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# The Distributional Implications of Reductions in Social Security COLAs

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THE GENERAL AGING OF THE POPULATION and the impending retirement of the large post–World War II birth cohorts are straining the Social Security system. Social Security actuaries estimate that Old-Age, Survivors, and Disability Insurance (OASDI) benefits paid by Social Security will consume 6.8 percent of the nation's gross domestic product (GDP) in 2030, compared with only 3.2 percent in 1970.[1]

To reduce the future burden of retirement benefits and to help ensure that Social Security is available to future generations, a number of reforms have been proposed, including the creation of publicly funded individual accounts, partial investment of the Social Security Trust Fund in equities, increases in the retirement age, reductions in spousal benefits, and increases in payroll taxes.

Some reform proponents have also advocated reductions in the automatic cost-of-living adjustments (COLAs) that beneficiaries currently receive, because the Consumer Price Index (CPI) used for COLA adjustments is thought to overstate the rate of inflation. Others would suggest that COLA adjustments be reduced even if the CPI were accurate, because they feel that current retirees should share in any sacrifices necessary to ensure the long-run viability of Social Security.

Although reductions in COLAs may in fact be warranted, it is important to recognize that these reforms may have serious implications for beneficiary income and that the effects may not be distributed equally across the elderly. This policy brief examines the distributional impact of reductions in Social Security COLAs.

To maintain the real value of retirement benefits after workers retire from the labor force, Social Security payments are tied to changes in the Consumer Price Index. Under current law, once retirees begin receiving benefits, payments increase each year by the percentage change in the CPI. COLAs have become increasingly important as life expectancy rises and retirees spend more years collecting benefits. The typical woman who reaches age 65 in 2000, for example, can expect to live another 19 years. If the inflation rate were 3 percent per year, the real value of Social Security benefits would decline by 43 percent during her expected 19 years in retirement if benefits were not indexed and Congress did not take action to maintain the real value of retirement income. Because other sources of retirement income, such as private pensions and savings, generally do not automatically adjust in response to changes in the cost of living, Social Security provides one of the few means of inflation protection available to the elderly.

Some recent studies suggest, however, that the CPI overstates the true rate of inflation. The CPI estimates changes in the price level by computing the cost to consumers of purchasing a fixed basket of goods and services at different points in time. This basket becomes less representative over time, though, as consumer spending patterns change in response to price changes and new choices. For example, as the prices of particular items in the basket rise, consumers may replace these products with less expensive substitutes. The ability to substitute for relatively expensive goods means that the true cost increase experienced by consumers is generally less than the change in the CPI. Similarly, consumers may respond to higher prices by finding less expensive

outlets where they can shop. Improvements in the quality of products, which can enhance durability and reduce the cost of repairs, are not well measured, further biasing upward the estimates of the true cost of living. In addition, new products are added to the market basket with long lags, if at all, so that the CPI basket may not always accurately reflect the types of products consumers purchase. The Advisory Commission to Study the Consumer Price Index, known as the Boskin Commission, concluded in 1996 that these factors lead the CPI to overstate the true increase in the cost of living by 1.1 percentage points per year.[2] Partly in response to the commission's recommendations, the Bureau of Labor Statistics has instituted a number of changes in the past few years in the way it computes the CPI. The Congressional Budget Office estimates that these changes will reduce the annual growth in the CPI by about 0.7 percentage points per year.[3]

Because the CPI has been overstating changes in the cost of living, a number of Social Security reform plans incorporate lower COLAs, either by assuming CPI reform or by proposing changes in the COLA formula. Senator Daniel Patrick Moynihan (D–New York), for example, introduced a bill (S. 21) in January 1999 that would reduce COLAs to one percentage point below the annual percentage change in the CPI.[4] Federal Reserve Board Chairman Alan Greenspan recently advocated that reductions to COLAs be considered as part of overall Social Security reform.[5] The 1994–1996 Advisory Council on Social Security recommended that changes be made to the CPI to remove bias from the cost–of–living estimates, although it did not support changes to the COLA formula.[6] Henry Aaron and Robert Reischauer of the Brookings Institution have also put forward a Social Security reform plan that assumes that the CPI would be corrected.[7]

