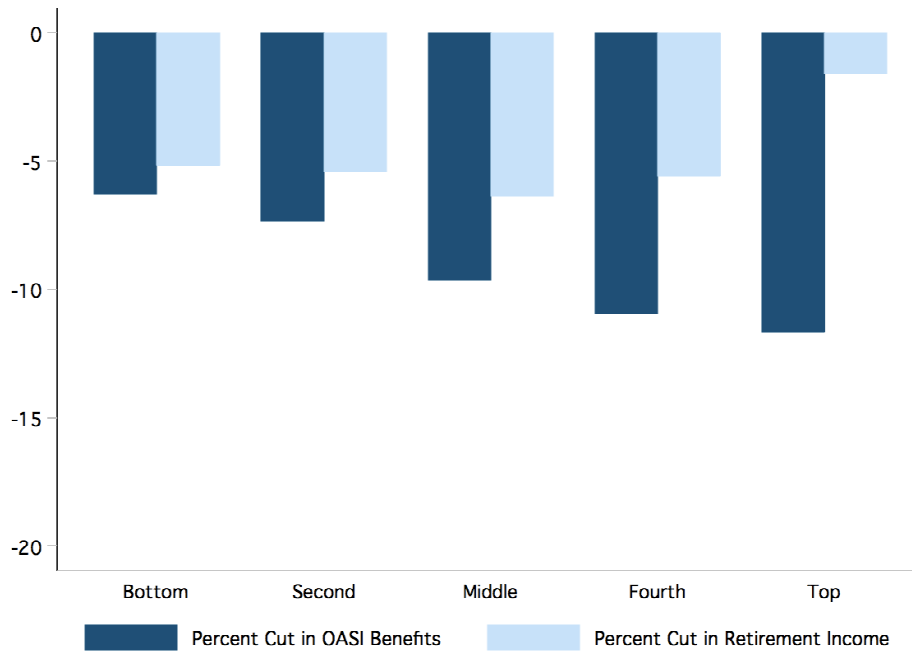

FIGURE 1B
Percentage Change in Benefits and Income from Progressive Price Indexation, by Income Quintile, 45-49 Age Cohort
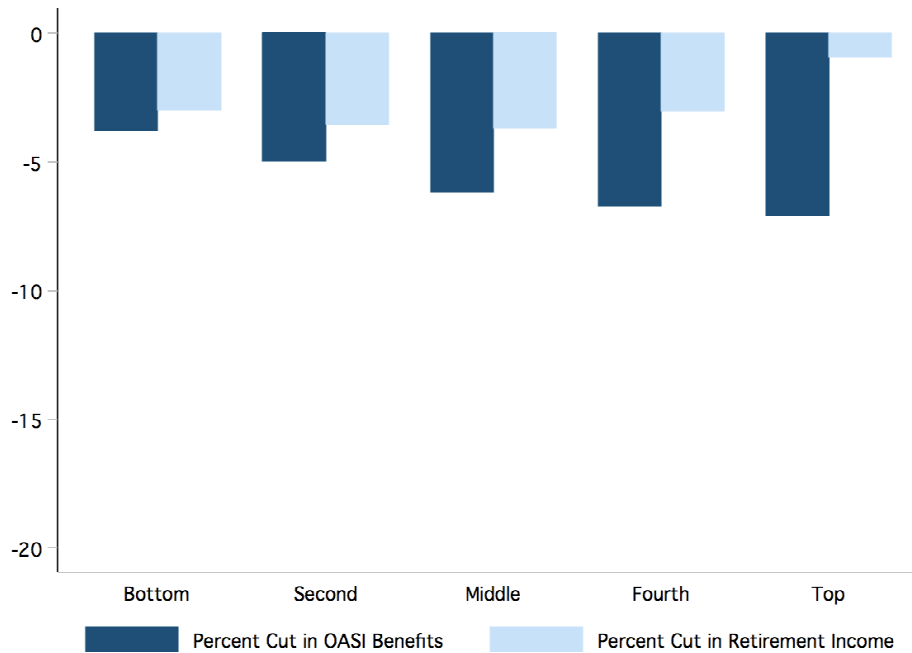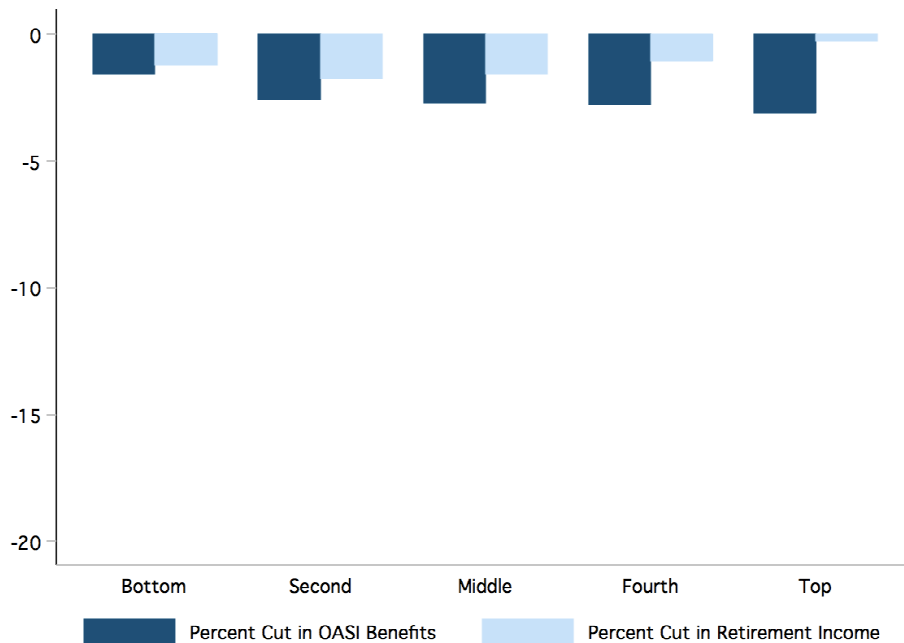
FIGURE 1C
Percentage Change in Benefits and Income from Progressive Price Indexation, by Income Quintile, 50-54 Age Cohort

The end result of this process is that the benefits for all workers with average incomes above the 30th percentile would eventually be the same. While the payout formula for Social Security has always been progressive, this indexation formula would end any link between contributions and benefits. A maximum wage earner would pay more than three times as much in Social Security taxes as a median wage earner, however they would get back no more in benefits than a median wage earner. This is a sharp departure from the structure of the program at present.

Raising the Normal Retirement Age

The compromise that came out of the 1983 Greenspan Commission raised the normal retirement age (NRA) from 65 to 67 with the increase phased in gradually over the years from 2003 to 2022. The first increase came in two-month-per-year intervals for workers reaching the age of 62 in the years 2000 to 2005. The normal retirement age is scheduled to stay at 66 from 2005 to 2016. It again increases at the rate of two months per year from 2017 to 2022, when it reaches 67.

