Issue Brief

Key Points

- From its inception, the formulas for determining benefits payable under the Social Security System have included elements of individual equity and social adequacy, so that benefits vary in proportion to differences in worker contributions, yet benefits are sufficient to meet the deemed financial needs of most workers and covered dependents.

- According to the 2021 Social Security Trustees Report, accumulated assets will be depleted by 2034 and income to the system thereafter will be insufficient to pay all scheduled benefits when due.

- Some or all of this shortfall can be averted by changing the primary formula for retired worker benefits, changing the formulas for determining the benefits of eligible spouses and other dependents of workers, and/or changing the formula for computing annual cost-of-living increases.

- This issue brief explores a wide variety of proposals for changing the formulas for determining benefits that have been made over the years by members of Congress, government-appointed panels and commissions, and outside experts, with an eye toward how the proposed changes would affect the balance between individual equity and social adequacy.

Social Security Reform: Benefit Formula Options

AUGUST 2022

The Social Security program has broad public support and has served as a financial safety net for older and disabled Americans for decades. However, the growing number of retirees—combined with fewer workers per retiree to support them—threatens the long-term solvency of the program.

To address the program's long-term solvency, policymakers have been considering various options for boosting the Social Security system's income or reducing scheduled benefits. The Social Security Committee of the American Academy of Actuaries has published several issue briefs that review options for improving Social Security's financial condition.

This issue brief focuses on proposed changes to the formulas for determining the benefits of retired workers and their eligible dependents. Such changes can be part of reforms intended to address Social Security's financial situation, but can address other policy goals as well.

Background

From its inception, Social Security has included elements of individual equity and social adequacy. In this context, **individual equity** refers to the degree to which covered workers' benefits vary in proportion to differences in workers' contributions, which are in turn based on workers' earnings histories. **Social adequacy** refers to the degree to which benefits of covered workers and eligible family members meet their deemed financial needs. Thus, while the Social Security benefit formula takes into account a worker's pre-retirement earnings, beneficiaries defined in the law do not need to demonstrate financial need to receive their full scheduled benefits, and

benefits are proportionately higher for lower-income workers. Certain other features of the program also favor lower-income workers. The balance between social adequacy and individual equity has been maintained to varying degrees since the program's inception.

Each year, the Social Security trustees publish a report showing the estimated financial status of the system over the next 75 years. According to the 2021 Trustees Report, current balances in the Social Security Trust Funds plus projected income will fall short of projected benefit payments and administrative expenses by an amount equivalent to 3.54% of taxable payroll over the 75-year valuation period, using the trustees' intermediate assumptions. Eliminating this deficit would require an immediate and permanent across-the-board reduction in benefits of about 21% from scheduled amounts or some equivalent combination of benefit reductions and tax increases. (See the Academy's issue brief *An Actuarial Perspective on the 2021 Social Security Trustees Report*, September 2021.)

This issue brief describes various proposals for changing the current benefit formulas for workers and their eligible dependents that are listed on the website of Social Security's Office of the Chief Actuary (OCACT) at https://www.ssa.gov/oact/solvency/provisions/index.html. Other Academy issue briefs describe proposals for changing other components of the system, such as the taxes that support the system, and the age at which unreduced benefits are first payable to nondisabled workers. All cost figures for proposals described in this issue brief are based on the same projection model used for the 2021 Trustees Report. These cost figures take into account the effects of the COVID-19 pandemic. These cost figures are not strictly additive: The net change in the deficit from adopting more than one of the proposals described below may not equal the sum of the changes in the deficit attributable to the individual proposals due to interactions among the proposals. For proposals published and originally effective before 2021, OCACT has advanced the effective and/or phase-in years in the original proposal by the number of years from the publication year to 2021 so that timing is comparable among all proposals.

The Current Program

Determining a retired worker's monthly benefit level begins with calculating an adjusted career-average earnings. For this purpose, earnings includes only wages and income from self-employment, together called "covered earnings," up to a maximum amount—the contribution and benefit base, often referred to as the Social Security wage base. The contribution and benefit base is $142,800 in 2021. The contribution and benefit base is adjusted each year in proportion to changes in the national average wage index. Each worker's covered earnings before age 60 are adjusted by the ratio of the national average wage in the earlier of the second year before benefit commencement or the year the worker turns age 60 divided by the national average wage in the year earned. There is no adjustment to earnings at age 60 or later. For workers whose benefits commence at age 62 or later, indexed earnings for the 35 highest years—including, if necessary, years with zero earnings—are averaged and divided by 12; the resulting amount is called the "average indexed monthly earnings" (AIME). For disabled workers whose benefits commence before age 62, the number of years used in the AIME is the number of years from the calendar year of attainment of age 22 to the calendar year of commencement less a number of "dropout years," which varies from 0 (for those disabled before age 27) to 5 (for those disabled after age 46).