Although reduced COLAs would ease the social burden of retirement benefits, they would also have significant effects on the level of income received by the elderly.[8] Moreover, reduced COLAs would not affect all elderly equally. Many experts agree that the distribution of income is currently more unequal among the elderly than among younger persons.[9] Reducing Social Security COLAs or basing COLAs on a corrected CPI may exacerbate inequality at older ages, because poor elderly people rely upon Social Security benefits for almost all of their income, whereas higher-income elderly have other sources of income. Figure 1 reports the percentage of income received by the elderly from different sources, by quintile of total income. For the elderly in the bottom two income quintiles, Social Security retirement benefits account-ed for 80 percent of their income, compared with only 19
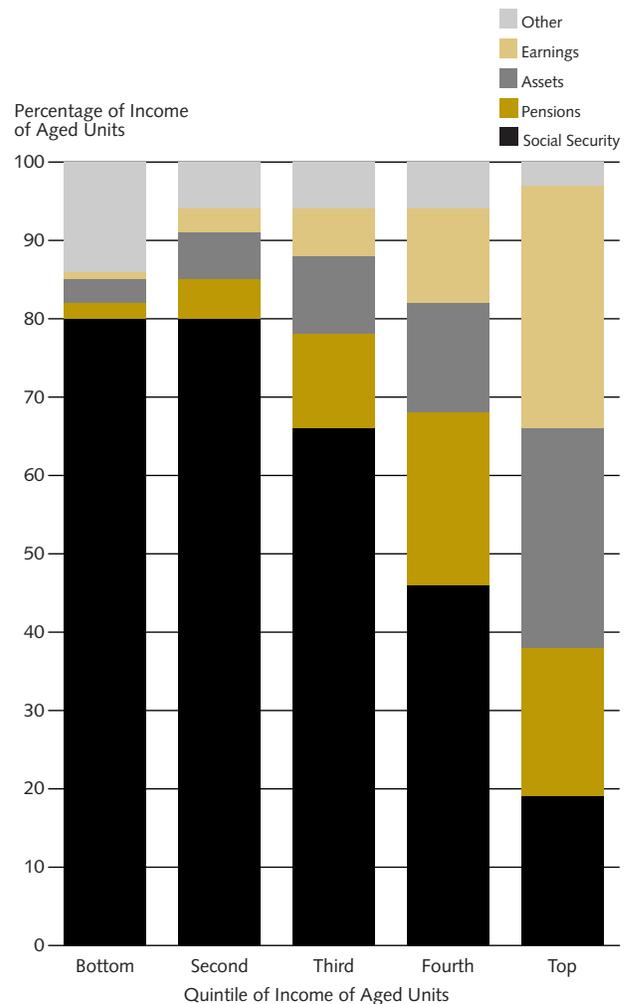
*Source:* Urban Institute computations based on the March 1998 Current Population Survey.

percent for the elderly in the top income quintile. Thus, reducing Social Security COLAs would affect almost all of the income received by the poor elderly, but only a relatively small portion of the income received by the affluent.

In addition, the proposed reductions would have larger effects for the oldest old than for relatively young beneficiaries. Changes to Social Security's COLA formulas would have no effect on the initial benefits received by retirees, because they are based on past average indexed monthly earnings (AIME), which are adjusted for changes over time in the

median wage received by covered workers.[10] Once workers begin collecting benefits, however, small annual reductions in payments that have only small effects on income in the early years can compound into large declines after many years. For example, a 1 percent annual reduction in benefits compounded for 23 years translates into a 26 percent reduction for 85-year-olds who began collecting benefits at age 62, whereas 65-year-olds who were collecting benefits for three years would experience only a 3 percent reduction in benefits compared with what they otherwise would have received.