The proposal analyzed in this section assumes that the NRA shortens the number of years held at 66 – increasing the retirement age by two months per year starting with those turning 62 in 2013 and continuing to increase the NRA to age 70 for those turning age 62 in 2036 and later.
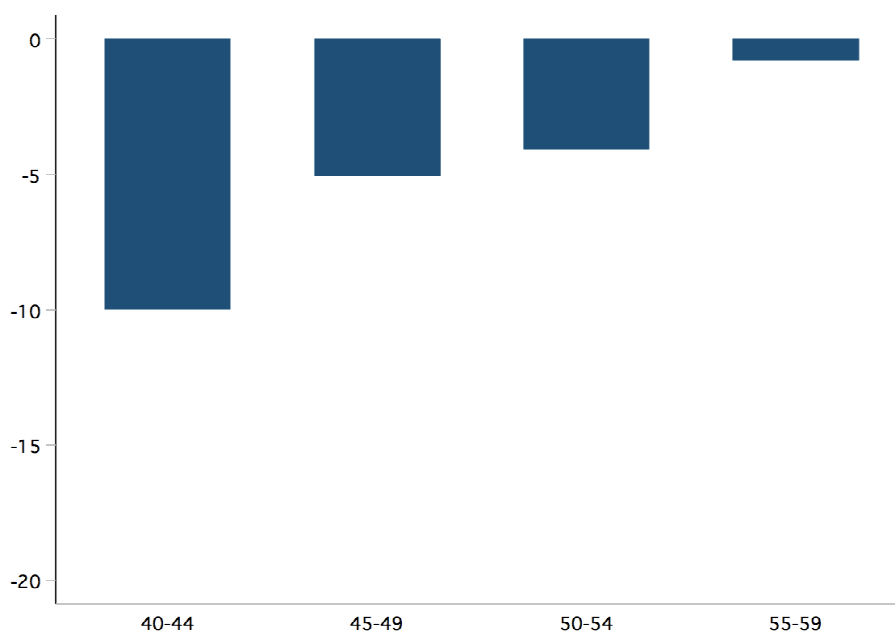
It is important to note that an increase in the NRA is essentially a cut in benefits since the vast majority of workers start collecting reduced benefits not long after they reach the early retirement age (ERA) of 62. For these workers, an increase in the NRA is simply a cut in benefits because their benefits are reduced a fraction of a percent for each month between the age at which they retire and

the NRA.[6] (There is an earnings test that reduces benefits for workers who start collecting benefits before the NRA but stay in the workforce. There is no earnings test for those who work after the NRA.)

As with the progressive indexation formula, the increase in the NRA has a greater impact through time. However, unlike the progressive indexation formula – which shielded the workers with the lowest lifetime earnings – an increase in the NRA reduces benefits by the same percent for all workers. (These calculations assume that workers do not change the age at which they start collecting benefits as a result of the increase in the NRA.)

For workers in the cohort that were between the ages of 40-44 in 2007, the increase in the NRA implies a 10.0 percent reduction in benefits. For workers between the ages of 45-49, the reduction in benefits would be 5.0 percent. For the cohort between the ages of 50-54, the reduction in benefits is 4.0 percent and for the cohort between the ages of 55-59, the reduction in benefits is 0.8 percent, as is shown in **Figure 2**.

FIGURE 2
Percentage Change in Benefits from Raising the Retirement Age to 70, by Age Cohort

While the percentage reduction in benefits is the same for all income groups, the implied percentage reduction in retirement income is relatively larger for lower income retirees. **Figures 3A**, **3B**, **3C**, and **3D**, show the percentage reduction in annual income implied by these cuts for each income quintile in the four age cohorts. For the bottom quintile, the increase in the retirement age implies a reduction in income of 7.9 percent for workers between the ages of 40-44 in 2007, 4.0 percent for those between the ages of 45-49, 3.1 percent for those between the ages of 50-54, and 0.8 percent for those between the ages of 55-59.

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6   See http://www.socialsecurity.gov/retire2/agereduction.htm for examples of how benefits are currently reduced for workers who retire between age 62 and the NRA.

FIGURE 3A
Percentage Change in Annual Income from Raising the Retirement Age to 70, 40-44 Age Cohort
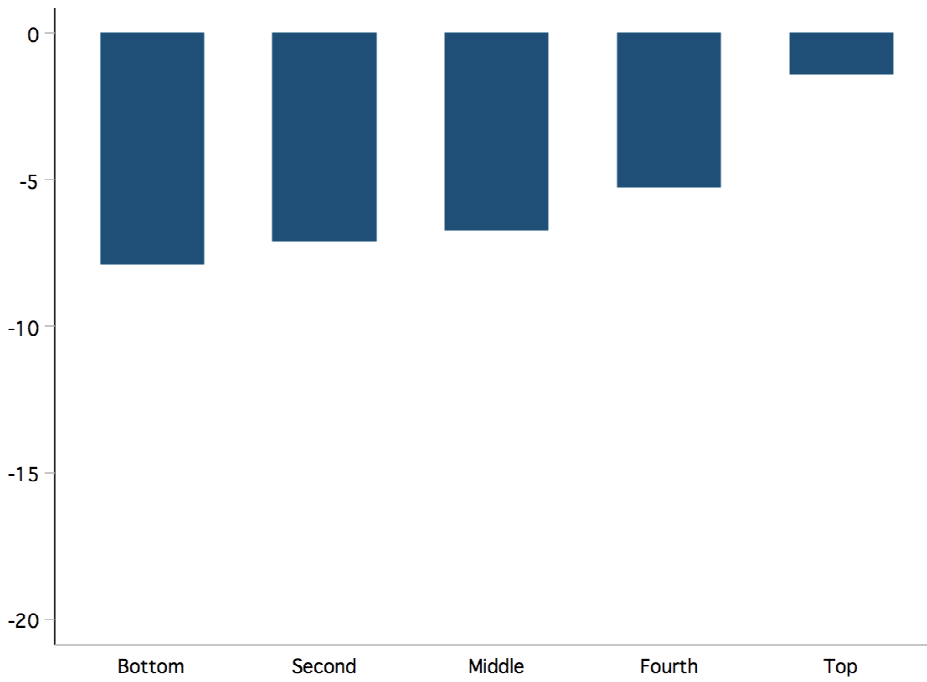