The fundamental amount on which most Social Security benefits are based is the "primary insurance amount" (PIA). The PIA is calculated by multiplying 90% times the AIME up to the first bend point in the formula, 32% times the portion of the AIME that falls between the first and second bend points, and 15% times the AIME over the second bend point, as illustrated in Graph 1. The bend points, where the percent factors in the formula change, are dollar amounts indexed over time by the same national average wage index used to adjust the contribution and benefit base and workers' earnings. The 2021 bend points are $996 and $6,002. Indexing workers earnings and the bend points in the benefit formula based on changes in the national average wage index helps ensure that initial Social Security benefits remain comparable over time for workers with similar earnings histories relative to prevailing wage levels.

Graph 1 below shows the PIA for persons turning age 62 in 2021 across the range of AIMEs. Although the PIA formula can be applied to any AIME, workers with AIMEs close to zero generally do not have a sufficient period of coverage under the system to be eligible for a benefit.

Graph 1: Monthly Primary Insurance Amount (PIA) Formula
(for Persons Turning Age 62 in 2022)
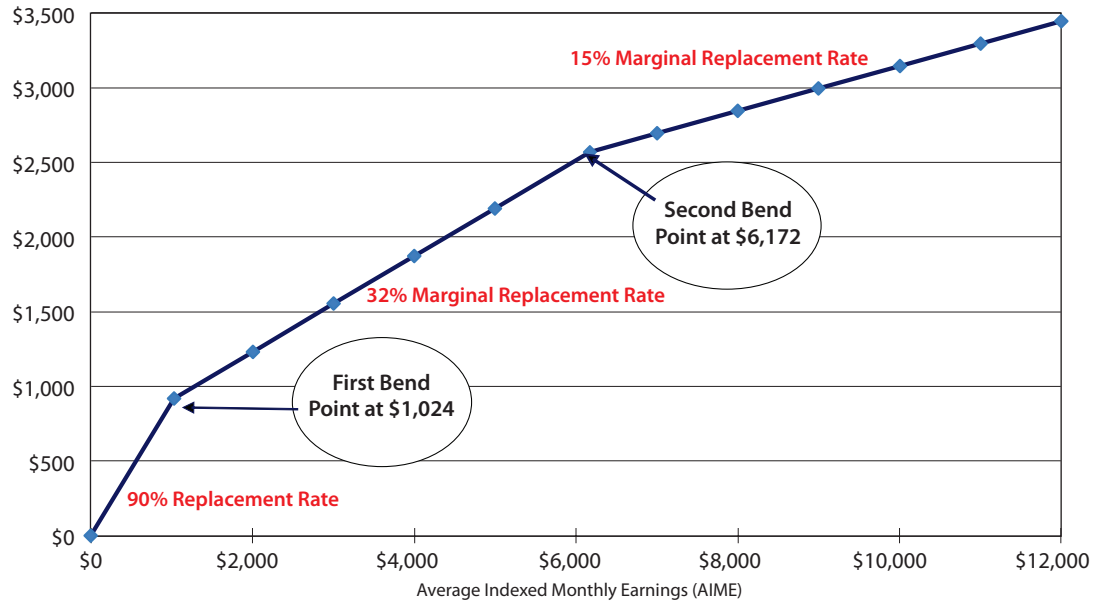
The PIA formula above does not include COLAs provided starting after age 62.

The PIA is indexed by an annual cost-of-living adjustment (COLA) beginning with December of the year the worker attains age 62. The COLA depends on changes in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), which is calculated by the Bureau of Labor Statistics (BLS). This indexing continues after benefit commencement in order to maintain the buying power of Social Security benefits during retirement. For workers whose benefits begin at normal retirement age (NRA), the monthly benefit equals the PIA. Benefits are reduced if a worker commences benefits before NRA and are increased if a worker commences benefits after NRA, but only up to age 70. NRA is 67 for workers born in 1960 or later, that is, those who attain age 62,—the earliest eligibility age for old-age benefits—in 2022 or later.