This policy brief explores the distributional effects of reductions in Social Security COLAs to one percentage point below the percentage change in the current CPI, either by changing the COLA formula or by revising the CPI. The analysis is based on data from the March 1998 Current Population Survey (CPS), a national survey of about 50,000 households that provides information about the type and amount of income received in 1997. The basic unit of analysis is the aged unit, defined here as unmarried persons ages 65 and older and married couples in which at least one spouse was 65 or older. When classifying units by age when both spouses were 65 or older, the age of the husband was used. Our measure of income included all money income received by the aged unit, before any deductions such as taxes, union dues, or Medicare premiums. Nonmoney transfers, such as food stamps and health benefits, and any income from other persons who may live with members of the aged unit, such as their adult children, were excluded.[11] On the one hand, by omitting in-kind benefits received by the poor elderly, such as food stamps and Medicaid benefits, comparisons of money income between the rich and the poor tend to overstate inequities in economic well-being. On the other hand, the failure of simple comparisons of money income to account for differences in health care costs tends to understate inequities in well-being, because the portion of income spent on medical expenses is almost four times as high for the elderly in the bottom income quintile as for those in the top income quintile, despite the availability of Medicaid.[12]

To examine the effects of COLA reductions on the elderly, we estimated what Social Security benefits and total income for the elderly would have been today had COLAs or the CPI been reduced at some point in the past and everything else remained the same. We considered two scenarios. In the first scenario, we assumed that the COLA formula used to adjust Social Security retirement benefits was changed to the percentage change in the CPI minus one percentage point, but that the CPI itself was not altered and COLAs for other government programs did not change. In the second scenario, we assumed that the computation of the CPI itself was revised, reducing the annual growth in the CPI by one percentage point, but that the Social Security and other COLA formulas did not change. In our simulations, reductions to Social Security benefits from the change in COLAs began the year the revision was assumed to be implemented or at age 62—the age at which Social Security benefits are calculated and tied to changes in the CPI—whichever came later. Comparing the level and distribution of our simulated elderly income with actual elderly income in 1997 can suggest some possible effects of COLA reductions and CPI reform in the future.

In the second scenario, when we investigated the effects of having changed the computation of the CPI itself, we had to identify the different types of income that are tied to the CPI.[13] In addition to Social Security benefits, Supplemental Security Income (SSI) payments and veterans' benefits are tied to the CPI. Pension, survivor, and disability benefits are generally indexed when provided by government employers, but not when provided by private-sector employers. Because the CPS data we analyzed did not indicate whether a particular benefit was tied to the CPI, we assumed that all benefits received from past government employers were perfectly indexed, increasing each year by the percentage change in the CPI, and that all benefits received from past private-sector employers were not indexed at all. We also assumed that nominal earnings would not be affected by changes in the way the CPI was computed, although it is possible in the short term that reductions in the CPI will reduce earnings if wages are tied to the index.

If the COLA formula were revised, the erosion in Social Security benefits would have led some persons to become eligible for SSI, offsetting at least part of the loss in Social Security income.[14] However, only about one-half of the elderly who are currently eligible for SSI actually receive benefits, possibly because of the stigma associated with receiving need-based transfer payments.[15] We assumed that all persons who became eligible for SSI received benefits, except for those who were already eligible for benefits in 1997 before the simulated change in COLAs but did not receive SSI. By assuming that all of those newly eligible for SSI receive benefits, our results overstate the extent to which SSI offsets the fall in Social Security for the very poor, and thus understates some of the distributional effects of reducing Social Security COLAs.

## SIMULATED IMPACT ON THE LEVEL OF ELDERLY INCOME

Over time, reducing Social Security COLAs to one percent-age point below the percentage change in the current CPI would have substantial effects on the level of elderly people's income, especially for the oldest old. Although the impact would be quite small in the years immediately after the COLA change had been introduced, 10 years and especially 20 years later the effects on elderly income would be pro-nounced. As reported in table 1, after 20 years mean annual Social Security income for the elderly would have fallen by $1,112, or 10.7 percent, compared with what it was without the reduction in Social Security COLAs, assuming all else remained the same. Of course, Congress could intervene at any time to suspend the COLA reduction if it believed that it was causing undue hardship for the elderly. Absent such intervention, total mean income of all aged units would have fallen by 4.2 percent after 20 years if the Social Security COLA formula were changed, and by 5.4 percent if the CPI itself were reduced by one percentage point per year, affecting all types of indexed income.