FIGURE 3B
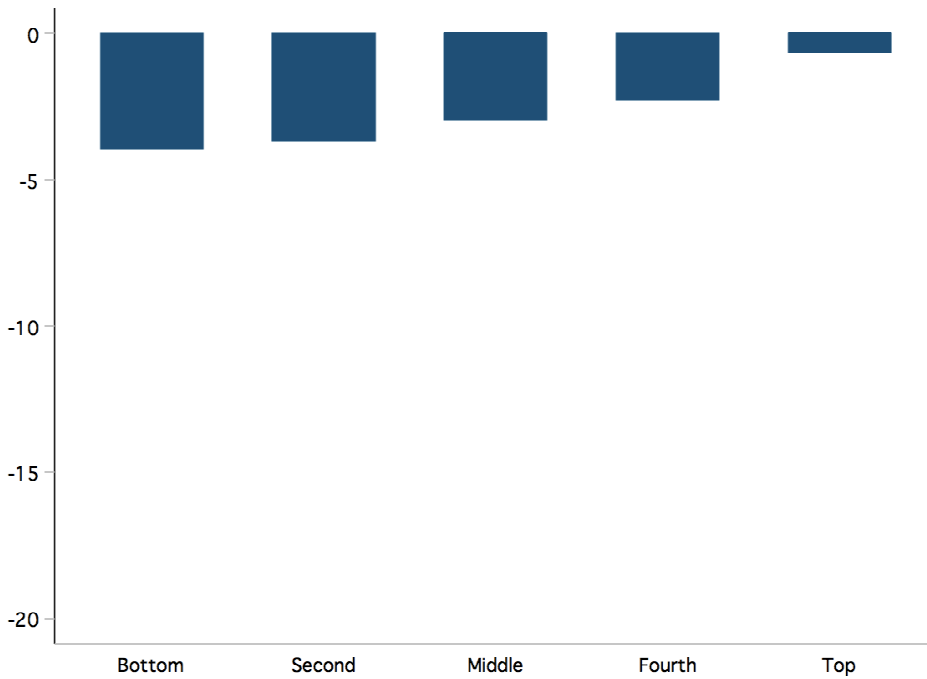**Percentage Change in Annual Income from Raising the Retirement Age to 70, 45-49 Age Cohort**

FIGURE 3C
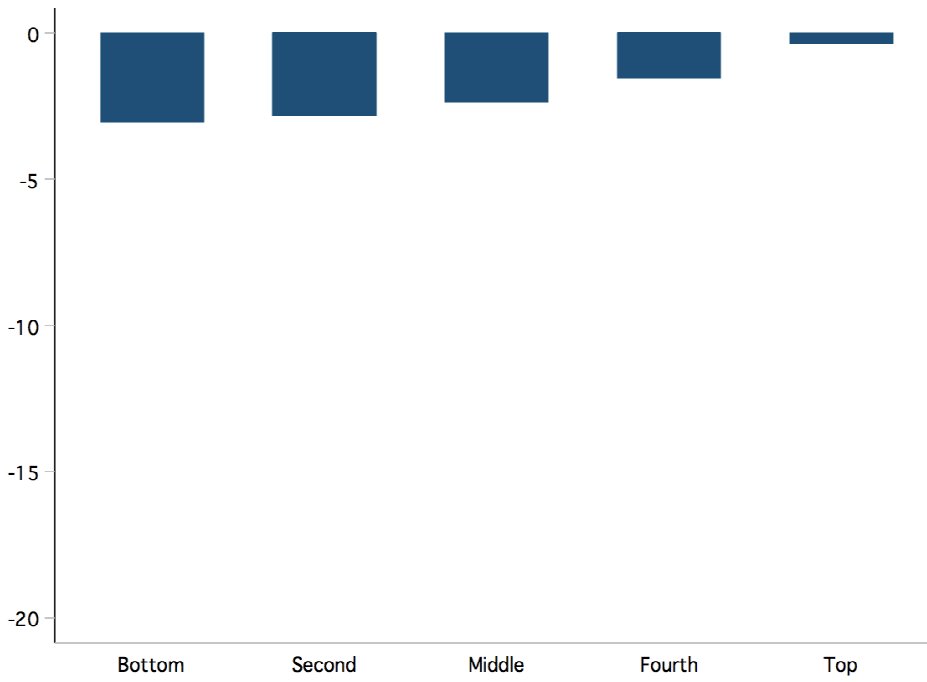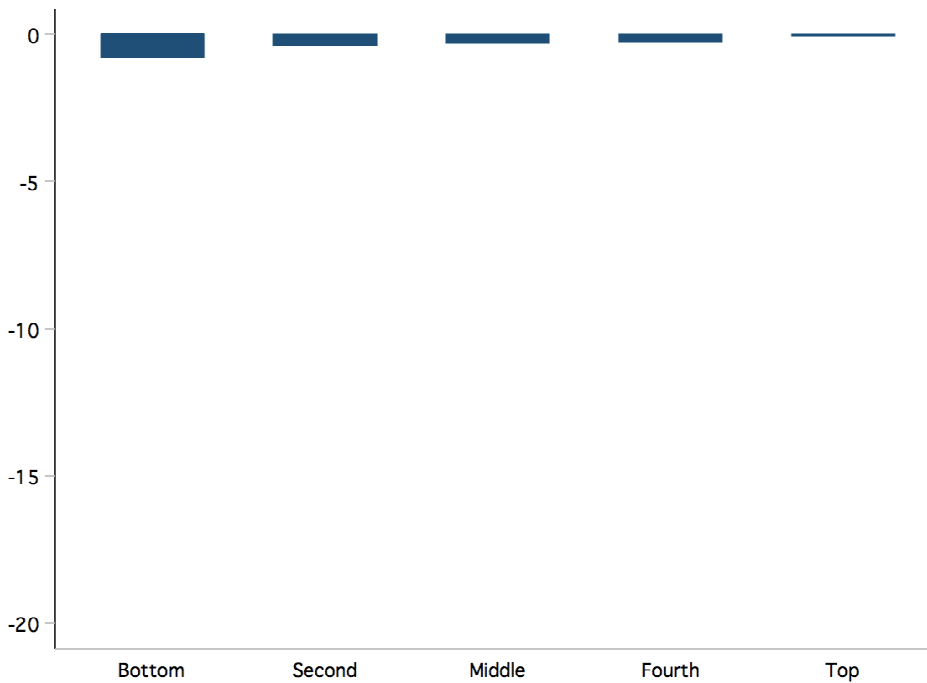**Percentage Change in Annual Income from Raising the Retirement Age to 70, 50-54 Age Cohort**

FIGURE 3D
Percentage Change in Annual Income from Raising the Retirement Age to 70, 55-59 Age Cohort

Reducing the Cost-of-Living Adjustment

As noted earlier, there have been numerous attempts in recent years to reduce the annual cost-of-living adjustment (COLA) based on the claim that the consumer price index (CPI) used for this indexation formula overstates the true increase in the cost of living.[7] This analysis shows the impact of a change in the COLA to 1.0 percentage point below the rate of inflation shown by the CPI. While there had been considerable support for a cut of this size in the recent past, another possible that has been widely discussed recently is a reduction of 0.3 percentage points to correspond to the difference in the rate of inflation between the CPI and the Chained Consumer Price Index for All Urban Consumers (C-CPI-U).[8] The reductions in benefits from this cut would be approximately 30 percent of the reductions calculated in this section.