The Department of Health and Human Services (HHS) publishes annually poverty guidelines for the purpose of determining eligibility for some need-based benefit programs. The first bend point, $11,952 annualized, is close to the poverty guideline for a single person, $12,880 in 2021. Thus, a worker with earnings up to the poverty guideline receives a benefit at NRA that replaces nearly 90% of pre-retirement earnings, a benefit far higher than can be supported by the contributions based on those earnings. Benefit

amounts continue to increase as the AIME increases, up to the highest possible AIME, but the formula factors are much lower. At the highest possible AIME, the benefit at NRA replaces about 27% of pre-retirement earnings—a level insufficient to maintain the pre-retirement standard of living without other sources of retirement income. In particular, the benefit attributable to earnings above the second bend point, based on the 15% factor, is significantly lower than can be supported by the contributions based on those earnings. Excess contributions at the higher earnings levels subsidize the benefits of those at lower earnings levels. This makes it more likely that lower-income workers will have an adequate retirement income, including sources other than Social Security, than if the formula percentage were the same across the AIME spectrum. Social Security's progressive benefit formula is the primary way the program addresses the challenge of providing adequate benefits for workers with lower earnings.

The program also provides auxiliary benefits for current and former spouses and other dependents of a worker based on the worker's earnings history. The current structure of spouses' benefits was established when one-earner couples still predominated. At retirement, the lower-paid (or non-working) spouse receives a benefit based on 50% of the higher-paid spouse's PIA unless the lower-paid spouse can receive a higher benefit based on his or her own earnings history. If the higher-paid spouse dies first, the surviving spouse's benefit is based on 100% of the deceased spouse's PIA. Note that, because spouses may have different early or late retirement factors applied when determining their benefits, the benefit received by the lower-paid spouse may not be exactly 50% or 100% of the higher-paid spouse's benefit. Social Security also pays benefits to other family members in certain circumstances, including former spouses, dependent children, and parents.
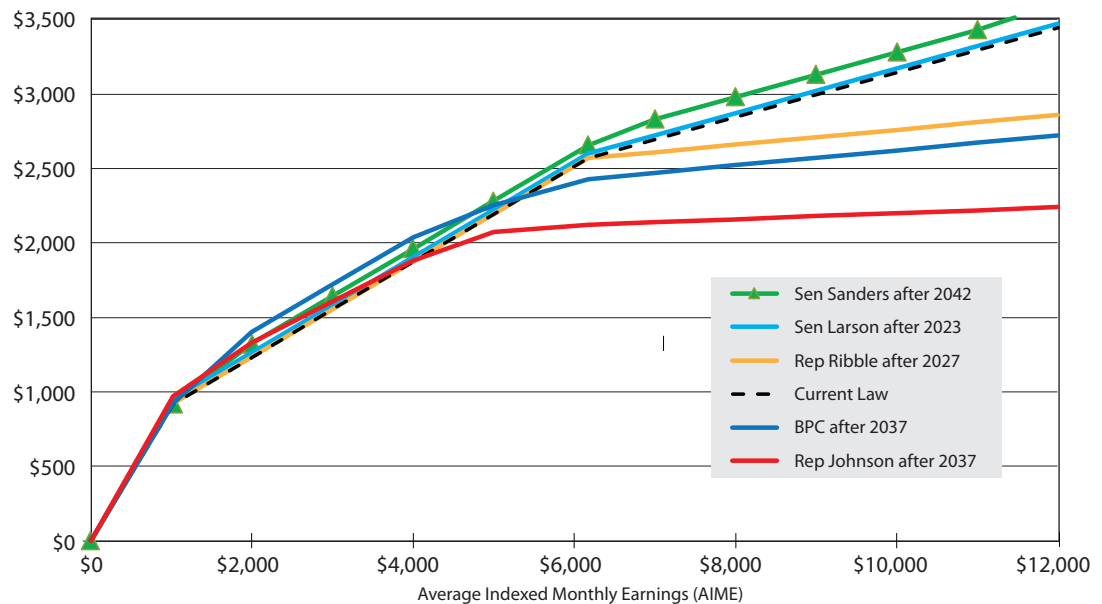
Reform Options and Possible Effects

PIA Formula

There are many ways the PIA formula may be changed, including changing the formula's bend points and/or percent factors, and adding new bend points and new percent factors. Following are five formula changes that have been proposed. Some of these formula changes increase the deficit while others decrease it. All are part of comprehensive proposals with various components that together would eliminate Social Security's long-term actuarial deficit. These comprehensive proposals include minimum benefits that override the PIA formula for some low-wage earners. These minimum benefits are described later in this issue brief.

- Sen. Bernie Sanders and Rep. Peter DeFazio, *Social Security Expansion Act (2019*): Would increase the first bend point by 1 percentage point of its current law value in addition to regular increases due to wage indexing from 2028 to 2042 until it is 15 percentage points higher than the indexed amount under current law. This proposal would increase the actuarial deficit by 0.39% of taxable payroll, expanding the deficit by 11%.

