

Social Security Reform and Benefit Adequacy

Lawrence H. Thompson

Over a third of all retirees, including more than half of retired women, receive monthly Social Security benefits that are less than the poverty level for a single elderly individual. Many receive benefits this low despite having worked under Social Security and contributed for more than 30 years. Any significant reduction in the benefits of these people would have serious consequences for both the adequacy of income among the elderly and for the 1935 social commitment to provide a floor of protection in retirement to those who contributed to Social Security while working.

This brief focuses on Social Security retirement benefit payments to low-wage workers and how current changes in the retirement age and likely future cost-cutting reforms could affect these benefits. The analysis begins by comparing the average level and distribution of current benefits with several benchmarks of benefit adequacy, using data on actual benefit awards in 2001. Information from the University of Michigan's Health and Retirement Study (HRS) is then used to simulate the impact on benefit adequacy of both the retirement-age increase and the further benefit reductions that would also be required to restore long-range fiscal balance to the Social Security program.¹ The brief concludes with some observations about the implications for future program policy.

Social Security is an income-transfer program based on a social contract. In return for payroll tax contributions while employed, workers are promised income support when they

retire or become disabled. Benefits are related to prior contributions, but the relationship is not proportional. Those who contribute more while working or work more years receive higher benefits when retired. But in keeping with the social aspects of the program, the benefits paid to lower earners replace a larger percentage of their previous earnings. This feature of the program's structure recognizes that lower earners are less likely to have other sources of retirement income and will be relying primarily on Social Security benefits to assure a minimally adequate living standard in retirement. In fact, among elderly households, Social Security accounts for over 80 percent of total family income in the bottom two-fifths of the income distribution.

The Actual versus the Hypothetical

The average retirement benefit is actually quite a bit lower than the hypothetical benefit illustrations used in most discussions of Social Security policy. Benefit illustrations often focus on a hypothetical worker that was employed continuously for at least 35 years, earned each year the average amount earned by all workers under Social Security that year (about \$33,000 in 2002), and retired at the normal retirement age. Such a worker retiring in January 2002 would have qualified for a monthly benefit of \$1,127, some 40 percent of his or her 2001 earnings (SSA 2002, Table VI.E11).²

Actual retirees do not fare as well. The average person retiring in 2001 was awarded a benefit of \$894; the average was \$1,033 for men, and \$694 for women. The actual average benefit is less than 80 percent of the benefit calculated for the hypothetical average earner and is equal to 32 percent of average earnings, not the 40 percent associated with the hypothetical worker. Clearly, the hypothetical average earner commonly used in Social Security policy discussions is not representative of actual retirees.

Table 1 shows the actual distribution of Social Security retired worker benefit awards during 2001. Workers are categorized by the amount of their January 2002 check. The first column shows the range of monthly benefits for each category in absolute terms, while the second column shows the ratio of the dollar amount at the category ceiling to the average earnings of current workers. As the table shows, 52 percent of 2001 monthly awards were for less than \$900. Over one-third were for less than \$700.

Standards of Benefit Adequacy

What level of protection should Social Security offer people that have worked for many years under the program, even if much of their work was at low wages? Table 2 shows some potential benchmarks for defining a minimally adequate level of support for such workers.

In contrast to most other developed countries, the United States has no official policy about minimum pension guarantees other than a relatively obscure provision known as the special minimum benefit. This special minimum pays a benefit that is based on the retiree's years of creditable service, defined as years in which the worker earned at least a specified amount. Workers must have at least 20 years of such service to qualify for a benefit, but don't get credit for any more than 30 years of service in

the benefit calculation. As shown in table 2, the maximum special minimum benefit payable in 2002 was \$617 a month, or about 22 percent of average Social Security earnings.³ Currently, about 120,000 retired workers qualify for benefits under this provision, most of them women.

The second row of table 2 shows the benefit awarded in 2002 to someone that retired at age 65 after being employed continuously at the federal minimum wage (SSA 2002, Table 2A26). Such a worker would have received a monthly benefit of \$729, or 26 percent of average Social Security earnings.

The third row shows the minimum income guarantee provided a Social Security recipient under the means-tested Supplemental Security Income (SSI) program, which provides a safety net for the elderly and disabled with few other resources. In 2002, the combination of the SSI and Food Stamp programs guaranteed an individual also eligible for Social Security a monthly income equal to \$575, or about 21 percent of average Social Security earnings.⁴ Those residing in states that supplement the SSI benefit would receive more.