A change in the cost-of-living adjustment is different from the other two cuts discussed in that it would affect current retirees. In the case of a change to the COLA, the percentage cut in benefits will not increase through time but rather as beneficiaries age. If the cut in the COLA is 1.0 percentage point after 1 year, it will be roughly 10 percentage points after 10 years, and 20 percentage points after 20 years.[9] This means that the oldest retirees will see the largest cuts in benefits under this formula. Oldest retirees also tend to have the lowest incomes and the highest poverty rates. They are also disproportionately women. As with the increase in the NRA, the proportionate cut in benefits is the same across income cohorts.
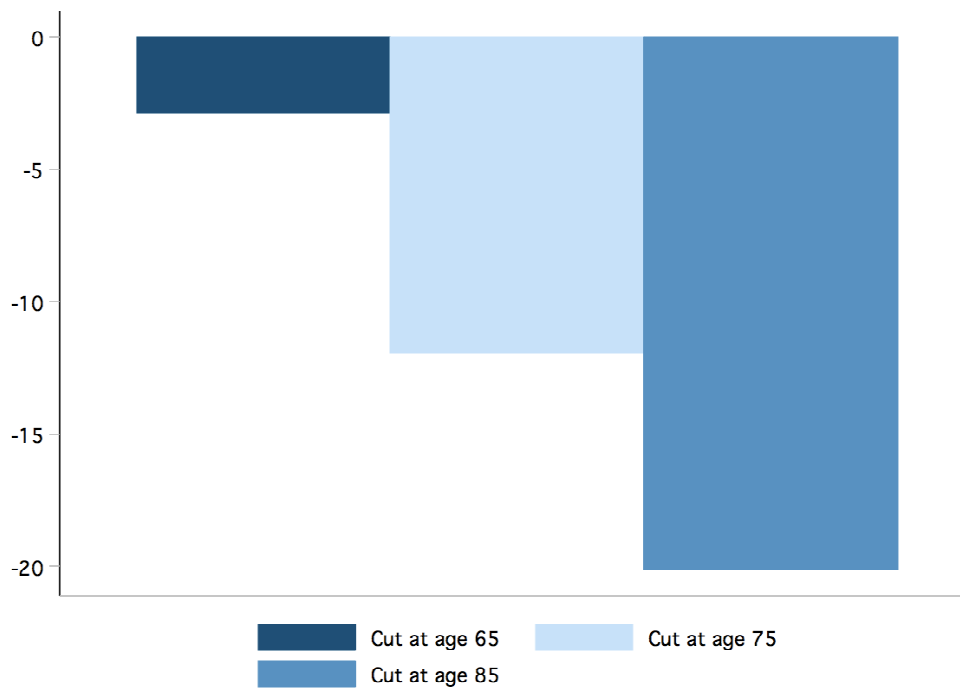
Figure 4 shows the projected cut in benefits for workers at ages 65, 75, and 85 as a result of a reduction in the COLA of 1.0 percentage point. At age 65 the reduction is 2.9 percent, based on the fact that workers would have received lower cost of living adjustments for 3 years. At age 75 the reduction in benefits would be 11.9 percent and age 85 the reduction in benefits would be 20.1 percent. As noted before, if a smaller 0.3 percentage-point reduction is used instead, then these cuts should be multiplied by 0.3.

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7   It is worth noting that cost-of-living adjustment for Social Security is based on the CPI-W (an index designed to follow the consumption patterns of wage and clerical workers) rather than the more commonly used CPI-U. The rate of inflation shown by the CPI-W has averaged approximately 0.1 percentage point less than the rate of inflation shown by the CPI-U.

8   See http://bls.gov/cpi/cpifaq.htm for explanations of the various CPIs.

9   The actual cuts will be somewhat smaller than is implied by this simple multiplication. The cut would be compounded through time, in the case of a 1.0 percentage point reduction in the annual COLA, the size of the reduction would determined by using the formula 0.99^t, where t is the number of years the person has received the lower COLA. The cut would be the difference between the value of the benefit, which should stay constant in real terms and the benefit as adjusted according to this calculation.

FIGURE 4
Percentage Change in Benefits from a 1.0 Percentage Point Reduction in COLA, at Ages 65, 75, and 85

Figures 5A, **5B**, and **5C** show the projected cut in income by quintile for workers between the ages of 40-44 in 2007 that would result from a 1.0 percentage point cut in the annual COLA, at ages 65, 75, and 85. **Figures 6A**, **6B**, and **6C** give the same information for the cohort of workers who were between the ages of 55-59 in 2007. (The appendix includes charts showing the percentage reduction in income by quintile for the other two age cohorts.) In the case of a person in the bottom quintile of the age 40-44 cohort, the cut in benefits would imply a 16.5 percent cut in income at the point where they have reached age 85. In the case of a person in the bottom quintile of the 55-59 age cohort, a 1.0 percentage point reduction in the COLA would lead to a cut in income of 14.6 percent when they have reached age 85. These are substantial cuts for people who already have incomes that are close to the poverty line.

FIGURE 5A
Percentage Change in Annual Income at Age 65 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 40-44 Age Cohort
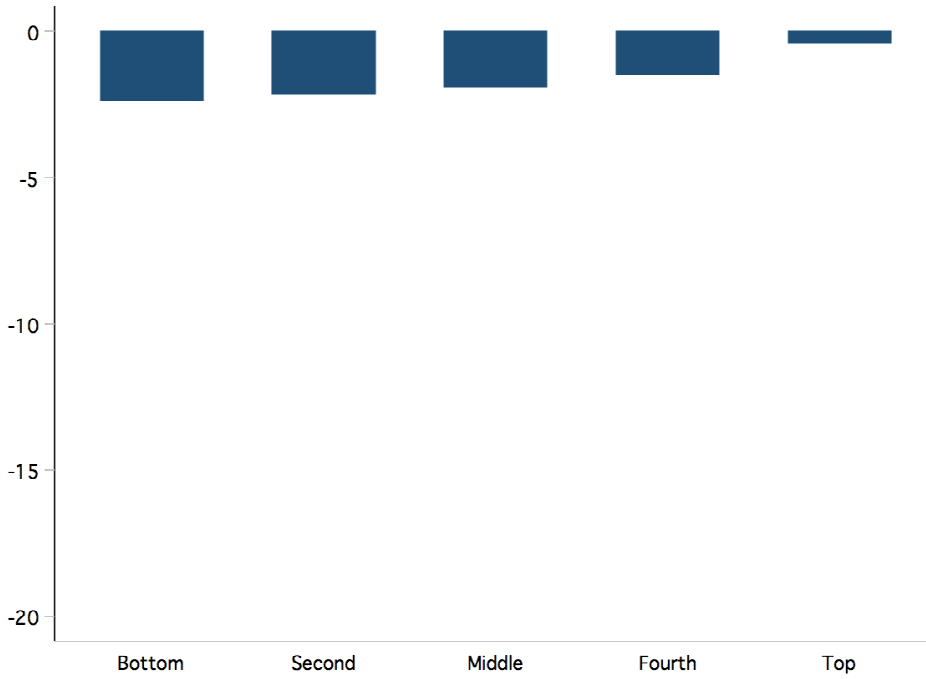