Because Social Security COLAs do not generally begin to affect income until age 62, the impact of COLA reductions would be substantially larger for the oldest old than for the relatively young elderly. Twenty years after COLAs were first scaled back, mean annual Social Security income would fall by more than $1,500, or 17 percent, for those ages 85 and older, compared with the amount of that income without the COLA reduction. By contrast, the average decline in annual Social Security benefits after 20 years would be less than $800, or 7.3 percent, for those between the ages of 65 and 74. If the Social Security COLA formula were revised, total mean unit income for those ages 85 and older would have declined by

**TABLE 1.**

Changes in Income of Aged Units after 1 Percent Reduction to Social Security COLA

| | Actual 1997 Income ($) | Income If COLA Reduction Began One Year Ago | | Income If COLA Reduction Began 10 Years Ago | | Income If COLA Reduction Began 20 Years Ago | |
|---|---|---|---|---|---|---|---|
| | | Mean Amount ($) | Percent Change | Mean Amount ($) | Percent Change | Mean Amount ($) | Percent Change |
| **Social Security Income** | | | | | | | |
| All elderly | 10,427 | 10,325 | −1.0 | 9,618 | −7.8 | 9,315 | −10.7 |
| Ages 65–74 | 10,656 | 10,553 | −1.0 | 9,939 | −6.7 | 9,873 | −7.3 |
| Ages 75–84 | 10,457 | 10,355 | −1.0 | 9,496 | −9.2 | 8,905 | −14.8 |
| Ages 85 and older | 8,937 | 8,849 | −1.0 | 8,111 | −9.2 | 7,391 | −17.3 |
| **Income of Aged Unit If Social Security COLA Were Reduced** | | | | | | | |
| All elderly | 27,661 | 27,503 | −0.6 | 26,806 | −3.1 | 26,513 | −4.2 |
| Ages 65–74 | 32,788 | 32,620 | −0.5 | 32,014 | −2.4 | 31,949 | −2.6 |
| Ages 75–84 | 21,624 | 21,469 | −0.7 | 20,623 | −4.6 | 20,049 | −7.3 |
| Ages 85 and older | 18,006 | 17,894 | −0.6 | 17,174 | −4.6 | 16,489 | −8.4 |
| **Income of Aged Unit If Growth in CPI Were Reduced** | | | | | | | |
| All elderly | 27,661 | 27,473 | −0.7 | 26,561 | −4.0 | 26,156 | −5.4 |
| Ages 65–74 | 32,788 | 32,585 | −0.6 | 31,755 | −3.2 | 31,622 | −3.6 |
| Ages 75–84 | 21,624 | 21,443 | −0.8 | 20,376 | −5.8 | 19,630 | −9.2 |
| Ages 85 and older | 18,006 | 17,878 | −0.7 | 17,015 | −5.5 | 16,171 | −10.2 |

*Source:* Urban Institute computations based on the March 1998 Current Population Survey.

8.4 percent after 20 years, compared with only 2.6 percent for those 65 to 74. If the CPI itself were reduced, total mean unit income for the oldest old would have declined by 10.2 percent, compared with only 3.6 percent for those 65 to 74.

## SIMULATED IMPACT ON THE DISTRIBUTION OF ELDERLY INCOME

The financial pain of reductions in Social Security COLAs would fall disproportionately on the elderly near the bottom of the income distribution. As reported in table 2, for those in the top decile of the income distribution, mean income of the aged unit would have fallen by 1.3 percent after 20 years in response to the revision in Social Security COLA formulas, and by 2.2 percent if the CPI itself were revised downward. In contrast, after 20 years those in the second income decile would experience income drops of 11.5 percent if COLA formulas were revised and 14.3 percent if the CPI itself were revised. The estimated financial impact would be smaller for those in the very bottom decile than for others in the bottom

half of the distribution, because the poorest elderly are likely to receive SSI payments that would partially offset the shortfall in Social Security benefits.

