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Memorandum

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TO: Senate Finance Committee
Attention: Democratic Staff

FROM: Patrick Purcell
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SUBJECT: **Estimated Effect of Price-Indexing Social Security Benefits on the Number of Americans 65 and Older in Poverty**

In December 2001, the President's Commission to Strengthen Social Security issued its final report.[1] The Commission suggested several policy options that could restore the Social Security system to long-term financial solvency. One such option would change the current method of establishing the initial Social Security benefit from a process in which the initial benefit of each successive cohort of workers grows at the national average rate of *wage* increases to a process in which benefits for successive cohorts of workers would grow at the national average rate of *price* increases.[2] As you requested, the Congressional Research Service has estimated the effects that a specific cut in Social Security benefits would have had on the number of Americans age 65 and older with incomes below the federal poverty threshold in 2003. As you specified, the benefit cut would be based on the ratio of the consumer price index to the average national wage index, using 1940 as the base for both indices.[3]

The Social Security retirement benefit payable at the program's full retirement age (65 and six months in 2005) is called the *primary insurance amount* (PIA). The PIA is equal to specified percentages of the worker's *average indexed monthly earnings* (AIME). In 2005, these percentages, called "PIA factors"are **90%** of the first \$627 of AIME, **32%** of AIME between \$627 and \$3,779 and **15%** of AIME over \$3,779. As described by the report of the President's Commission, the policy of "price indexing" initial Social Security benefits "would be implemented by multiplying the PIA bend point factors ... by the ratio of the

[1] *Strengthening Social Security and Creating Personal Wealth for All Americans,* available online at [http://www.csss.gov/reports/].

[2] "Benefits in the traditional Social Security system would be indexed to price inflation rather than national wage growth beginning in 2009," Report of the President's Commission, p. 120.

[3] The first Social Security benefits were paid in 1940. We calculated the ratio of the consumer price index for urban wage earners (CPI-W) to the national average wage index in each year thereafter.

Consumer Price Index to the Average Wage Index in successive years."[4] Price indexing the PIA factors would cause the PIA to increase at the rate of CPI-measured price increases rather than at the average rate of wage increases, as under current law.

Methods

Each year the U.S. Census Bureau estimates the number of Americans living in poverty. The Census Bureau's estimates are based on data collected through the *Current Population Survey*, a nationally representative sample of approximately 100,000 U.S. households. The most recent estimates published by the Census Bureau are based on data collected in March 2004 and reflect income and poverty status in 2003. The Census Bureau estimates that 35.9 million Americans were in poverty in 2003, representing 12.5% of the resident civilian noninstitutionalized population of the United States.[5] Among those who were 65 and older in 2003, the Census Bureau estimates that 3.552 million people were in poverty, representing 10.2% of the noninstitutionalized elderly population.

CRS estimated the percentage reduction in Social Security retirement benefits that would have resulted in 2003 if benefits had been reduced by the ratio of the change in the consumer price index to the national average wage index since 1940. In 1940, the Consumer Price Index for Urban Wage Earners (CPI-W) was 14.1.[6] By 2003, the CPI-W had increased to 179.8. This is an increase of 1,175% or an average annual increase of 4.12% over the 63-year period from 1940 to 2003. In 1940, the national average wage was $1,105. By 2003, the national average wage had increased to $34,065. This is an increase of 2,983% or an average annual increase of 5.59% over the period from 1940 to 2003. Using 1940 as the base year for both wages and prices, the ratio of the CPI-W to the national average wage index (AWI) in 2003 was 1,275.2/3,083.2 or 0.414. In other words, if initial Social Security retirement benefits had been reduced by the ratio of the CPI to the AWI each year since 1940, the initial benefit in 2003 would have been 58.6% lower than under current law.

