The Impact of Cutting Social Security Cost of Living Adjustments on the Living Standards of the Elderly

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Introduction

During the negotiations over raising the debt ceiling, President Obama proposed cutting the annual cost of living adjustment for Social Security by switching to an index that would show a lower measured rate of inflation. This alternative index, the chained consumer price index (C-CPI-U), shows an annual rate of inflation that averages approximately 0.3 percentage points less than the consumer price index (CPI-W) that is currently used to index benefits.

While this change would lead to $122 billion in savings to the government over the next decade, it also means that beneficiaries would receive lower benefits.[1] The effect will initially be small, just 0.3 percent in the first year, however it becomes more significant the longer a beneficiary lives. After ten years, benefits will be almost 3 percent lower as a result of the use of the C-CPI-U, after twenty years benefits would be lowered by almost 6 percent, and after thirty years benefits would be almost 9 percent lower.

Since the vast majority of retirees rely on Social Security for the bulk of their retirement income, this cut in the cost of living adjustment would imply a substantial reduction in the standard of living of retirees, unless they offset it by saving more during their working years or retiring later in life. While we cannot know for sure how workers in future years will adjust their behavior, it is possible to assess their past response.

Previous Changes to the CPI and Worker Response

In the mid and late 1990s there were a series of changes to the CPI that had the effect of reducing the measured rate of annual inflation by 0.5-0.7 percentage points. The changes put in place, along with their estimated impact on the CPI and the year in which they were put in place, is shown in **Table 1**.

According to these estimates from the Council of Economic Advisers, the cumulative effect of these changes was to lower the measured rate of inflation by 0.69 percentage points. This may have overstated the impact slightly. A reduction in the measured rate of inflation by 0.5 percentage points is probably somewhat closer to the mark.[2]

1 Congressional Budget Office, 2011. "Reducing the Deficit: Spending and Revenue Options." Washington, DC: Congressional Budget Office, Option 27, available at http://www.cbo.gov/doc.cfm?index=12085.

2 The impact of the updated market basket, which meant the more frequent changing of the goods and services in the index, would not be expected to have any systemic effect on the measured rate of inflation although it would mean that the measure more accurately reflects the change in prices of goods that consumers are actually purchasing.

TABLE 1
Expected Effects on Changes in the CPI and Real GDP of CPI Methodological Changes

Change in method	Year Introduced	Percentage-point effect on CPI percent change
Pre-1998		-0.28
Generic prescription drugs	1995	-0.01
Food at home seasoning	1995	-0.04
Owners' equivalent rent formula	1995	-0.10
Rent composite estimator	1995	0.03
General seasoning	1996	-0.10
Hospital services index	1997	-0.06
1998 and after		-0.41
Personal computer hedonics	1998	-0.06
Updated market basket	1998	-0.15
Geometric means	1999	-0.15
Rotation by item	1999	-0.05
Total		**-0.69**

Source: Table 2-4, 1998 Economic Report of the President.
http://www.gpoaccess.gov/usbudget/fy99/pdf/erp.pdf

These changes in the CPI mean that Social Security benefits fell by 0.5-0.7 percentage points each year relative to the level if they had been adjusted with the CPI that had been in place before these changes. As a result, a beneficiary who had been retired for 10 years would be receiving a benefit that is 5.0-7.0 percent less relative to their initial benefit than would have been the case with the earlier CPI.

If workers responded to this reduction in Social Security benefits either by working later into life or saving more for retirement, then we should expect that non-Social Security income would be a larger portion of total income for beneficiaries in their mid-70s now (and therefore would have mostly been receiving the lower cost of living adjustment for a decade) than was the case before the CPI was changed.

To test this, we compared the share of Social Security income in total income for people aged 73-77 in the years 1995 to 1997 with people aged 73-77 in the years 2008-2010. The calculations were done separately for each quintile of single and married men and women. The results are shown in **Tables 2A**, **2B**, **2C** and **2D** below.

TABLE 2A
Social Security Income as Share of Total Income, Unmarried Males

Income Quintile	1995 - 1997	2008 - 2010	change in share (percentage points)	t-statistic, change in share
Lowest	0.8345	0.8413	0.0068	0.1865
Second	0.8144	0.8711	0.0567	2.1833*
Middle	0.7046	0.6812	-0.0234	-0.8708
Fourth	0.4894	0.4658	-0.0236	-1.0659
Highest	0.2247	0.1949	-0.0297	-1.5350

Levels of significance: # 10%, * 5%, ** 1%.
Source: Authors' analysis of Current Population Survey.

TABLE 2B
Social Security Income as Share of Total Income, Unmarried Females

Income Quintile	1995 - 1997	2008 - 2010	change in share (percentage points)	t-statistic, change in share
Lowest	0.8207	0.7915	-0.0292	-1.4038
Second	0.8660	0.8774	0.0114	0.8355
Middle	0.8304	0.8410	0.0106	0.9025
Fourth	0.6341	0.5982	-0.0359	-2.5934**
Highest	0.3215	0.2918	-0.0297	-2.0949*

Levels of significance: # 10%, * 5%, ** 1%.
Source: Authors' analysis of Current Population Survey.