- Rep. John Larson, Sen. Richard Blumenthal, and Sen. Chris Van Hollen, *Social Security 2100 Act (2019*): Would increase the first PIA percent factor from 90% to 93% effective January 2023 for both beneficiaries in that month and future awards. This proposal would increase the actuarial deficit by 0.25% of taxable payroll, expanding the deficit by 7%.

- Bipartisan Policy Center (BPC), *Securing Our Financial Future (2016)*: Would raise the first bend point by about 28% and creates a new second bend point (with the current second bend point becoming the third) at about 63% of the way from this new first bend point to the third. The PIA percent factors would be 95% up to the first bend point, 32% from the first to the second, 15% from the second to the third, and 5% above the third. The changes would be phased in over 10 years from 2028 to 2037. This proposal would reduce the actuarial deficit by 0.09% of taxable payroll, eliminating 3% of that deficit.

- Former Rep. Reid Ribble, *S.O.S. Act (2016)*: Would decrease the third PIA percent factor from 15% to 5% in five equal steps from 2023 to 2027. This proposal would reduce the actuarial deficit by 0.37% of taxable payroll, eliminating 10% of that deficit.

- Former Rep. Sam Johnson, *Social Security Reform Act (2016)*: Would define three new bend points that replace the current two, set at 25%, 100% and 125% of the national average wage two years before a worker's initial benefit eligibility. The PIA formula would be 95% up to the first bend point, 27.5% from the first to the second, 5% from the second to the third, and 2% above the third. The new formula would be phased in from 2028 to 2037. This proposal would reduce the actuarial deficit by 1.00% of taxable payroll, eliminating 28% of that deficit.

Graph 2 shows how these five benefit formula proposals compare with each other and to the current benefit formula. The BPC proposal includes a separate provision that increases the contribution and benefit base, and thus the maximum AIME, beyond the current-law level. The graph shows the BPC PIA only up to the current law maximum AIME.

Graph 2: Monthly Primary Insurance Amount (excluding minimums)

Legend:
- Sen Sanders after 2042
- Sen Larson after 2023
- Rep Ribble after 2027
- Current Law
- BPC after 2037
- Rep Johnson after 2037

Average Indexed Monthly Earnings (AIME)

Number of Years Counted in the AIME

As noted above, current benefits are based on a worker's AIME, which for nondisabled workers is the average of the highest 35 years of indexed earnings. Some proposals would increase the number of years in the averaging period for non-disabled workers by three or five years, to 38 or 40 years, respectively, on the premise that improvements in health and longevity enable workers to have longer careers. Some of these proposals would, in addition, reduce the maximum number of dropout years for disabled workers by the same number, three or five. Because the current AIME uses indexed earnings in the highest 35 years, or some lesser number of years for most disabled workers, any additional years would necessarily be years with indexed earnings no higher than the lowest year included in the current average. Thus, such proposals would reduce the AIMEs of nearly all affected workers. The following proposals fit these criteria:

A. Social Security Advisory Board, _Request for Information_ (2005)

B. Former Rep. Jason Chaffetz, _Request for Estimates_ (2011)

C. Former Rep. Reid Ribble (2016), _S.O.S. Act_ (2016)

D. Mark Warshawsky, _Reform Proposal to Make Social Security Financially Sound, Fairer and More Progressive_ (2008)

Table 1 summarizes these four proposals:

Table 1

Proposal	Additional Years in AIME Calculation	Phase-In Period	Applies to Disabled Workers?	Savings as Percent of Taxable Payroll	Savings as Percent of Current Deficit
A	3	2022–2026	No	0.27%	8%
B	5	2022–2030	No	0.45%	13%
C	2-4	2023–2025	Yes	0.37%	10%
D	5	2023–2031	Yes	0.60%	17%

Increasing the number of years in the averaging period would have especially adverse consequences for workers who do not have steady earnings. Concern has been particularly focused on parents who leave paid employment to care for children. One way to address this concern is to allow dropout years for child care, i.e., shortening the averaging period by excluding qualifying zero earnings years from the calculation of AIME. Former Rep. Patrick Murphy's bill, _The Social Security Parent Penalty Repeal Act_ (2016) would provide up to five dropout years for a parent caring for one or more children under age six. Under this bill, a parent must have no earnings, covered or non-covered, in a calendar year due to child care responsibilities to qualify for a dropout year. For each child, only one parent can qualify in a given year, and neither parent can qualify for more than two years. This bill would increase the actuarial deficit by 0.05% of taxable payroll, expanding the deficit by 1%.