To estimate the effect of a reduction in Social Security benefits based on the ratio of CPI to AWI, we adjusted the Social Security benefits reported by persons age 65 and older on the March 2004 *Current Population Survey*. For each Social Security recipient age 65 or older, we multiplied the reported amount of Social Security income by the ratio of CPI/AWI in the year that the recipient would have been 62 years old.[7] For example, for a person age 70 in 2003, we multiplied his or her 2003 Social Security income by .475, which was the ratio of CPI/AWI eight years earlier when this person was first eligible for Social Security retirement benefits. We then summed the income of each person in the family and compared their family income to the appropriate federal poverty threshold for the appropriate family size and age of the family head. In 2003, the federal poverty threshold for a single person age 65 or older was $8,825 and the poverty threshold for an aged couple was $11,133.

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[4] Report of the President's Commission, p. 120, footnote.

[5] See U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage in the United States: 2003*, Series P60-226, Aug. 2004 at [http://www.census.gov/prod/2004pubs/p60-226.pdf].

[6] Base: 1982-1984 = 100.

[7] In each case, the base year for both the CPI and AWI was 1940.

Results

According to the Census Bureau, 3.552 million Americans age 65 or older had total family incomes below the federal poverty threshold in 2003. This number was 10.2% of the 34.659 million noninstitutionalized persons who were age 65 or older in 2003. If Social Security benefits had been reduced that year by the ratio of CPI/AWI with both indices based on their 1940 level, benefits would have been reduced for the average recipient by approximately 55%.[8] Our analysis indicates that a reduction in Social Security benefits in 2003 based on the decline in the ratio of CPI/AWI since 1940 would have resulted in an increase in the number of Americans age 65 or older with incomes below the poverty threshold from 3.552 million to 10.537 million. This number would have been equal to 30.4% of the 34.659 million noninstitutionalized persons who were age 65 or older in 2003. Our estimates are consistent with those published by the Social Security Administration on the effect that Social Security has on the number of Americans living in poverty. The Social Security Administration has estimated that without income from Social Security, the number of people 65 and older living in poverty in 2000 would have increased by 9.2 million.[9]

The results of our analysis can be interpreted as showing the estimated effect of a substantial *immediate reduction* in Social Security benefits on the number of Americans age 65 and older living in poverty in 2003. The estimates do not show the effect that smaller *successive reductions* in Social Security benefits each year since 1940 would have had on the number of Americans 65 or older living in poverty in 2003. In the case of successive reductions in Social Security benefits, it would be reasonable to assume that both workers and employers would have responded with changes in their behavior. In response to a series of benefit reductions over a long period of time, workers would have had an incentive to save more for retirement, and employers would have had an incentive to change their worker's compensation so that a greater proportion of total compensation was offered in the form of pension benefits. Nevertheless, because such a large proportion of the total income of the elderly consists of Social Security benefits (42% in 2003), it is unlikely that these behavioral changes would have fully offset the reductions in Social Security benefits.

Estimated Number of Americans Age 65 and Older in Poverty in 2003 under Current Law and a Benefit Cut based on the Ratio of CPI/AWI

(Number of people, in thousands)

	Family income relative to poverty threshold				
	Under 100%	100% - 149%	150% - 199%	200% and up	Total
Current Law					
Number	3,552	4,960	4,912	21,235	34,659
Percent	*10.2%*	*14.3%*	*14.2%*	*61.3%*	*100%*
Proposal					
Number	10,537	4,703	3,592	15,827	34,659
Percent	*30.4%*	*13.6%*	*10.4%*	*45.7%*	*100%*

Source: CRS analysis of the March 2004 *Current Population Survey*.

[8] Benefits would have been reduced by approximately 59% for a 65-year-old Social Security recipient and by approximately 53% for an 80-year-old Social Security recipient.

[9] Social Security Administration, *Income of the Population 55 or Older: 2000*, Feb. 2002, p. 148.

Estimated Social Security Benefit for Individual Retiring in 2005 with Lifetime Average Earnings, if initial benefits had been price indexed after 1940*

			Social Security Benefit		Replacement Ratio	
Year started working	Year of retirement	Final monthly earnings	Current law	With PIA Price-Indexed	Current law	With PIA Price-Indexed
1962	2005	$3,056	$1,278	$515	42%	17%

Source: Congressional Research Service

* The first Social Security benefits were paid in 1940. The estimate shows the effect on the benefit of a worker retiring in 2005 if initial benefits had been price-indexed in each year thereafter.