TABLE 2C
Social Security Income as Share of Total Income, Married Males

Income Quintile	1995 - 1997	2008 - 2010	change in share (percentage points)	t-statistic, change in share
Lowest	0.8581	0.8486	-0.0095	-0.5254
Second	0.8200	0.8757	0.0557	4.8804**
Middle	0.6103	0.6415	0.0313	2.3374*
Fourth	0.4071	0.4133	0.0062	0.5958
Highest	0.2051	0.1783	-0.0268	-2.6648**

Levels of significance: # 10%, * 5%, ** 1%.
Source: Authors' analysis of Current Population Survey.

TABLE 2D
Social Security Income as Share of Total Income, Married Females

Income Quintile	1995 - 1997	2008 - 2010	change in share (percentage points)	t-statistic, change in share
Lowest	0.8948	0.9188	0.0240	1.2459
Second	0.8691	0.9248	0.0557	3.9407**
Middle	0.7484	0.8410	0.0926	5.7802**
Fourth	0.5681	0.6483	0.0803	4.7506**
Highest	0.2948	0.2919	-0.0029	-0.1467

Levels of significance: # 10%, * 5%, ** 1%.
Source: Authors' analysis of Current Population Survey.

As can be seen, in the case of most quintiles in these age groups, the share of Social Security in retirement income *increased* rather than decreased. In 6 of the 20 quintiles, there was a statistically significant increase in the share of income derived from Social Security. In 5 other quintiles there was an increase in the Social Security share of income that was not statistically significant. In only 3 of the 20 quintiles was there a statistically significant decline in the Social Security share of income.[3] These data indicate the vast majority of beneficiaries did not take steps to counteract the reduction in Social Security benefits that resulted from the changes in the CPI in the mid-90s. Either they did not recognize that the value of their benefits would be reduced relative to the wages earned during their working years or they were not able to change their work and saving behavior to offset this reduction. While there may have been factors that made the cohort of workers who were aged 73-77 in the years 2008-10 less capable of adjusting their work and savings behavior than those now approaching retirement, it is not apparent what that would be. Certainly, the enormous loss of wealth associated with the collapse of the housing bubble will make most workers less well prepared for retirement.

Benefits Have Already Been Cut

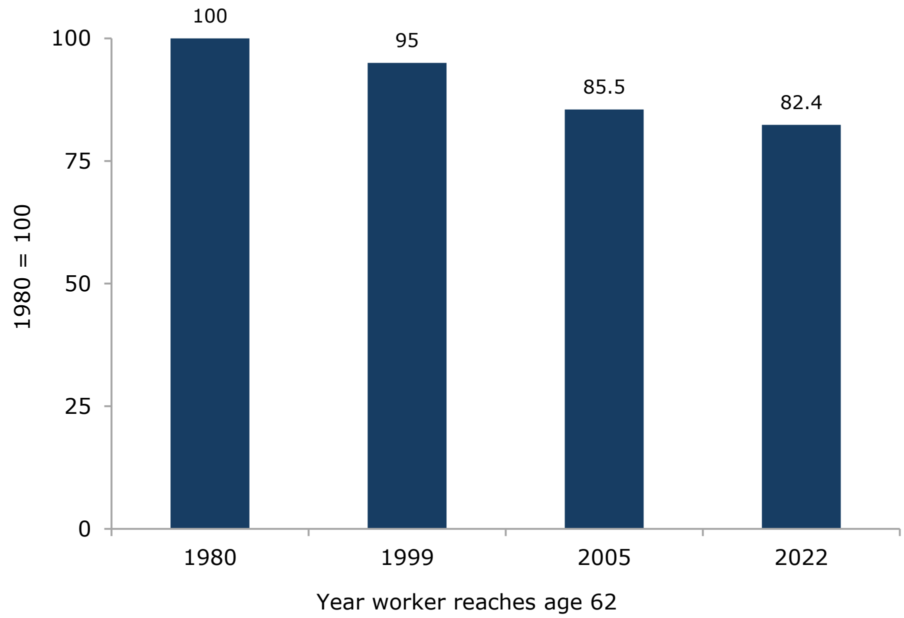
In this respect, it is worth noting that the cohorts of workers who have turned 62 after 2000 also face an additional reduction in benefits relative to the wages earned during their working years since the age for receiving normal benefits was raised to 66 in two month intervals from 2003 to 2008. It is scheduled to rise further to 67 over the years 2017 to 2022. This implies a further reduction in benefits relative to the wages earned during their working years.

Figure 1 shows the reduction in expected benefits relative to the lifetime earnings (as calculated for Social Security) for workers who turned 62 in the years 1999, 2008, and 2022 as a result of the changes already put in place in the CPI and the scheduled increase in the age of eligibility for normal benefits.[4]

3 The three exceptions, showing a drop in the Social Security share of wage income, were the highest and second highest quintile of unmarried women and the highest quintile of married men.