Across virtually the entire income distribution, the estimated financial impact of reducing COLAs is greater among those ages 85 and older than among the relatively young elderly. For example, if the CPI itself were scaled back, the oldest elderly in the second and third income deciles would lose 17.5 percent of their income after 20 years. For elderly people in the bottom income decile, however, the financial impact of reducing COLAs would be somewhat smaller for the oldest elderly than for relatively young elderly, because the oldest elderly are more likely to become eligible for SSI benefits that can offset in part the reduction in Social Security income.

As table 2 suggests, reduced COLAs would exacerbate income inequality among the elderly by hitting low-income Social Security beneficiaries hardest. One way of measuring the impact on income inequality is to compute the Gini coefficient before and after the change in COLAs or the CPI. Gini coefficients measure the extent to which income is

**TABLE 2.**

Changes in Mean Income of Aged Units 20 Years after 1 Percent Reduction in COLA, by Income Decile

|  | First | Second | Third | Fourth | Fifth | Sixth | Seventh | Eighth | Ninth | Tenth |
|---|---|---|---|---|---|---|---|---|---|---|
| **ALL ELDERLY** | | | | | | | | | | |
| **Income of Aged Unit If SS COLA Were Reduced** | | | | | | | | | | |
| Actual 1997 income ($) | 3,822 | 7,435 | 9,860 | 12,473 | 15,600 | 19,481 | 24,533 | 31,622 | 44,115 | 101,621 |
| Income after change ($) | 3,684 | 6,582 | 8,766 | 11,192 | 14,241 | 18,064 | 23,138 | 30,268 | 42,855 | 100,320 |
| Change (%) | −3.6 | −11.5 | −11.1 | −10.3 | −8.7 | −7.3 | −5.7 | −4.3 | −2.9 | −1.3 |
| **Income of Aged Unit If Growth in CPI Were Reduced** | | | | | | | | | | |
| Actual 1997 income ($) | 3,822 | 7,435 | 9,860 | 12,473 | 15,600 | 19,481 | 24,533 | 31,622 | 44,115 | 101,621 |
| Income after change ($) | 3,448 | 6,373 | 8,644 | 11,093 | 14,092 | 17,844 | 22,767 | 29,799 | 42,198 | 99,337 |
| Change (%) | −9.8 | −14.3 | −12.3 | −11.1 | −9.7 | −8.4 | −7.2 | −5.8 | −4.3 | −2.2 |
| **AGES 85 AND OLDER** | | | | | | | | | | |
| **Income of Aged Unit If SS COLA Were Reduced** | | | | | | | | | | |
| Actual 1997 income ($) | 2,657 | 6,129 | 7,409 | 8,831 | 10,306 | 11,901 | 14,357 | 18,366 | 25,010 | 70,088 |
| Income after change ($) | 2,595 | 5,587 | 6,314 | 7,418 | 8,681 | 10,106 | 12,474 | 16,223 | 22,925 | 67,765 |
| Change (%) | −2.3 | −8.8 | −14.8 | −16.0 | −15.8 | −15.1 | −13.1 | −11.7 | −8.3 | −3.3 |
| **Income of Aged Unit If Growth in CPI Were Reduced** | | | | | | | | | | |
| Actual 1997 income ($) | 2,657 | 6,129 | 7,409 | 8,831 | 10,306 | 11,901 | 14,357 | 18,366 | 25,010 | 70,088 |
| Income after change ($) | 2,475 | 5,055 | 6,116 | 7,289 | 8,618 | 10,003 | 12,356 | 15,943 | 22,311 | 66,764 |
| Change (%) | −6.8 | −17.5 | −17.5 | −17.5 | −16.4 | −15.9 | −13.9 | −13.2 | −10.8 | −4.7 |

*Source:* Urban Institute computations based on the March 1998 Current Population Survey.