The "Mini-PIA"

Former Rep. Sam Johnson's and BPC's proposals in 2016 both include a provision that would eliminate the AIME for nondisabled workers, so that the PIA formula is applied separately to each year of a worker's earnings, adjusted by the national average wage index as described above. The separately calculated amounts for the highest 40 years of adjusted earnings are totaled and divided by 37 to yield the PIA. The PIA calculated by this method is frequently referred to as the "mini-PIA." Benefits for disabled workers would continue to be calculated under the current law. Adopting the mini-PIA without any change to the PIA formula itself would reduce the actuarial deficit by 0.21% of taxable payroll, eliminating 6% of that deficit.

For workers whose earnings remain consistently either (1) below the first bend point, (2) between the first and second bend points or (3) above the second bend point during their entire careers, adopting the mini-PIA would affect their PIAs only due to increasing the number of years used in the calculation from 35 to 40 but increasing the denominator from 35 to only 37. The mini-PIA has a greater impact on workers with fewer than 37

years of covered earnings or whose compensation varies markedly from year to year, especially those with periods of unemployment or part-time employment. The mini-PIA is intended to address a perceived unintended consequence of the progressive benefit formula that allows high-wage workers to enjoy periods of voluntary unemployment and be treated as low-wage workers when the resulting zero earnings years are included in the AIME. However, a 2013 study by the Urban Institute showed that lower-wage workers are more likely to have periods of unemployment. Based on this study, this proposal would reduce benefits more for lower-wage than for higher-wage workers.

Minimum Benefits

The Social Security Amendments of 1972 created the special minimum PIA to provide adequate benefits to long-term low-wage earners. Initially set at $170 per month for workers with at least 30 years of covered employment, prorated for workers with fewer than 30 years of covered employment, the amount has grown by the CPI adjustment to $950.80 in 2021. Because the bend points used to calculate the regular PIA are adjusted by the national average wage index, which historically has increased more rapidly than the CPI, the special minimum PIA has affected an ever-smaller percentage of Social Security beneficiaries over time. In 2019, the most recent year for which data is available, only 32,092 out of over 64 million Social Security beneficiaries were receiving benefits determined by the special minimum PIA.

The same 1972 law also created the Supplemental Security Income (SSI) program, funded by general revenue rather than the dedicated payroll tax, which provides additional income for persons who are disabled, blind, or over age 65 and who meet eligibility requirements based on income and resources. The maximum resources allowed to qualify for an SSI benefit have not been updated since 1989: $2,000 for a single person or $3,000 for a couple, excluding a primary residence, an automobile valued up to $4,500, household goods valued up to $2,000 and a life insurance policy with a face value not exceeding $1,500. As a result of these limits on resources and limits on income that vary by state, only about 2% of recent nondisabled retired workers and their dependents qualify for SSI benefits. (The percentage is much higher for those disabled or blind.)

Many proposals have been made to address the problem of retirement income adequacy for low-wage workers. Most commonly, the proposals update the special minimum PIA by basing the amount on a percentage of HHS's poverty guideline for a single person, described above, in the year of implementation, adjusted in subsequent years by the national average wage index. Proposal C below uses, instead, the Census Bureau's poverty threshold for an aged single person, a slightly higher figure ($12,996 for the threshold vs. $12,880 for the guideline). Such proposals include four parameters used to determine

the minimum PIA: the minimum percentage of the poverty level under the proposal; the number of years of coverage required to qualify for the minimum percentage; the maximum percentage of the poverty level; and the number of years of coverage required to qualify for the maximum percentage. The percentage of the poverty level increases linearly going from the minimum to the maximum coverage years. Thus, for example, under Proposal A in Table 2, for a worker with 10 or fewer years of coverage the special minimum PIA is 0% of the poverty level; i.e., there is no minimum PIA. For each year of coverage over 10 years, the percentage increases by 6.25 percentage points, until the percentage reaches 125% for a worker with 30 or more years of coverage. Under Proposal B there is no minimum benefit for 10 years or less of coverage. At 11 years of coverage the applicable percentage would be 36⅔ percent, which would then increase by 3.33 percentage points for each of the next 19 years to 100% after 30 years. The following proposals fit these criteria:

 A. Rep. John Larson, Sen. Richard Blumenthal and Sen. Chris Van Hollen, *Social Security 2100 Act* (2019); Sen. Bernie Sanders and Rep. Peter DeFazio, *Social Security Expansion Act* (2019)

