Older Americans' Economic Security

Number 6, December 2005 THE RETIREMENT PROJECT

Reforming Social Security through Price and Progressive Price Indexing

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Social Security's long-run financial imbalance is prompting some policymakers to consider changing the method of indexing retirement benefits. In 2001, the President's Commission to Strengthen Social Security (CSSS) proposed indexing initial benefits to prices instead of to wages. Now the White House has signaled support for progressive price indexing: indexing benefits to prices for high-wage workers, but retaining wage indexing for low-wage workers. Since prices generally grow more slowly than wages, price indexing would reduce benefits for most new retirees by about 30 percent by 2050, compared to current law. Progressive price indexing would reduce average benefits by about 18 percent, but hold harmless the lowest earners. Both proposals reduce benefits further below current law every year and, if continued indefinitely, would significantly reduce Social Security's role in providing retirement security for middle-income workers.

Price Indexing Reduces Replacement Rates

Social Security benefits are currently wage-indexed, meaning that starting benefits at the normal retirement age increase by the growth in average wages. Initial benefits replace about the same proportion of preretirement earnings over time. Because wages generally grow faster than prices, starting benefits increase in inflation-adjusted dollars. The Urban Institute's Dynamic Simulation of Income Model (DYNASIM)[1] projects that average benefits as a percent of economy-wide earnings will hold steady at about 30 percent, and average inflation-adjusted benefits will increase from $12,100 to $17,600 between 2012 and 2050 (table 1).

Under price indexing, benefits are reduced annually relative to current law by the growth in wages beyond inflation.[2] Starting benefits remain constant in inflation-adjusted dollars, but replace ever-smaller proportions of preretirement earnings. If price indexing were implemented in 2012, average inflation-adjusted benefits at retirement would only be slightly higher in 2050 and average benefits would be only 20 percent of economy-wide earnings. According to the Congressional Budget Office (CBO), price indexing would replace Social Security's cumulative deficit over the next 75 years with a modest surplus.[3]

Progressive price indexing is an alternative that preserves benefits for low-income retirees.[4] Retirees with career average earnings above the maximum covered by Social Security, currently $90,000, would receive price-indexed benefits. Those with career average earnings below the 30th percentile, currently about $25,000, would receive wage-indexed benefits. All other retirees would receive something in between.[5] Assuming implementation in 2012, average inflation-adjusted benefits at retirement would increase to $14,400 in 2050 and average benefits as a percentage of economy-wide earnings would fall to 24 percent. According to CBO, progressive price indexing would eliminate most of Social Security's cumulative deficit over the next 75 years.

Progressive Price Indexing Protects Vulnerable Groups

Progressive price indexing reduces benefits less for low-earning and less-educated groups than for higher-earning and more-educated groups. Compared with current law, benefits fall by less than 3 percent for those in the bottom fifth of lifetime earnings and 11 percent for high school dropouts, but decline by 27 percent for the top fifth of lifetime earners and 22 percent for college graduates. In contrast, price indexing reduces benefits by about 30 percent for most groups (table 2).[6]

Economic growth reduces the share of retirees in the future with near-poverty level incomes. DYNASIM projects the proportion of new retirees with family incomes below 150 percent of the federal poverty level (FPL) will fall from 15.2 percent in 2012 to 7.5 percent in 2050 if Social Security benefits are paid as scheduled (table 1). This occurs because Social Security, pensions, savings, and earnings grow with wages while the poverty level only grows with inflation. If Social Security benefits were price indexed, the near-poverty rate would only fall to 12.7 percent by 2050. In contrast, progressive price indexing results in a near-poverty rate that is less than a percentage point higher than under current law.