4 For simplicity, the calculations hold the expected period over which workers receive benefits constant at 20. Life expectancy at age 65 is projected to increase by 3.7 years over this period which would increase the expected period over which workers receive benefits. However, workers may also work somewhat later into their lives both due to better health and also the increase in the age at which they are eligible for normal benefits. This would partially offset the projected increase in life expectancy. The changes in the CPI would have more impact the longer workers receive benefits.

FIGURE 1
Changes in the Ratio of Social Security Benefits to Lifetime Earnings



Source: Social Security Trustees Report, 2011 and authors' calculations.

As can be seen, workers retiring in this decade can already expect to see substantially lower benefits relative to their lifetime earnings than did workers who reached retirement age three decades ago.

Taxes Have Already Been Increased

In addition to getting lower benefits relative to their lifetime earnings, current and future retirees are also paying a considerably higher share of their wages into the system than workers who retired in 1980. The Social Security tax rate has been increased repeatedly since the program was created. The most recent set of tax increases was put in place following the Greenspan Commission's report in 1983. The last of the scheduled tax hikes took effect in 1990.

Table 3 shows the increases to the Social Security tax rate since the program's inception. A worker who began receiving benefits in 1980 was likely paying just a 1.0 percent tax rate during their first years in the work force, and so was their employer. By 1960, the tax rate had been raised to 3.0 percent on both the employee and the employer. It had risen further to 4.2 percent in 1970 and 5.08 by 1980, their last year in the work force.

TABLE 3
Social Security Tax Rates

Calendar Years	Employee	Employer	Self-Employed
1937-49	1.00	1.00	–
1950	1.50	1.50	–
1951-53	1.50	1.50	2.25
1954-56	2.00	2.00	3.00
1957-58	2.25	2.25	3.38
1959	2.50	2.50	3.75
1960-61	3.00	3.00	4.50
1962	3.13	3.13	4.70
1963-65	3.63	3.63	5.40
1966	3.85	3.85	5.80
1967	3.90	3.90	5.90
1968	3.80	3.80	5.80
1969-70	4.20	4.20	6.30
1971-72	4.60	4.60	6.90
1973	4.85	4.85	7.00
1974-1977	4.95	4.95	7.00
1978	5.05	5.05	7.10
1979-1980	5.08	5.08	7.05
1981	5.35	5.35	8.00
1982-83	5.40	5.40	8.05
1984-87*	5.70	5.70	11.40
1988-89*	6.06	6.06	12.12
1990-2012**	6.20	6.20	12.40

Source: The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, Table VI.A. http://www.ssa.gov/oact/tr/2011/VI_A_cyoper_hist.html#171352
*In 1984 only, an immediate credit of 0.3 percent of taxable wages was allowed against the OASDI payroll tax contributions paid by employees. Similar credits of 2.7 percent, 2.3 percent, and 2.0 percent were allowed against the combined OASDI and Hospital Insurance (HI) contributions on net earnings from self-employment in 1984, 1985, and 1986-89, respectively. These credits were offset by reimbursements from the General Fund of the Treasury. Beginning in 1990, self-employed persons have been allowed a deduction, for purposes of computing their net earnings, equal to half of the combined OASDI and HI contributions that would be payable without regard to the contribution and benefit base. The OASDI contribution rate is then applied to net earnings after this deduction, but subject to the OASDI base.
**The temporary reduction in 2011 has not been included here.

By contrast, workers who reach age 62 in 2022 – the year when the rise in the age of eligibility for normal benefits is completed – will have paid the 6.2 percent current tax rate for most of their working careers. Even in their first years in the labor force, the tax rate would have already been over 5.0 percent. This means that they will have paid a considerably higher portion of their wages into the Social Security system than the cohorts that retired before them. They can also expect to get considerably less back due to the cuts in benefits over this period.

Conclusion

Proposals to reduce the annual cost of living adjustment for Social Security by changing the indexation formula are likely to lower the living standards of retirees. The effect of this reduction would be to lower the real value of benefits by approximately 3 percent after workers have been collecting benefits for 10 years, 6 percent after 20 years, and 9 percent after 30 years. The evidence from the reduction in benefits that resulted from changes in the consumer price index in the 1990s indicates that retirees did not change their work or saving behavior to offset this reduction in benefits. The Social Security share of retirement income actually rose for most groups, even though the size of the benefit was smaller relative to the lifetime earnings.

It is also important to recognize that benefits, relative to lifetime earnings, have already been cut for those retiring this year or in the near future. This is due in part to changes in the consumer price index that already cause it to show a rate of inflation that is at least 0.5 percentage points annually lower relative to the true rate of inflation than the consumer price index that was in place in the 1980s. The phase-in of the increase in the age of receiving normal benefits from 65 to 67 also reduces benefits. In addition, this group of near retirees has paid a considerably higher share of their wage income as Social Security taxes.

This is the baseline for any further cuts in benefits. These cuts are directed at a group of workers who are already getting less back in benefits and paying more into the system in taxes, relative to their wages, than the cohorts that preceded them.