 B. Rep. Gwen Moore, *Social Security Enhancement and Protection Act* (2019)

 C. Former Rep. Reid Ribble, *S.O.S. Act* (2016)

 D. Former Rep. Jason Chaffetz, *Request for Estimates* (2011)

Table 2 summarizes these four proposals:

Table 2

Proposal	Year of Implemen-tation	Minimum Percent of Poverty Guideline	Minimum Percent Years of Coverage	Maximum Percent of Poverty Guideline	Maximum Percent Years of Coverage	Cost as Percent of Taxable Payroll	Cost as Percent of Current Deficit
A	2022	0%	10	125%	30	0.17%	5%
B	2022	36 %	11	100%	30	0.11%	3%
C	2023	100%	20	125%	40	0.12%	3%
D	2022	0%	10	100%	30	0.09%	3%

Note: Proposal C has an additional phase-in from 0% to 100% of the poverty level from 10 to 20 years of coverage.

Two other proposals take different approaches. Former Rep. Johnson's 2016 proposal would base the special minimum PIA on a percentage of the national average wage two years prior to initial benefit eligibility, adjusted by the CPI index after initial eligibility. The percentage would be zero—i.e., there would be no minimum benefit—for workers with 10 or fewer years of work. Starting from zero, the percentage would increase 3

percentage points per year for each year of work over 10, reaching 15% after 15 years, and then increase 1 percentage point per year to 19% after 19 years. It would then jump to 25% after 20 years, and then increase 0.66 percentage points per year to 35% for 35 or more years of work. Years of work for this purpose is defined as years a worker earns an amount at least equal to $10,875 in 2021, adjusted thereafter according to the national average wage index. The minimum benefit would be phased in from 2028 to 2037. This proposal would increase the actuarial deficit by 0.33% of taxable payroll, expanding the deficit by 9%.

BPC's 2016 proposal would define a basic minimum benefit (BMB) equal to a BMB base—$604 for a single worker and $906 for a couple in 2015, adjusted thereafter by the national average wage index—reduced, but not below zero, by 70% of total monthly household Social Security benefits based on the PIA. The BMB would be paid in addition to other Social Security benefits, but only to beneficiaries at or over the normal retirement age. The BMB would be reduced further for households with significant income other than Social Security. This proposal would increase the actuarial deficit by 0.21% of taxable payroll, expanding the deficit by 6%.

Graph 3 shows the same five proposed PIA benefit formulas illustrated above in Graph 2 modified to incorporate the minimum benefits also included in their respective reform packages, in each case on the basis that the worker has sufficient years of coverage for the full minimum benefit:

Graph 3: Monthly Primary Insurance Amount (including minimums)
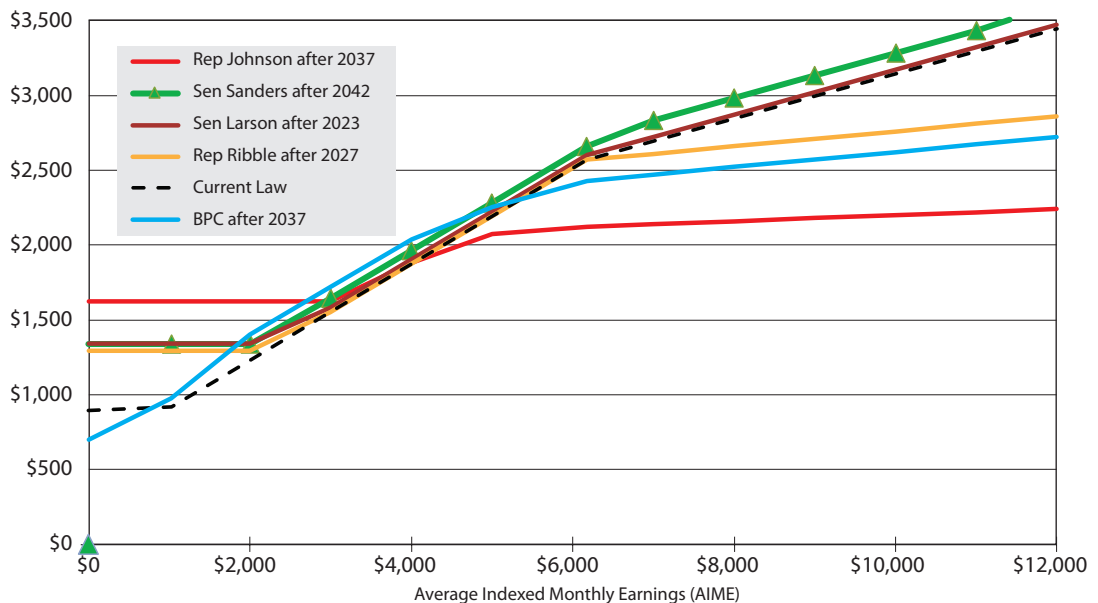
While minimum benefits can address poverty among the elderly, if combined with formula changes that reduce benefits for high-wage workers, the overall effect would be to make benefits more level across the wage spectrum. This would shift the individual equity/social adequacy balance described above away from individual equity and toward social adequacy.