The next two rows in table 2 show two other parameters not directly related to the Social Security program but useful in establishing benefit adequacy criteria. The 2002 poverty level for a single elderly individual was equal to roughly

TABLE 1. Cumulative Distribution of Retired Worker Awards, 2001

Monthly benefit	Percent of average earnings ^a	Men receiving this amount (%)	Women receiving this amount (%)	Total receiving this amount (%)
Below \$450	16.1	8	18	12
Below \$500	17.9	10	24	16
Below \$700	25.1	19	58	36
Below \$900	32.3	31	77	52
Below \$1,000	35.8	40	84	59
Below \$1,200	43.0	60	94	75

Source: SSA (2002), Table 6B3.

a. Ratio at the top boundary to estimated average 2002 earnings under Social Security.

TABLE 2. *Potential Adequacy Benchmarks: Monthly Amount and Ratio to Average Social Security Earnings, 2002*

Adequacy benchmarks	Monthly amount (\$)	Percent of average earnings
Special minimum benefit (at full retirement age)	617	22
Career minimum wage retiree (at full retirement age)	729	26
Federal SSI guarantee for a single individual	575	21
Poverty line, single elderly individual	719	26
Minimum wage	893	32
<i>Average Social Security earnings</i>	<i>2,790</i>	

Sources: SSA (2002, 2003), U.S. Census Bureau.

26 percent of average Social Security earnings, and the earnings of a full-time minimum-wage worker would have equaled roughly 32 percent of average Social Security earnings.⁵

These various parameters suggest that a reasonable benchmark for a minimally adequate retirement benefit would be in the range of 21 to 25 percent of average Social Security earnings. The full retirement benefit awarded to a career, full-time minimum-wage worker and the single-person poverty level lie just above this range. The maximum benefit under the special minimum and the income guarantee under the universal means-tested assistance program (SSI) for the elderly fall at the bottom of this range. The analysis that follows focuses on the fraction of retired worker benefits that falls below 21 percent and 25 percent, respectively, of average earnings.

Distribution of Benefit Awards by Years of Service

Low Social Security benefits can signify either low annual earnings over most of the individual's work career or that the individual spent relatively few years working under the program. The concern about Social Security benefit adequacy is greater for long-service, low-wage workers than for those with relatively short service. Workers with many years of service are likely to be relying on their retirement benefits as

their primary means of support. In contrast, those whose low Social Security benefits are the result of relatively few years of service probably had some other source of support during much of their working lives and can be expected to continue to rely on that source of support in retirement.

The Social Security administrative data cited earlier do not allow us to differentiate retirees by length of service. We therefore turn to another data source, the Health and Retirement Study (HRS), to explore the link between length of service and benefit levels at retirement.

Table 3 shows the distribution of initial Social Security retired worker benefits from the HRS. Benefits are expressed as a percentage of average earnings in the year of retirement.⁶ For the purpose of these calculations, the year of retirement is assumed to be the year in which retirement benefits were actually initiated. For those still working when the most recent wave of the survey was administered, it is the year reported as the intended retirement date.⁷

The first set of columns in table 3 refers to all workers in the sample who are eligible for Social Security retired worker benefits. The second set refers to only those workers with at least 20 years of covered earnings, and the third set refers to only those with at least 30 years of covered earnings. Among men, 98 percent of those eligible for retired worker benefits had at least 20 years of

TABLE 3. Cumulative Distribution of Retired Worker Benefits Ratio to Average Earnings in the Year of Award

	All workers			Workers with at least 20 years of service			Workers with at least 30 years of service		
	Men	Women	Total	Men	Women	Total	Men	Women	Total
Fraction of workers with each length of service									
Ratio to all workers	100%	100%	100%	98%	84%	92%	85%	52%	72%
Ratio of benefit to average earnings									
Under 21%	14	46	27	12	39	22	7	22	11
Under 25%	21	61	37	19	54	32	13	37	19
Under 41%	44	91	63	43	89	59	35	83	48

Source: Urban Institute tabulations of the first four waves of the Health and Retirement Study.

Notes: The calculations exclude persons born after 1934, persons who received disability insurance benefits at some point in their working lives, persons who began receiving benefits prior to age 60 for any reason, and persons who had not already retired or given an expected retirement date. The ratio is the initial benefit in the year of retirement (or the year retirement is planned) divided by the average Social Security earnings that year.

service and 85 percent had at least 30 years of service. Among women, however, while 84 percent had at least 20 years of service, only 52 percent had 30 or more years of service.

These data show that the incidence of very low benefits among long-service workers is only about half of the incidence among the entire group of retirees. Of the long-service workers, only about 13 percent of men and 37 percent of women had benefits that were less than 25 percent of average earnings.

The Impact of Future Benefit Reductions

The figures in table 3 imply that long-term workers retiring right now, even those with a history of low wages, stand a good chance of getting benefits close to or above the single-person poverty level. However, this may not be the case in the future.