FIGURE 5B
Percentage Change in Annual Income at Age 75 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 40-44 Age Cohort
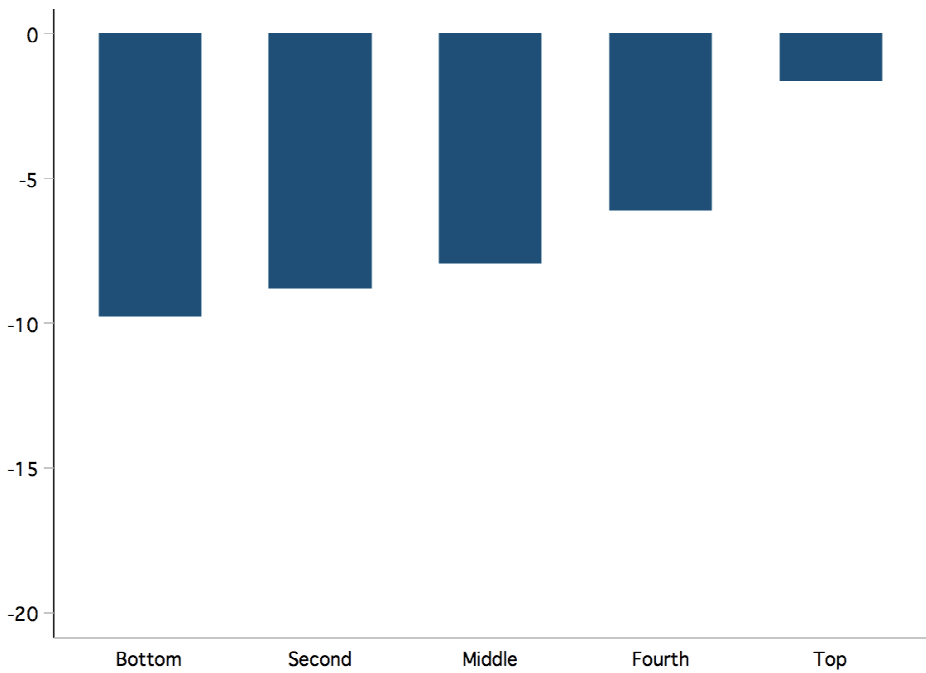
FIGURE 5C
Percentage Change in Annual Income at Age 85 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 40-44 Age Cohort
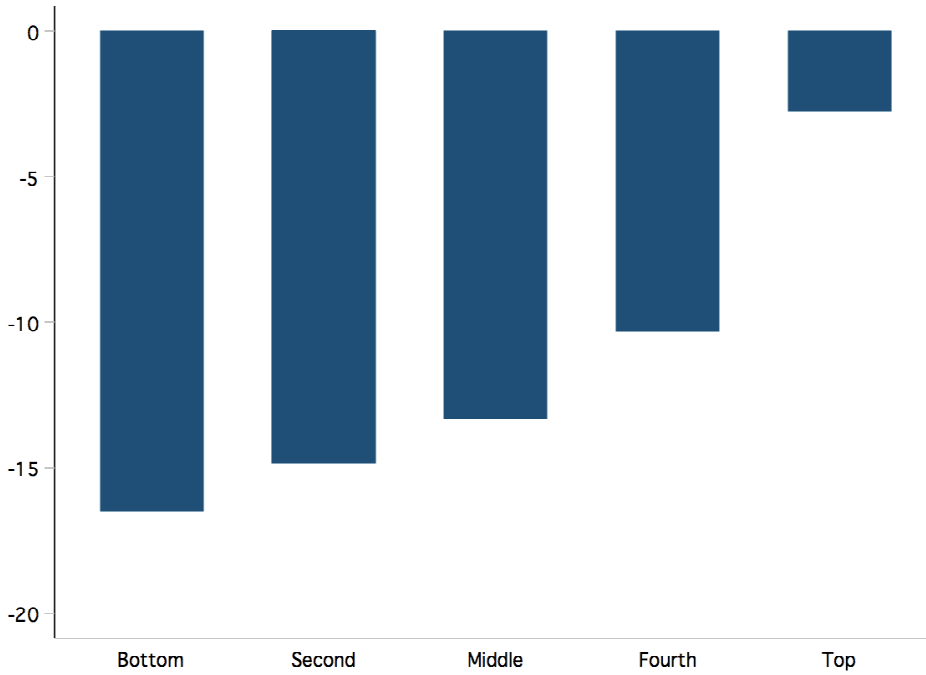