Distribution of Income of Aged Units, 20 Years after 1 Percent Reduction in COLAs

| | Gini Coefficients, Based on: | | |
| --- | --- | --- | --- |
| | Actual 1997<br>Income | Income If SS COLA<br>Were Reduced | Income If Growth in<br>CPI Were Reduced |
| All elderly | 0.455 | 0.473 | 0.475 |
| Ages 65–74 | 0.452 | 0.463 | 0.465 |
| Ages 75–84 | 0.408 | 0.430 | 0.430 |
| Ages 85 and older | 0.448 | 0.472 | 0.476 |

*Source:* Urban Institute computations based on the March 1998 Current Population Survey.

concentrated among a subgroup of the population: the larger the Gini coefficient, the more unequal the distribution of income.

Table 3 reports Gini coefficients for the elderly, based on the actual 1997 distribution of income of aged units and the predicted distribution of income that would result 20 years after a permanent reduction in Social Security COLAs. If the COLA formula for Social Security benefits were changed, the Gini coefficient for all elderly would increase from 0.455 to 0.473. The coefficient would rise among all elderly age groups, but the increase would be greatest among the oldest old. Among those ages 85 and older, the Gini coefficient would increase from 0.448 to 0.472. Revising the CPI itself or changing only the Social Security COLA formula would lead to similar distributions of income for the elderly.

## PREDICTED IMPACT ON THE PERCENTAGE OF AGED UNITS WITH INCOME BELOW THE POVERTY LEVEL

Reducing Social Security COLAs without enhancing social safety nets for the aged would over time substantially increase the proportion of the elderly who receive very low income. Table 4 reports the percentage of elderly persons with income below the federal poverty level, based on actual 1997 income and predicted income 20 years after a permanent reduction in Social Security COLAs. If the formula for computing Social Security COLAs were set equal to one percentage point below the CPI, the proportion of the elderly population with income below the poverty level would increase from 14.4

percent immediately before the policy change to 18.8 percent 20 years after the change was introduced. In other words, income for about 1.5 million more elderly persons would be below the poverty level today if the Social Security COLA formula had been reduced 20 years ago, assuming that individuals did not change their time of retirement or saving behavior and that Congress did not intervene in response to the declining income of the elderly. If the CPI were revised downward by one percentage point per year but the COLA formulas did not change, the proportion of elderly persons with income below the poverty level would actually fall to 13.6 percent 20 years after the CPI was initially revised, because the poverty threshold itself would have declined.

For particular subgroups of the elderly, revising the Social Security COLA formula would place especially large numbers at risk of poverty. After the revised formula had been in place for 20 years, 35.2 percent of those ages 85 and older would have income below the poverty level, compared with only 24.3 percent before COLAs were revised. In other words, the number of oldest elderly with very low income would rise about 45 percent because of the change in the COLA formula. Nonwhites, those with limited education, and unmarried women would also be especially hard hit by the change in COLAs. For example, income for 35.4 percent of unmarried women would be below the poverty level 20 years after the revision, compared with only 27.3 percent today, and income for 43.7 percent of nonwhites would fall below the poverty level.

The poverty statistics cited here do not correspond to the official poverty rates published by the Bureau of the Census, which are lower than the percentages reported in table 4.

## TABLE 4.

Percentage of Elderly with Income below the Poverty Level, 20 Years after 1 Percent Reduction in COLAs

|  | Based on Actual 1997 Income | Based on Income If SS COLAs Were Reduced | Based on Income If Growth in CPI Were Reduced |
|---|---|---|---|
| **All Elderly** | 14.4 | 18.8 | 13.6 |
| **By Age** | | | |
| 65–74 | 12.3 | 14.7 | 11.3 |
| 75–84 | 15.1 | 21.1 | 14.4 |
| 85 and older | 24.3 | 35.2 | 25.1 |
| **By Race** | | | |
| White | 10.5 | 14.2 | 9.7 |
| Nonwhite | 34.9 | 43.7 | 34.0 |
| **By Education** | | | |
| Did not complete high school | 24.8 | 33.1 | 23.8 |
| High school graduate | 10.4 | 13.4 | 9.0 |
| Some college | 7.4 | 9.4 | 6.8 |
| College graduate | 5.4 | 6.7 | 5.6 |
| **By Gender and Marital Status** | | | |
| Married men | 5.5 | 7.3 | 5.2 |
| Unmarried men | 18.5 | 23.9 | 17.6 |
| Married women | 6.1 | 8.5 | 6.0 |
| Unmarried women | 27.3 | 35.4 | 25.7 |

*Source:* Urban Institute computations based on the March 1998 Current Population Survey.