Table 4 contains estimates of the impact on the incidence of low benefit awards of the retirement-age increase already legislated and the additional

impact of the further benefit reductions needed if Congress decided to balance the program’s long-range finances solely by cutting benefits. The estimates, calculated from HRS data, include the fraction of benefit awards that are less than 21 percent and 25 percent, respectively, of average earnings, with workers categorized by sex and length of service.

The rows labeled “actual benefit” contain the baseline data from table 3. The “retirement-age increase” rows show the impact of recalculating each worker’s benefit assuming no change in the date at which the benefit was claimed but using the benefit-reduction factors in effect when the higher retirement age is fully phased in in 2022. The next rows show the impact of the retirement-age increase if each worker reacts to the change by delaying retirement by two months, the approximate behavioral response estimated at the time the legislation was adopted (e.g., Fields and Mitchell 1985). The final row in each set of numbers shows the impact of an additional 25 percent across-the-board reduction in benefits, the approximate size of the benefit cut

TABLE 4. *Estimated Share of Workers with Inadequate Benefits: Monthly Benefits below Reasonable Benchmarks, Different Benefit Reduction Scenarios (percent)*

	Share of workers receiving less than 21%			Share of workers receiving less than 25%		
	Men	Women	Total	Men	Women	Total
All eligible workers						
Actual benefit in late 1990s	14	46	27	21	61	37
Effect of retirement-age increase	20	58	35	24	70	42
—if work effort increases	19	57	34	22	69	40
Effect of additional 25% benefit cut	28	76	47	36	86	55
Workers with at least 20 years of service						
Actual benefit in late 1990s	12	39	22	19	54	32
Effect of retirement-age increase	18	51	30	22	64	37
—if work effort increases	18	49	29	20	63	36
Effect of additional 25% benefit cut	26	71	42	34	84	52
Workers with at least 30 years of service						
Actual benefit in late 1990s	7	22	11	13	37	19
Effect of retirement-age increase	12	33	20	15	48	24
—if work effort increases	12	32	19	14	47	23
Effect of additional 25% benefit cut	18	57	33	25	75	39

Source: Urban Institute tabulations of the first four waves of the Health and Retirement Study.

Notes: The calculations exclude persons born after 1934, persons who received disability insurance benefits at some point in their working lives, persons who began receiving benefits prior to age 60 for any reason, and persons who had not already retired or given an expected retirement date. The ratio is the initial benefit in the year of retirement (or the year retirement is planned) divided by the average Social Security earnings that year.

needed to balance Social Security in the middle of this century, assuming no tax increase.⁸

The retirement-age increase now being implemented will cause more benefit awards to fall below the adequacy benchmarks. Most people begin receiving benefits before reaching the normal retirement age. In fact, about one-third of the gap between the hypothetical average earner and the actual average retiree is the result of the benefit adjustment made when someone retires early.⁹

The change now being implemented increases the normal retirement age to 67 but maintains 62 as the age at which people can first receive their retirement benefits. Until recently, those retiring at age 62 had their benefits reduced permanently by 20 percent. Those who retire at

age 62 in the future will face larger early retirement reductions; after 2022, the reduction will be 30 percent.¹⁰

Calculations using the HRS data find that the larger reductions for early retirement will increase the fraction of long-service workers receiving less than 21 percent of average earnings from 7 percent to 12 percent among men and from 22 percent to 32 percent among women, after adjusting for the expected behavior change of working an additional two months. The fraction of long-service women whose benefits fail to reach the higher adequacy benchmark will increase from 37 to 47 percent.

Predictably, the additional benefit reduction required to balance the program's finances, should that be accomplished only through bene-

fit cuts, would further increase the incidence of low-benefit awards. That change would cause about half of all retirees to get benefits that fell short of the minimal adequacy standard used here. Even workers with at least 30 years of service fare poorly. These further benefit reductions would cause one-quarter of long-service men and three-quarters of long-service women to have benefits amounting to less than 25 percent of average earnings. Over half of long-service women would fail to reach the lower of the two adequacy benchmarks.¹¹

Summary and Implications

A little over a third of the people now retiring receive Social Security benefits that amount to less than 25 percent of the average earnings of those working under the program, earnings that are less than the current poverty level for a single elderly individual. Just over a quarter receive benefits of less than 21 percent of average earnings.

The retirement-age increase now being phased in will cause more people to receive Social Security benefits at these low levels, and attempting to solve the future financing predicament entirely through benefit reductions will make the problem even worse. Taken together, the two changes would cause over half of new retirees, including 85 percent of women, to receive benefits amounting to less than 25 percent of average earnings. Many of these people would have worked under and contributed to Social Security for many years before retiring. Among those with at least 30 years of service under the program, three-quarters of women and one-quarter of men would have benefits amounting to less than 25 percent of average earnings.