Discussion

Progressive price indexing potentially eliminates most of Social Security's 75-year deficit, without reducing benefits for many low lifetime earners and without significantly raising the number of beneficiaries in near-poverty. But even with progressive price indexing, benefits would over time replace ever-smaller proportions of preretirement earnings for most workers. If continued indefinitely, both price indexing and progressive price indexing would transform Social

TABLE 1. *Social Security Benefits and Near-Poverty Rates*

75-year deficit/surplus (% of taxable payroll)	Scheduled Benefits	Price Indexing	Progressive Price Indexing
	–1.69	+0.68	–0.14
Ages 62 to 67			
Mean benefits			
In real 2005 dollars			
2012	12,100	12,000	12,100
2050	17,600	12,200	14,400
As percent of economy-wide earnings			
2012	29.8	29.8	29.8
2050	29.0	20.2	23.8
Percent with family income below 150% of FPL			
2012	15.2	15.2	15.2
2050	7.5	12.7	8.1

TABLE 2. *Distribution of Social Security Benefits at Ages 62 to 67 in 2050*

	Scheduled Benefits	Price Indexing	Progressive Price Indexing
	Mean (2005 $)	% of scheduled benefits	
All	17,600	69.5	81.8
Education			
HS dropout	13,700	70.9	88.9
HS grad	16,400	69.7	83.8
College	20,600	69.1	78.0
Shared lifetime earnings quintile			
Bottom	9,800	73.6	97.5
Middle	17,600	69.3	83.6
Top	25,300	68.3	72.6

Source: Authors' calculations from DYNASIM3 (Runid: 432) and CBO (2005)

FPL = federal poverty level

Notes: Shared lifetime earnings include a worker's entire earnings in years he or she is single and half of the earnings of both the worker and the worker's spouse in years he or she is married. Family income includes Social Security, pensions, earnings, asset income, and Supplemental Security Income (SSI). For technical reasons, Social Security benefits do not include the impact of the retirement earnings test. Under this price indexing scenario, benefits are reduced annually relative to current law by the growth in wages beyond inflation. Under this progressive price indexing scenario, benefits for retirees with career average earnings above the maximum covered by Social Security (currently $90,000) receive price indexed benefits, those with career average earnings below the 30th percentile (currently about $25,000) receive wage indexed benefits, and all other retirees receiving something in between, with the rate of indexing declining with lifetime earnings.

Security from a major source of retirement income for middle-class workers to a minimal safety net program.

Other options for achieving solvency include payroll tax increases, allocation of other funding to Social Security (e.g., estate taxes), or alternative cuts that do not reduce benefits further every year, such as raising the normal retirement age, one-time changes to the benefit formula, or price indexing for a finite number of years. Any option could include provisions to protect low-income retirees. Whatever options are selected, policymakers should address the system's long-term imbalance soon, to give workers time to plan and to avoid dramatic changes in the future.

Notes

1. See Favreault and Smith (2004) for a description of DYNASIM.
2. See CSSS (2001) and H.R. 530, introduced by Rep. Johnson (R-TX) on February 2, 2005.
3. See CBO (2005), http://www.cbo.gov/ftpdocs/63xx/doc6377/Social_Security_Menu-SSA_baseline.pdf.
4. Proposed by former CSSS member Paul Pozen. Sen. Bennett (R-UT) has said he plans to introduce a bill including progressive price indexing. See Pozen (2005) and http://bennett.senate.gov/press/documents/062205bennett_sossummary.pdf.
5. The indexing formula for those with lifetime earnings between the 30th percentile and maximum covered earnings would gradually shift from full wage indexing to price indexing as earnings rise.
6. However, price indexing does reduce benefits by a smaller proportion for recipients of survivor and disability benefits than for recipients of retired worker benefits; this results in a somewhat smaller percentage reduction for beneficiaries in the bottom fifth of lifetime earnings. Because price indexing affects benefits each year, the earlier an individual becomes eligible for benefits, the less benefits are reduced relative to current law. Disability recipients and survivors often become eligible for benefits before the early retirement age and therefore receive proportionately smaller benefit reductions.

References

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