FIGURE 6A
Percentage Change in Annual Income at Age 65 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 55-59 Age Cohort
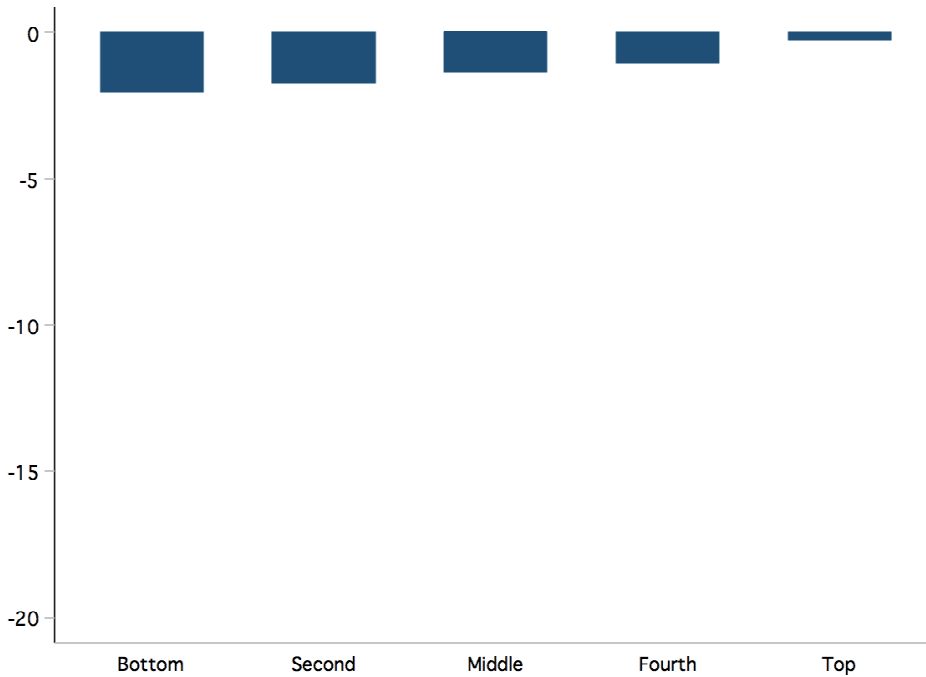
FIGURE 6B
Percentage Change in Annual Income at Age 75 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 55-59 Age Cohort
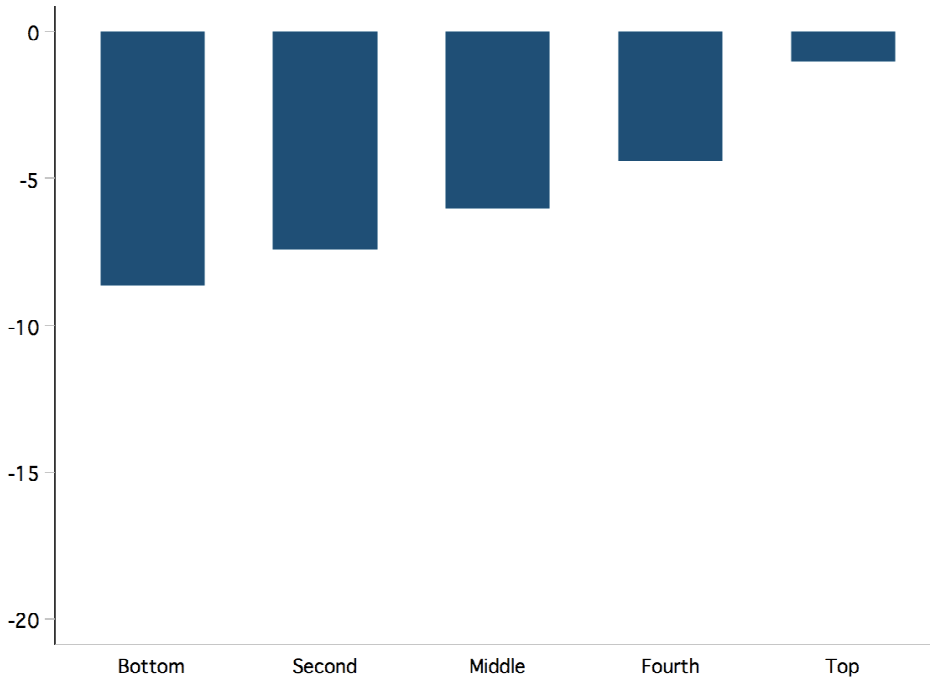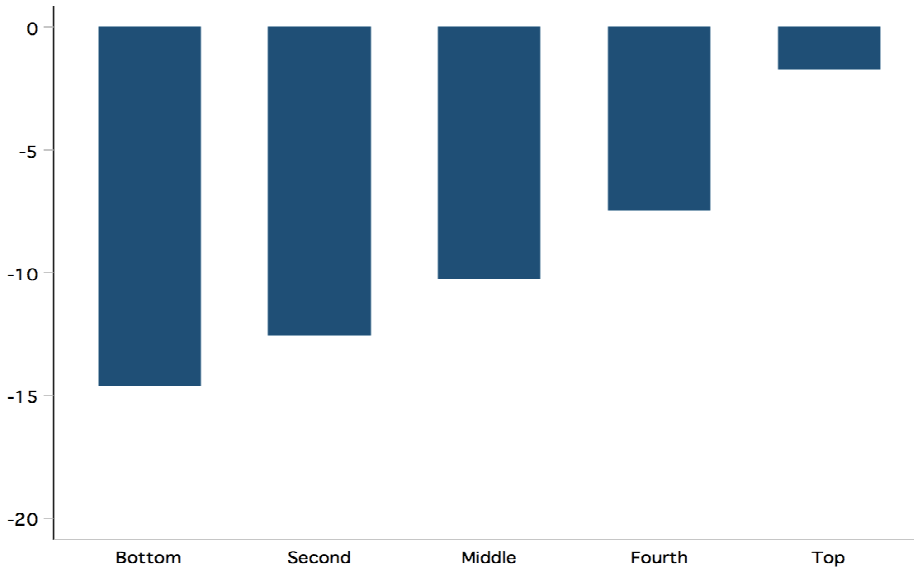

FIGURE 6C
Percentage Change in Annual Income at Age 85 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 55-59 Age Cohort

Conclusion

This paper examines some of the frequently suggested routes for cutting Social Security and projects their impact for near-retirees at various points along the income distribution. One fact that is apparent in all of the projections is that any substantial cuts to Social Security will inevitably have a large impact on households who are far from any reasonable definition of affluent.

The reason for this is that Social Security benefits are relatively equally distributed across the retiree population. Since the number of genuinely affluent elderly is small, reducing or even eliminating their benefits produces only small savings for the government. In order to generate any substantial amount of savings, it is necessary to widen the group of people being targeted to middle-income retirees.

Cutting benefits for these retirees is likely to be especially painful for the age cohorts who are now approaching retirement. The vast majority of older workers do not have traditional defined benefit pensions. Most had not accumulated much in defined contribution plans before the recession and they lost much of what they did accumulate in the stock market plunge. Even more importantly, these older cohorts lost much of their housing equity with the collapse of the housing bubble. As a result, many middle-class homeowners among these cohorts can expect that they still will be paying off a mortgage long after they have retired.

If Congress is seriously considering cuts in Social Security benefits for these age cohorts, legislators must recognize and understand the financial condition of current and near-retirees in the wake of the housing crash.[10] Thus far this issue has received very little attention.

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[10]   Rosnick, David and Dean Baker. 2009. "The Wealth of the Baby Boom Cohorts After the Collapse of the Housing Bubble." Washington, DC: Center for Economic and Policy Research.
http://www.cepr.net/documents/publications/baby-boomer-wealth-2009-02.pdf

Appendix

Cohort life tables were computed from single-year period life table data provided by the Social Security Actuaries and discounted life expectancy was computed for males aged 63.

Income and wealth data came from the 2007 Survey of Consumer Finances (SCF). Wealth variables were extracted through a Stata translation of the Federal Reserve Bank's SAS program for producing the 2007 SCF Chartbook.

Primary and secondary wages were annualized among earners reporting regular wage or salary income. Only families with at least one regular wage and with head of household at least 25 and less than 60 not living on a farm, ranch, or in an RV were considered. Families were broken into 5-year age groups and each group was re-weighted in the survey to equalize the rate of marriage to the 55-59 age cohort.

2007 income was estimated by inflating total regular wage income by the CPI from 2007 to 2010 (4.9 percent) and assumed to rise 1 percent above inflation each year. Total savings at age 63 were estimated to be 5 percent of annual income and generate interest at a 2.9 percent annual rate.