Benefits for Spouses and Other Dependents

Current Social Security benefits are structured to meet the needs of families with one primary wage earner—the situation that predominated when the system was designed. As a result, one-earner couples receive proportionately higher benefits than two-earner couples relative to the taxes they pay into the system. Consider a simplified hypothetical illustration: Suppose each member of a two-earner couple receives a monthly benefit of $2,000 based on his or her own earnings history. When both spouses are alive, the couple together receives $4,000. If one spouse had never worked in covered employment, the nonworking spouse would receive 50% of a benefit based on the working spouse's AIME, so the couple together would receive a monthly benefit close to $3,000 per month, three quarters of the amount the two-earner couple receives. The two-earner couple pays twice the taxes of the one-earner couple, but receives benefits only about a third higher. The disparity is greater after one spouse dies. In the two-earner couple, the surviving spouse receives the benefit based on the higher AIME, $2,000 or slightly higher. In the single-earner couple, if the employed spouse dies first, the surviving spouse receives 100% of a benefit based on the working spouse's AIME, again close to $2,000. Thus, after the death of one spouse, the surviving spouse in the two-earner couple gets little, if any, benefit from the additional payroll taxes they paid.

Two reform proposals include limiting benefits to nonworking spouses and other dependents, thereby decreasing system costs and the actuarial deficit while reducing the benefit disparity described above between one-earner and two-earner couples:

Under the BPC's 2016 proposal, for nondisabled workers who attain age 62 in 2028, benefits to the spouses of living workers would be limited to the benefits under current law payable to the spouse of a worker whose AIME is at the 75th percentile of all such workers. Thus, among workers who attain age 62 in 2028, the 75% with the lowest AIMEs would be eligible for the same spousal benefit as under current law, while the spousal benefit of the remaining 25% would be limited to the highest dollar amount payable to the spouse of a worker in the 75% low-AIME group. For workers who attain age 62 after 2028, the dollar amounts of the 2028 limits would be indexed annually by the "chained CPI" (described below). Because other Social Security benefits are indexed by the national average wage, as time goes by these limits would be expected to affect

an increasing proportion of spousal benefits. This proposal would reduce the actuarial deficit by 0.08% of taxable payroll, eliminating 2% of that deficit.

Under former Rep. Sam Johnson's 2016 proposal, benefits payable to the spouses and children of living workers, both disabled and nondisabled, would be limited to the benefits under current law payable to the eligible dependents of a worker whose earnings equal the national average age in each year of employment. This limit would be phased in from 2028 to 2037. In contrast to the BPC proposal described in the preceding paragraph: (1) the Johnson proposal would include children as well as spouses, and disabled as well as nondisabled workers; (2) in the effective year, 2028, the Johnson proposal would apply to a higher proportion of workers, because the AIME of a worker whose earnings always equaled the national average wage is lower than the 75th percentile AIME; (3) however, the proportion of affected workers would remain roughly constant over time under the Johnson proposal, because the dollar limits are recalculated each year based on current earnings levels rather than increased by a the chained CPI; and (4) the full effect of the Johnson proposal would be phased in over 10 years instead of becoming fully effective in 2028. This proposal would reduce the actuarial deficit by 0.08% of taxable payroll, eliminating 2% of that deficit.

A proposal first made by the 1994–1996 Social Security Advisory Council and later taken up by former Sen. Mark Begich and Sen. Patty Murray in 2014 (*Retirement and Income Security Enhancements [RAISE] Act*) and by Rep. Al Lawson in 2017 (*Social Security for Future Generations Act of 2017*) provides a minimum surviving spouse benefit of 75% of the sum of each spouse's benefit based on the spouse's own earnings history (even if one spouse actually receives a benefit based on the other's earnings history when both are living), but not greater than the PIA of a hypothetical worker whose earnings has always equaled the national average wage. This would increase the survivor benefit in some situations when the lower earning spouse's benefit is at least a third of the higher-earning spouse's benefit, but the cap on this minimum benefit means that couples with high combined earnings receive no increase. This provision would improve equity in survivor benefits between one-earner and two-earner couples, but at the cost of increasing the actuarial deficit by 0.11% of taxable payroll and expanding that deficit by 3%.

