Joint Economic Committee Democrats

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What if President Bush's Plan for Cuts in Social Security Benefits Were Already in Place?

Introduction

President Bush has proposed a change in the way retirees' initial Social Security benefits are calculated. Compared with the current method of calculating those benefits, which was first put in place in 1979, the President's approach would produce progressively steeper cuts in retirement benefits for all workers with earnings greater than $20,000.

To illustrate the effects of the President's proposal, this paper compares retirement benefits under current law for today's 65-, 45-, and 25-year olds with what those benefits would be if the President's preferred approach had been the one implemented in 1979. The following are the main conclusions:

- Middle-class workers retiring this year would receive a Social Security benefit that is 9 percent smaller than they would get under current law, and workers with higher earnings would experience even larger cuts.
- The size of the cuts in initial benefits would grow larger over time, replacing an ever smaller share of workers' pre-retirement earnings.
- The erosion of benefits would hit middle-income workers much harder than upper-income workers, because middle-income workers rely on Social Security for a much larger fraction of their retirement income than upper-income workers do.

Wage Indexing vs. Price Indexing

The current method for calculating initial Social Security benefits began in 1979, and since then the initial benefit level has risen with the growth in wages, ensuring that benefits reflect increases in living standards over time. President Bush has proposed replacing this "wage-indexing" approach with one that would have initial benefit levels grow more slowly for workers whose earnings are above a certain minimum level.

Under the President's proposal, dubbed "progressive price indexing" by its proponents, the initial benefit level for low-earning workers (those with earnings equivalent to about $20,000 or less in 2005) would continue to increase with growth in wages as under current law. The initial benefit level of high-earning workers, in contrast, would increase only at the rate of growth of prices. Workers in the middle would see their initial benefit level increase by a mixture of price and wage growth. The effect of this policy would be a substantial reduction in benefits over time compared with what is scheduled under current law, because wages tend to grow faster than prices over long time periods.

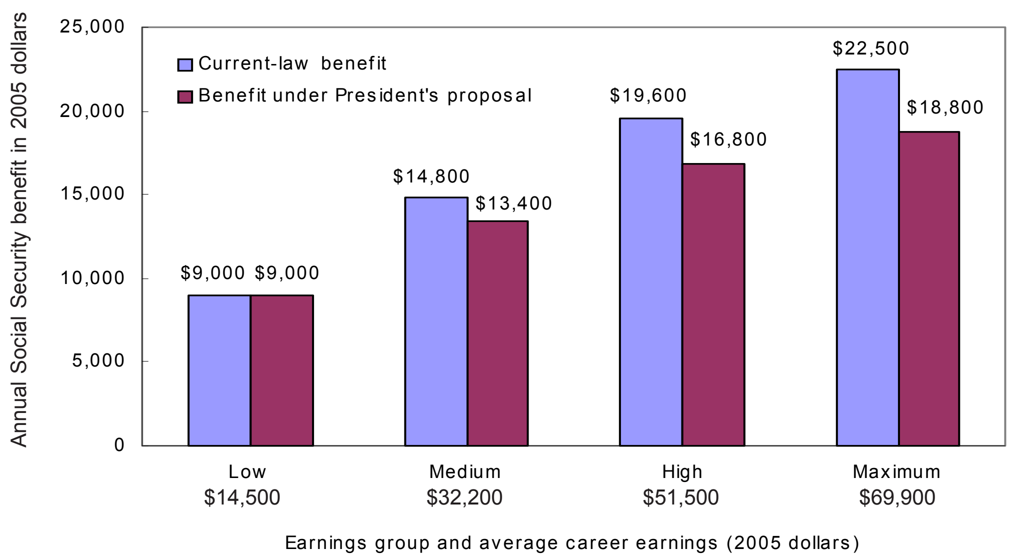
Middle-Class Workers Would Receive Steep Benefit Cuts

Chart 1 shows how implementing the President's price-indexing proposal instead of wage indexing in 1979 would have affected the retirement benefit of workers born in 1940 and retiring this year at age 65. Low-earning workers (with average career earnings

Chart 1

Most Workers Would Get Lower Retirement Benefits under the President's Price-Indexing Proposal

Current-Law Benefit for Today's 65-Year-Olds Compared with Benefit if President's Price-Indexing Proposal Had Started in 1979, by Average Career Earnings Level