The official poverty rates are based on income received by all family members, whereas the statistics reported here reflect only income received by elderly persons and their spouses. Consequently, not all of the elderly with low income live in poverty, because some of them may reside with their adult children. However, unlike the official poverty rates, the num–bers presented here do indicate the proportion of the elderly who would need some type of assistance, either from families or from the state, to avoid impoverishment.

## CONCLUSIONS

Policy initiatives that would lower cost–of–living escalators for Social Security benefits but would not provide additional income support for the poorest elderly would substantially reduce elderly income over time, especially for particular sub–

groups. Twenty years after Social Security COLAs would have first been scaled back to one percentage point below the percent change in the CPI, mean income of the elderly would have fallen by about 4 percent from its current level. The financial impact of this policy change would be more serious for the oldest elderly and for the poor. After 20 years, mean income would fall by more than 8 percent from its current level for those ages 85 and older and by about 12 percent for the elderly near the bottom of the income distribution. Consequently, the distribution of income would become even more unequal for the elderly. Even with additional SSI bene–fits offsetting at least part of the decline in Social Security income for the most needy, income for an additional 1.5 million elderly would be below the poverty level today if the Social Security COLA formula had been reduced 20 years ago. The proportion with income below the poverty level would rise to 43.7 percent for elderly nonwhites, to 35.4

percent for elderly unmarried women, and to 35.2 percent for those ages 85 and older. The reduction in income would be even greater for the elderly if the growth in the CPI itself were permanently reduced by one percentage point, but the proportion of the elderly with income below the poverty level would decline because the poverty level itself would fall with CPI reform.

It is difficult to estimate precisely the effects of policy initiatives on future levels of income, and there are a number of potential sources of error with our estimates of the effects of COLA reform. First, we have attempted to predict the effects of future policy reforms by investigating how the level and distribution of elderly people's income today would change if the proposed initiatives had been implemented in the past. The problem, however, is that our approach assumes that in the absence of any policy reform the future distribution of income will be the same as today's. Given ongoing changes in work patterns, retirement behavior, women's employment, the demographic composition of the labor force, and labor market returns to human capital, it seems likely that the distribution of elderly income will change markedly over time even if public policy remains the same. It is not clear, however, how the changing distribution of income would affect our conclusions. Second, the estimates presented here assume that individuals do not change their behavior in response to changes in Social Security COLAs. If individuals do in fact respond to reductions in COLAs, perhaps by saving more or by delaying retirement, then our estimates may overstate the effects of COLA reductions on the distribution and level of income. Third, our simulations were based on the assumption that Congress would not intervene to support the elderly as their Social Security benefits erode over time. Before Social

Security COLAs were implemented in 1972, however, Congress repeatedly passed legislation to increase the benefits received by the elderly. Despite these caveats, our findings clearly suggest that reducing Social Security COLAs would have serious financial consequences for the elderly over time, especially for the oldest and poorest of them, unless Congress took special steps to correct these problems.

The serious financial implications for the elderly notwithstanding, revising Social Security COLAs may be a worthy policy goal if combined with other initiatives to protect the financial security of the aged near the bottom of the income distribution. Some type of reform, such as reduced COLAs, is necessary to reduce the social burden of providing support for the elderly and to ensure the financial stability of the Social Security system. The failure to implement reform soon may lead to even lower retirement benefits and higher payroll taxes in the future. Efforts should be made to correct the CPI so that it better reflects true changes in the overall price level. If the current Social Security COLA formula is overly generous to the elderly, either because changes in the CPI overstate inflation in general or because they overstate changes in the cost of living for the elderly in particular, then the COLA formula should be revised. However, it is important that the distributional consequences of these reforms be understood and that measures be taken to protect the most vulnerable of the elderly. Policymakers should consider other reforms in combination with reduced COLAs to enhance the progressivity of the Social Security system, such as increasing the minimum benefits payable by Social Security, enhancing SSI payments, increasing federal taxation of benefits, altering the Social Security bend points, or reducing COLAs only for the wealthiest beneficiaries.