2007 stock holdings were reduced by the fall in the S&P Index (24.3 percent) and assumed to grow 7.0 percent above the CPI thereafter to age 63.

Assets, excluding those related to a primary residence, were inflated to 2010 dollars, and (if positive) assumed to grow at a 2.9 percent real rate to age 63. This was added to the projected stock holdings and savings generated out of income to produce non-housing net worth at age 63 (less any wealth in defined benefit pensions). This amount was converted to an annuity at age 63 based on discounted life expectancy, a 5 percent annuitization fee, and (if married) an additional 20 percent reduction in initial benefits to account for survivorship.

The overall average defined benefit pension wealth was estimated to be $73,000[11] in 2003 for those age 65 in that year, declining at a constant rate to $50,000 in 2020.

Within each age group, the families were divided into quintiles of non-defined-benefit pension income. The average defined benefit pension income for the quintile relative to the overall average[12] was divided by discounted life expectancy to obtain retirement income in non-OASI defined benefit income.

OASI income was estimated for the primary earner based on the assumptions of the Social Security Trustees based on the previously assumed wage path and retirement at age 63. If married, a 50 percent spousal benefit was added. Four different calculations were made: 1) a baseline based on currently promised benefits, 2) benefits based on "progressive price indexing" of benefits to those

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11 Poterba, James, Steven Venti, and David A. Wise. 2006. "The Decline of Defined Benefit Retirement Plans and Asset Flows." Paper prepared for the 8th Annual Joint Conference of the Retirement Research Consortium, August 10-11, 2006 in Washington, DC. http://www.nber.org/programs/ag/rrc/1.1.pdf

12 Porell, Frank and Beth Almeida. 2009. "The Pension Factor: Assessing the Role of Defined Benefit Plans in Reducing Elder Hardships." Washington, DC: National Institute on Retirement Security. http://www.nirsonline.org/storage/nirs/documents/pension_factor_web.pdf
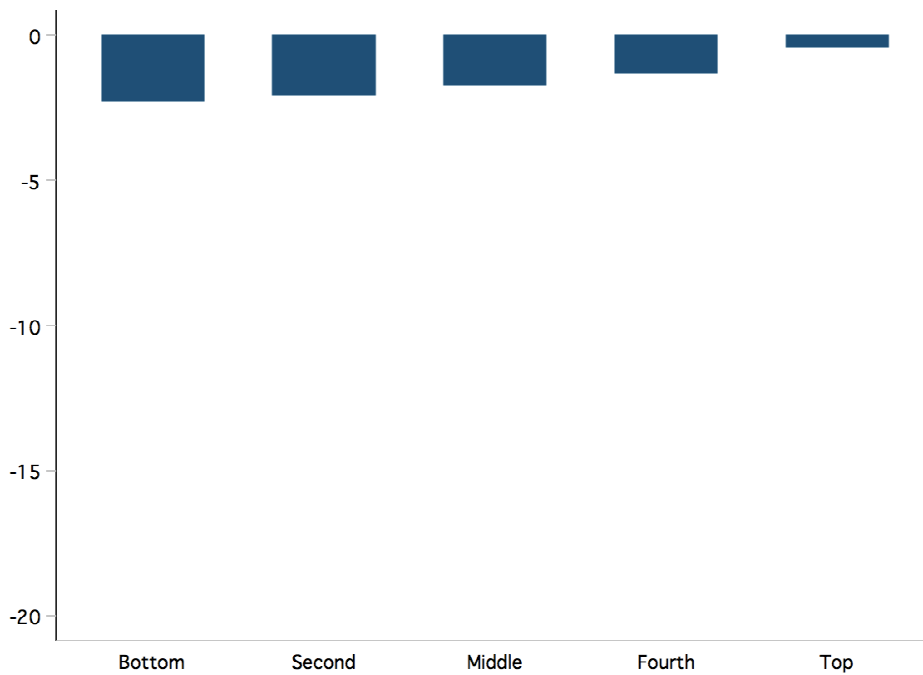
newly-eligible in 2015, 3) benefits based on raising the retirement by two months per year to age 70 for those turning 62 in 2036 (those born in 1974), and 4) benefits assuming a 1 percentage point reduction in the COLA.

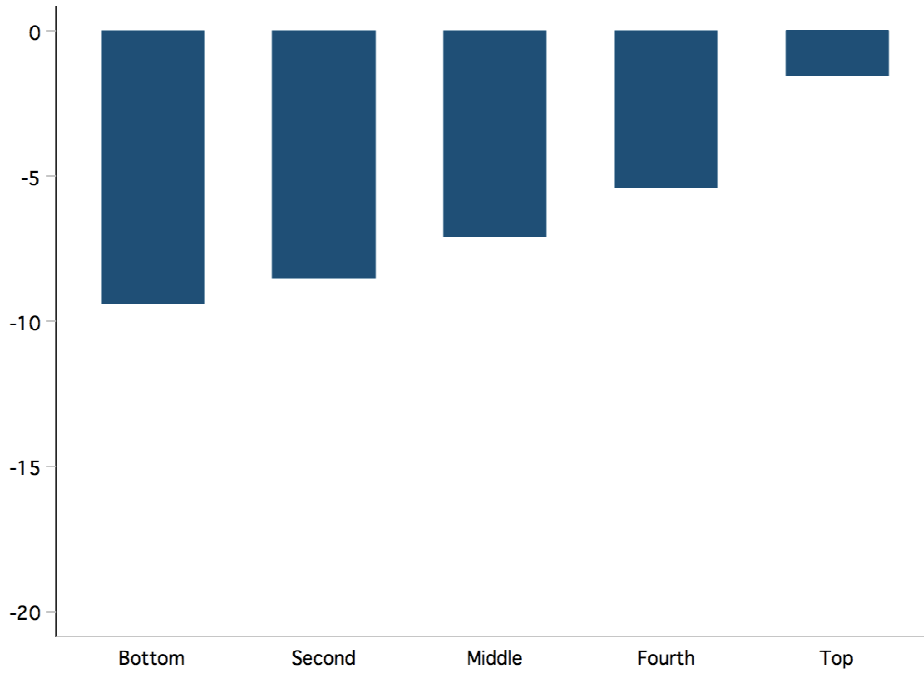Real OASI benefits were computed at ages 65, 75, and 85.