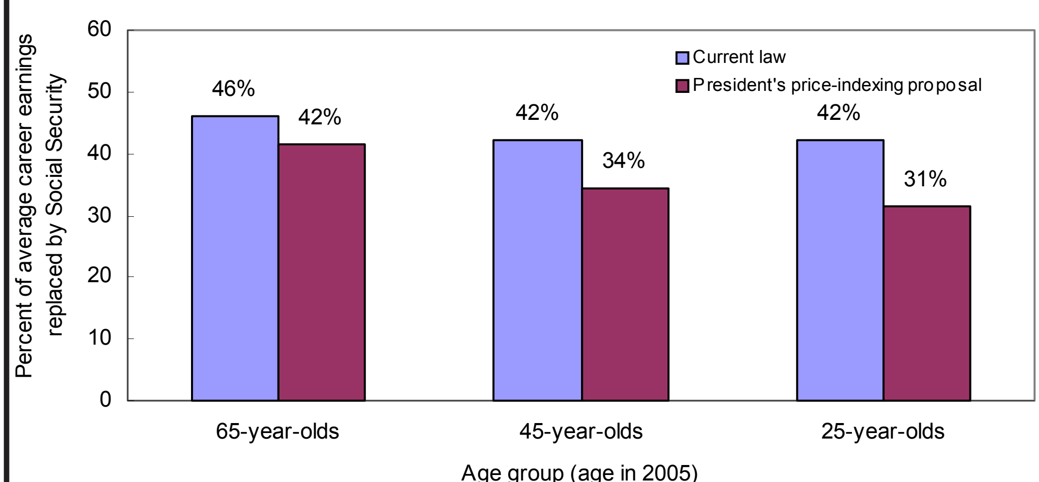


Source: Joint Economic Committee Democratic Staff

Chart 2

Social Security Would Replace a Smaller Fraction of Earnings over Time under the President's Price-Indexing Proposal

Replacement Rates for Medium Earners if President's Price-Indexing Proposal Had Started in 1979, by Age Group



Source: Joint Economic Committee Democratic Staff of $14,500 in 2005 dollars) would see no cut in benefits, because the current wage-indexing approach would be used to determine their initial retirement benefit. However, workers with average career earnings above $20,000 would receive benefit cuts, and the size of those cuts would be larger for those with higher earnings. For example, under the President's proposal, the benefit of a worker with medium earnings of $32,200 would be $1,400 (9 percent) lower than the current-law benefit of $14,800. The benefit of workers with the highest earnings—so-called maximum earners[1]—would be $3,700 (16 percent) lower.

These benefit reductions reflect only 25 years of price indexing. The longer price indexing is in place, the larger the benefit cuts would be, as illustrated in the Appendix table. The table compares the average retirement benefit of today's 65-, 45-, and 25-year olds under current law with what those benefits would be if the President's price-indexing proposal had been in effect since 1979. For example, today's 45-year-old medium earner would see a cut of $2,900 (18 percent) under price indexing; today's 25-year old medium earner would see a cut of $5,100 (26 percent).

Social Security Would Replace a Smaller Share of Pre-Retirement Earnings Over Time

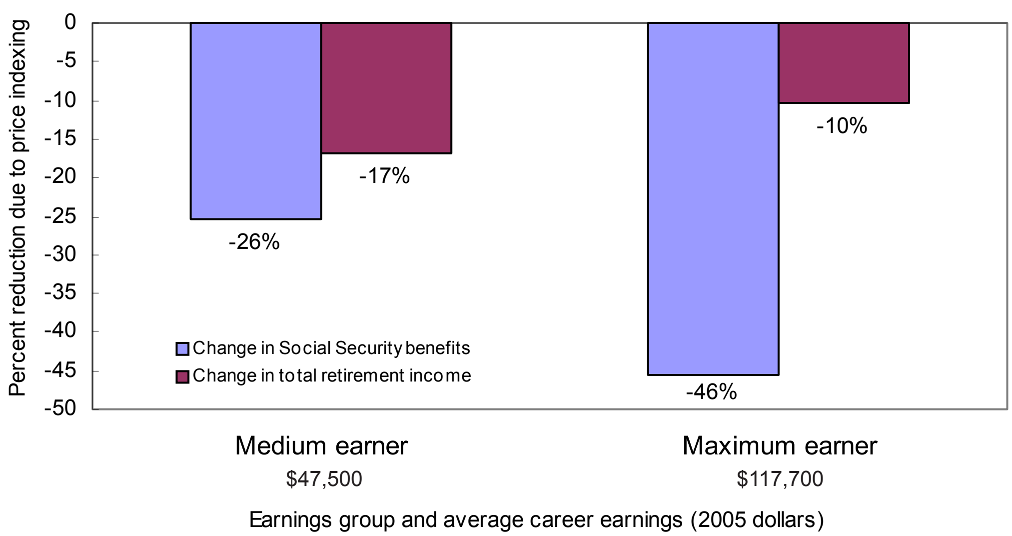
The benefit reductions under price indexing mean that Social Security benefits would replace an ever smaller share of pre-retirement earnings over time. **Chart 2** shows that under current law Social Security will replace more than 40 percent of average career earnings for workers with medium earnings. (The replacement rate for medium earners aged 65 today is slightly higher than the replacement rate for medium earners aged 45 or 25 today because of future benefit reductions put in place by the 1983 Social Security amendments.)