These results suggest that across-the-board benefit reductions are probably not a viable way of dealing with the currently projected financing gap. When added to the impact of the retirement-age increase that has already been legislated, reductions would lower benefits to levels that

undermine the social purpose of the Social Security program. Even among long-service workers, as many as half of all retirees would have benefits that fall below reasonable benchmarks for benefit adequacy.

This analysis suggests two basic conclusions. First, any further increase in the normal retirement age needs to be accompanied by an equal (or greater) increase in the age at which people are first eligible to draw benefits. Otherwise, further increases in the reduction factors for early retirement will cause actual retirement benefits to continue to fall relative to average earnings levels. Second, absent a substantial increase in the age at which benefits can first be drawn, it is probably not possible to close the financing gap currently projected for Social Security without finding additional revenues. Attempting to close the financing gap entirely through benefit reductions would drive average benefits to such low levels that the program would fail to serve the social purpose for which it was created.

Notes

1. The University of Michigan Health and Retirement Study surveys more than 22,000 Americans over the age of 50 every two years. Supported by the National Institute on Aging, the study paints an emerging portrait of an aging American's physical and mental health, insurance coverage, financial status, family support systems, labor market status, and retirement planning.
2. The average earnings used in these calculations and this brief is the figure used to index prior-year earnings in the Social Security benefit calculation.
3. The special minimum is calculated by multiplying the number of years of creditable earnings in excess of 10 and up to 30 by a dollar factor. In 2001, the dollar factor was \$30.90 and the maximum possible full retirement benefit was therefore 20 times \$30.90, or \$617. The dollar factor is indexed to changes in the price level. Since 1990, a year of creditable earnings has been defined as a year with annual earnings greater than 15 percent of what the taxable maximum would have been had there been no ad hoc increases after 1973. This amounted to \$9,450 in 2001, or about 31 percent of average Social Security earnings. Prior to 1990, the amount required was 25 percent of what the taxable maximum would have been (SSA 2002, Tables 2A12 and 5A8).

4. The basic SSI benefit was \$545. The guaranteed income to someone receiving Social Security benefits was \$565, since the first \$20 of the Social Security benefit is disregarded in the SSI benefit calculation. Persons receiving SSI benefits of this level would also be eligible for \$10 a month in food stamps.
5. Assuming the individual works 173 hours (4 and 1/3 weeks) each month at \$5.15 an hour.
6. These data reflect the initial benefit at retirement divided by the average earnings figure for the year of retirement. The calculations exclude persons born after 1934, persons who received disability insurance benefits at some point in their working lives, and persons who began receiving benefits prior to age 60 for any reason. The database includes the first four waves of the survey. For more information on the HRS, see <http://hrsonline.isr.umich.edu>.
7. People who neither retired nor reported an intended retirement date were excluded from the analysis. The resulting distribution of HRS benefit awards for all workers tracks the administrative data quite closely when men and women are considered separately. However, the resulting HRS distribution has relatively more women and relatively fewer men than are shown in the administrative records. To adjust for this, the figures shown here for both sexes combined are a weighted average of the male and female numbers, with the weights derived from the administrative data.
8. Current projections show 2050 outgo as 18.2 percent of taxable payroll and 2050 income as 13.3 percent of taxable payroll (SSA 2003, Table IV.B.1). The benefit reduction required in 2050 would actually be slightly higher than 25 percent, and even higher in subsequent years.
9. Another cause of the discrepancy between the theoretical benefit and the actual average benefit is the taxable maximum. The average earnings figure used to calculate the

hypothetical earner's benefit is based on total earnings, whereas actual benefit calculations are based only on taxable earnings.

10. Retirement benefits for those retiring at age 62 in the late 1990s were permanently reduced by 20 percent (from the level they would have received if they waited until the "normal retirement age"). When the retirement-age increase is phased in fully, the benefit awarded at age 62 will be reduced by 30 percent.
11. These calculations assume that earnings levels and service years are the same in the future as they were for people retiring the late 1990s. In fact, future female retirees are likely to have longer careers and higher average earnings than female retirees in the late 1990s, somewhat reducing the incidence of inadequate benefits among women. Since the key parameters of the Social Security benefit calculation are adjusted each year to reflect changes in average Social Security earnings levels, the increase in the relative status of women will lead automatically to a decrease in the relative status of men, somewhat increasing the incidence of inadequate benefits among men.

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URBAN INSTITUTE

2100 M Street, NW
Washington, DC 20037

Telephone: 202-833-7200
Fax: 202-429-0687

E-mail: paffairs@ui.urban.org
Urban Institute web site:
<http://www.urban.org>

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ABOUT THE AUTHOR

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