Appendix Figures 1A, **1B**, and **1C** show the projected cut in income by quintile for workers between the ages of 45-49 in 2010 that would result from a 1.0 percentage point cut in the annual COLA, at ages 65, 75, and 85. **Appendix Figures 2A**, **2B**, and **2C** give the same information for the cohort of workers who are between the ages of 50-54 in 2010. (The body of this report includes charts showing the percentage reduction in income by quintile for the other two age cohorts.)
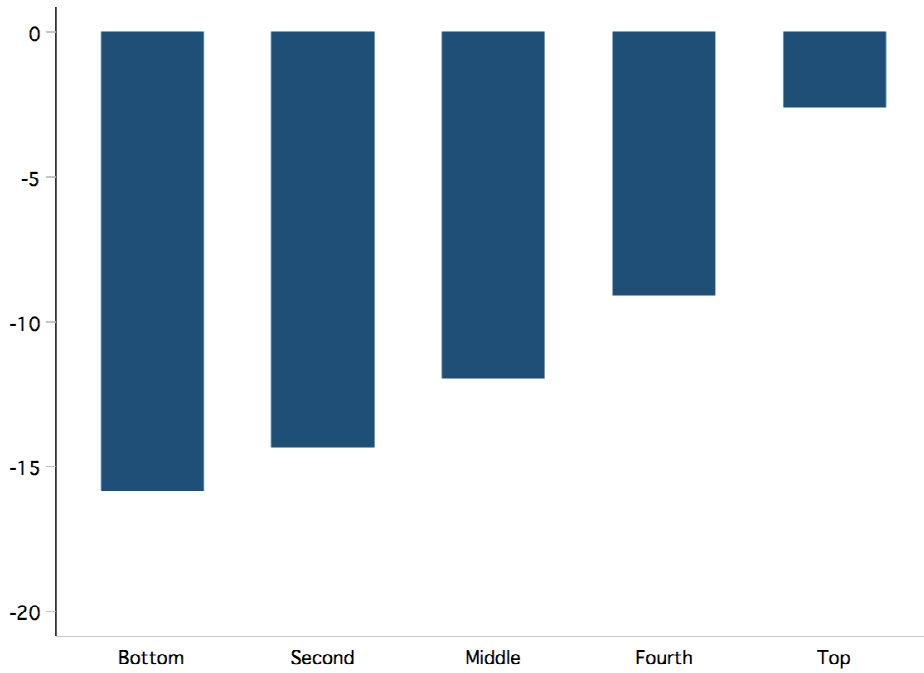
APPENDIX FIGURE 1A
Percentage Change in Annual Income at Age 65 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 45-49 Age Cohort
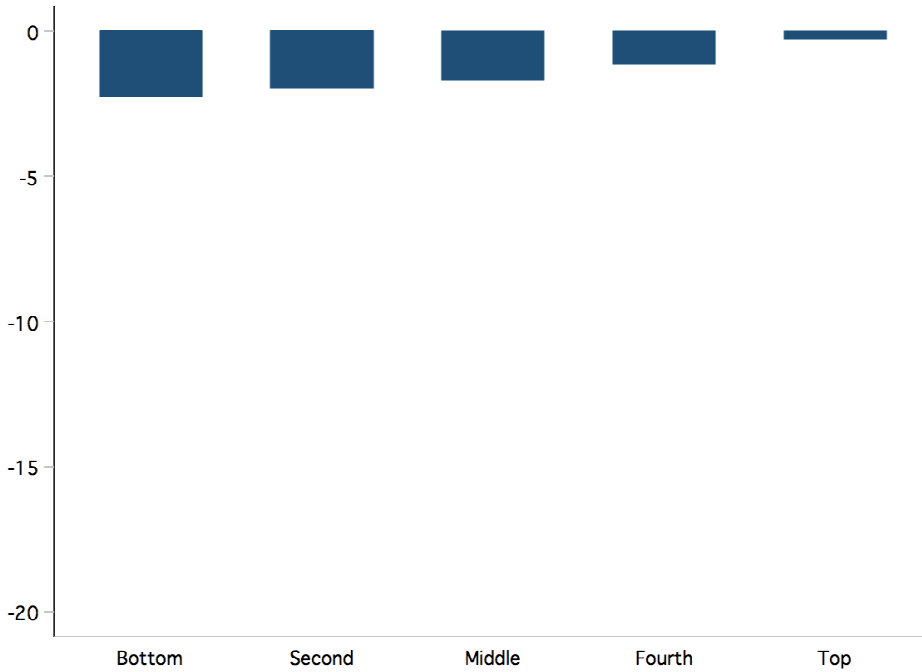
APPENDIX FIGURE 1B
Percentage Change in Annual Income at Age 75 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 45-49 Age Cohort
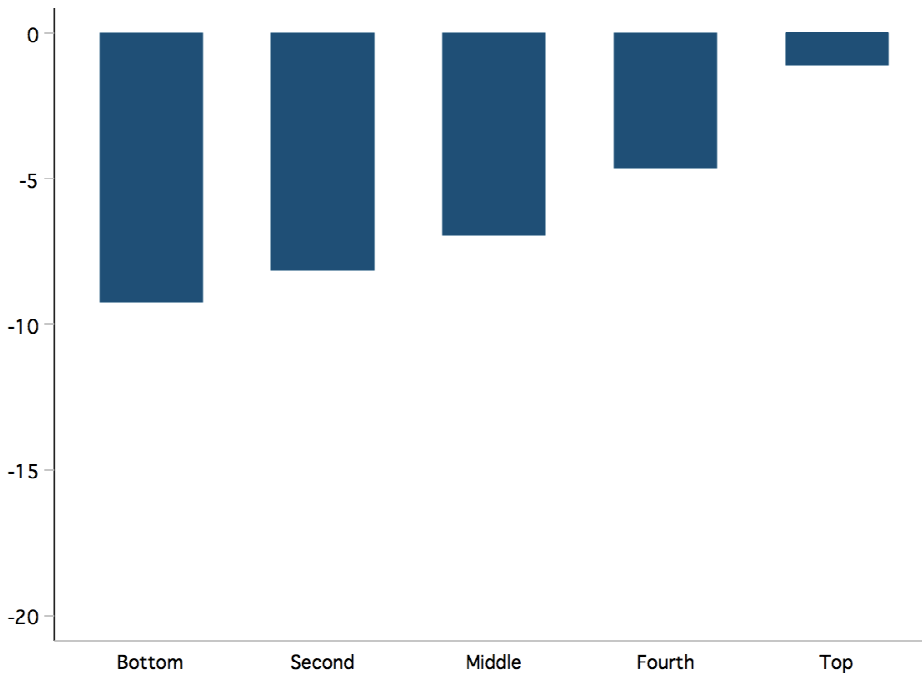

APPENDIX FIGURE 1C
Percentage Change in Annual Income at Age 85 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 45-49 Age Cohort

APPENDIX FIGURE 2A
Percentage Change in Annual Income at Age 65 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 50-54 Age Cohort

APPENDIX FIGURE 2B
Percentage Change in Annual Income at Age 75 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 50-54 Age Cohort

APPENDIX FIGURE 2C
Percentage Change in Annual Income at Age 85 from a 1.0 Percentage Point Reduction in COLA, by Income Quintile, 50-54 Age Cohort