If the President's price-indexing proposal had started in 1979, the replacement rate for a medium earner aged 65 today would fall from 46 percent of average career earnings under current law to 42 percent under price indexing. For today's 25-year-olds, the replacement rate for a medium earner would fall from 42 percent under current law to 31 percent under price indexing.

Chart 3

The President's Price-Indexing Proposal Would Hurt Middle-Income Workers More Than High-Income Workers

Impact of Price Indexing Starting in 1979 on Social Security Benefit and Total Retirement Income of Today's 25-Year-Olds, by Earnings Group



Source: Joint Economic Committee Democratic Staff

Price-Indexing Would Hurt Middle-Income Workers More Than Upper-Income Workers

The benefit reductions and commensurate fall in replacement rates caused by the President's price-indexing proposal would be larger for the highest earners than for medium earners. However, because middle-income retirees rely on Social Security for a much larger fraction of their retirement income than wealthy retirees, the benefit reductions and fall in replacement rates would hit them much harder.

For example, retirees in the middle of the income distribution currently receive about two-thirds of their income from Social Security, while the wealthiest fifth of retirees rely on Social Security for only 23 percent of their income.[2] If the President's price-indexing proposal had been in effect since 1979 and if retirees in the future continue to rely on Social Security to the same degree as current retirees, the 26 percent benefit cut caused by price indexing for medium earners aged 25 today would translate into a 17 percent reduction in their retirement income **(Chart 3)**. While maximum earners would experience a larger benefit cut than medium earners (46 percent compared with 26 percent), their total retirement income would fall by less (10 percent compared with 17 percent).

Conclusion

The President's price-indexing proposal will result in large benefit cuts for all workers with earnings over $20,000 annually. Those benefit cuts will hit the middle class particularly hard because of their reliance on Social Security income in retirement.

Endnotes

[1] Maximum earners have earnings equal to or higher than the maximum earnings level taxed for Social Security purposes ($90,000 in 2005).
[2] Calculations by Joint Economic Committee Democratic Staff based on the March 2004 Current Population Survey.

Appendix

Social Security Benefits if the President's Price-Indexing Proposal Had Been in Place Since 1979 Compared with Current Law Benefits

Constant 2005 dollars

Worker Characteristic	Average Career Earnings	Annual Social Security Retirement Benefit: Current Law	Annual Social Security Retirement Benefit: President's Proposal	Size of Proposed Benefit Cut: Dollars	Size of Proposed Benefit Cut: Percent of Current-Law Benefit	Replacement Rate: Current Law	Replacement Rate: President's Proposal
Age 65 in 2005, retiring in 2005							
Earnings Category*							
Low	14,500	9,000	9,000	0	0%	62%	62%
Medium	32,200	14,800	13,400	-1,400	-9%	46%	42%
High	51,500	19,600	16,800	-2,800	-14%	38%	33%
Maximum	69,900	22,500	18,800	-3,700	-16%	32%	27%
Age 45 in 2005, retiring in 2025							
Earnings Category*							
Low	17,200	9,800	9,800	0	0%	57%	57%
Medium	38,300	16,100	13,200	-2,900	-18%	42%	34%
High	61,300	21,400	15,600	-5,800	-27%	35%	25%
Maximum	94,700	26,100	17,800	-8,300	-32%	28%	19%
Age 25 in 2005, retiring in 2045							
Earnings Category*							
Low	21,400	12,100	12,100	0	0%	57%	57%
Medium	47,500	20,000	14,900	-5,100	-26%	42%	31%
High	75,900	26,500	16,300	-10,200	-38%	35%	21%
Maximum	117,700	32,400	17,600	-14,800	-46%	28%	15%

* The earnings for workers in each category are assumed to be scaled according to the method outlined in the Social Security actuaries' Actuarial Note Number 2004.3, "Scaled Factors for Hypothetical Earnings Examples Under the 2004 Trustees Report Assumptions." These earnings levels reflect the average earnings patterns of workers in each category throughout their careers, with workers earning less early in their careers than later in their careers. The Social Security actuaries adjust the scaled factors so that the career-average earnings level for each category of worker is as follows: 45 percent of the average wage index (AWI) for low earners, 100 percent of the AWI for medium earners, and 160 percent of the AWI for high earners. Maximum earners are assumed to earn at least the maximum taxable earnings level each year.