## ENDNOTES

[1]U.S. Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Annual Report, Washington, D.C.: U.S. Government Printing Office, 1999.

[2]Advisory Commission to Study the Consumer Price Index, "Toward a More Accurate Measure of the Cost of Living," final report to the Senate Finance Committee, December 4, 1996.

[3]Congressional Budget Office, "Economic and Budget Outlook: Fiscal Years 2000–2009," January 1999.

[4]The bill also proposed reducing payroll tax rates, increasing the wage base subject to the payroll tax, restoring the normal retirement age to 65, increasing the number of years of earnings that are included in the computation of retirement benefits, subjecting benefits to full federal income taxation, repealing the earnings test for retirees, creating voluntary personal savings accounts for workers, and establishing savings accounts for children.

[5]Alan Greenspan, testimony before the Senate Committee on the Budget, January 28, 1999.

[6]1994–1996 Advisory Council on Social Security, "Report of the 1994–1996 Advisory Council on Social Security," January 1997.

[7]Robert D. Reischauer, testimony before the House Committee on Ways and Means, November 19, 1998. Henry J. Aaron, testimony before the Senate Committee on the Budget, July 23, 1998.

[8]The 1994–1996 Advisory Council on Social Security estimated that a 1.0 percent reduction in COLAs would lower the long-term deficit in the OASDI trust funds by more than one-half.

[9]Stephen Crystal and Dennis Shea, "Cumulative Advantage, Cumulative Disadvantage, and Inequality among Elderly People," *The Gerontologist* 30 (1990): 437–43. Stephen Crystal and Keith Waehrer, "Later-Life Economic Inequality in Longitudinal Perspective," *Journals of Gerontology: Social Sciences* 51(b) (1996): S307–S318. Richard Disney, *Can We Afford to Grow Older? A Perspective on the Economics of Aging,* Cambridge. MIT Press, 1996. Timothy M. Smeeding, "Full Income Estimates of the Relative Well-Being of the Elderly and the Nonelderly," in David E. Bloom and Daniel J. Slottje, *Research in Economic Inequality*, vol. 1, Greenwich, Connecticut. JAI Press, 1989. However, for a dissenting view, see Victor R. Fuchs, "Provide, Provide: The Economics of Aging," NBER Working Paper No. 6642, 1998.

[10]Changes to the CPI itself could affect AIME by altering wage histories, however. Employers may informally tie wage growth to changes in the CPI, and union contracts are often explicitly related to it.

[11]There is evidence that the CPS underreports some types of income, particularly interest and dividend income (Bureau of the Census, Current Population Reports, No. 184, 1993). We have not attempted to correct for income underreporting here. Because most asset income is received by high-income persons who would be less affected by changes in Social Security COLAs than low-income persons, our failure to adjust for underreporting is likely to lead us to underestimate the distributional consequences of reducing COLAs.

[12]Stephen Crystal, Richard W. Johnson, and Rizie Kumar, "Out-of-Pocket Health Care Costs among Older Americans," presented at the annual meeting of the Gerontological Society of America, Philadelphia, 1998.

[13]Because we are focusing on before-tax income, we did not consider the tax implications of changes to the CPI.

[14]Elderly persons were eligible for SSI in 1997 if their monthly income was below $484 for unmarried individuals or below $726 for couples, and if they had limited assets. Countable monthly income excludes the first $20 of income, $65 in earnings, and one-half of any earnings above $65.

[15]Kathleen McGarry, "Factors Determining Participation of the Elderly in Supplemental Security Income," *Journal of Human Resources* 31 (1996): 331–58.

## ACKNOWLEDGMENTS

# THE RETIREMENT PROJECT

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**About the Author**
Richard W. Johnson is an economist in the Urban Institute's Income and Benefits Policy Center. His current research focuses on retirement behavior and how it is influenced by the availability of health insurance, the care of elderly parents, and the labor supply of spouses.