None of these proposals would have a major impact on Social Security's financial condition. Proposals regarding benefits for spouses and dependents are often intended to achieve greater parity between one-earner and two-earner families rather than to address Social Security's financial condition.

Cost-of-Living Adjustments (COLAs)

As noted above, the benefit amounts of all beneficiaries and of workers beginning at age 62 are adjusted annually according to the consumer price index (CPI-W) calculated by the BLS. Proposals have been made for both decreasing and increasing the rate of adjustment. In such proposals, the changes would apply to all current and future beneficiaries, although in theory one or more categories of beneficiaries could be exempt from the change. Decreasing the adjustment rate would cause benefits to decrease gradually over time compared to benefits under current law, thereby decreasing system costs and the actuarial deficit. Increasing the adjustment rate would have the opposite effects.

Proposals to decrease the adjustment rate are often justified by claims that the CPI as currently calculated overstates the rate of inflation. Since August 2002, BLS has published a chain-weighted version of its Consumer Price Index for All Urban Consumers (CPI-U), commonly referred to as the "chained CPI," which is intended to better take into account consumers' tendency to change their buying habits when the prices of some goods increase more rapidly than others. OCACT estimates that adopting the chained CPI would reduce the annual COLA by 0.3 percentage points, thereby reducing the actuarial deficit by 0.62% of taxable payroll and eliminating 18% of that deficit. Former Rep. Ribble's 2016 proposal included this provision. The BPC's 2016 proposal includes a similar provision that applies the chained CPI to old age and survivor benefits, but not to disability benefits.

An alternate approach to lowering future annual benefit adjustments is to set the COLA at a fixed percentage below the full increase in the current CPI-W. A 2011 proposal by former Sen. Kay Bailey Hutchison would reduce the COLA by 1 percentage point below the CPI, but not below zero, beginning in 2021. This change would reduce the actuarial deficit by 1.84% of taxable payroll, eliminating 52% of that deficit.

If a reduction in the COLA were enacted, it could be instituted quickly without major adjustments in program administration—and unlike most other changes, it could apply to current beneficiaries, thus providing a more immediate improvement to Social Security's finances. Some policymakers suggest that everyone should participate in eliminating Social Security's long-range deficit, including current beneficiaries. On the other hand, reducing the COLA could over time push into poverty additional workers close to the poverty threshold at retirement. A reduction in the COLA would have a cumulative effect, so that the oldest beneficiaries would experience the largest relative benefit reductions. If benefits increased by 1% per year less than under the current program, the cumulative reduction would be about almost 10% after 10 years, and over 18% after 20 years.

Going in the opposite direction, some proposals would adopt for Social Security purposes a separate CPI reflecting the buying patterns of elderly people. An experimental CPI-E, based on the buying patterns of households in which either the head of household or that person's spouse is age 62 or over, has been constructed by the BLS. OCACT estimates that adopting the CPI-E would increase the annual COLA by 0.2 percentage points, thereby increasing the actuarial deficit by 0.42% of taxable payroll, expanding the deficit by 12%. This provision is included in the 2019 proposals by Rep. Larson, Sen. Blumenthal and Sen. Van Hollen, and by Sen. Sanders and Rep. DeFazio.

Policy Questions

According to the 2021 Trustees Report, without some combination of benefit decreases and tax increases, the Social Security trust fund reserves will be depleted in 2034, at which time benefits must be reduced to the level that can be supported by current income, which in 2034 would be about 78% of scheduled benefits. Changing the formulas for calculating benefits to yield a net reduction in benefits can be part of system reforms that delay or avoid trust fund reserve depletion. Changing the formulas can serve other purposes as well, such as meeting the needs of diverse families, responding to changes in working patterns and alleviating poverty among the elderly. Balancing these sometimes competing goals requires careful deliberation.

Congress might consider the following policy questions during the coming debate over Social Security solvency and other possible system reforms:

- How much of the actuarial deficit should be addressed by reducing benefits, whether by changing benefit formulas, as discussed in this issue brief, or by mechanisms covered in other Academy issue briefs, such as raising the normal retirement age, and how much by raising taxes?
- How can the benefit formulas best be restructured to meet the needs of a society whose family structures and working patterns are becoming increasingly diverse?
- Should Social Security be the principal vehicle for lifting out of poverty those retirees who remain in poverty under the current system, or can this goal best be achieved through a need-based program such as SSI?
- Would a change to the benefit formula that affects the balance between individual equity and social adequacy affect public support for the program?