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CAPITAL INCOME FLOWS AND THE RELATIVE WELL-BEING OF AMERICA'S AGED POPULATION

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One way to assess the effectiveness of a nation's pension system is to measure its success in bringing the incomes of the aged close to those enjoyed by nonaged adults. The comparability of income estimates for the aged and nonaged depends, however, on the relative accuracy of the income reports for the two populations. Unfortunately, some income items that are particularly important to the elderly, including occupational pensions, income derived from financial assets, and returns on homeowners' net equity in their principal residence, are either unreported or significantly underreported in household surveys.

In this paper we assess the effects of unmeasured and underreported income flows on the relative incomes of the aged and near-aged. We first consider the accuracy of "money income" estimates on two household survey files, the Census Bureau's Current Population Survey (CPS) and the Federal Reserve Board's Survey of Consumer Finances (SCF). Income reports on these surveys are compared to aggregate income totals recorded in the National Income and Product Accounts (NIPAs) and the Internal Revenue Service's Statistics of Income. We define money income in a way that is consistent in the NIPAs and the household surveys, and we then document and account for the reporting differences in the three sources. We compare the distributions of money income reported on the CPS and SCF to see whether these two micro-census files tell a consistent story about the relative income positions of households headed by aged and nonaged adults.

Estimates of aggregate household income from the CPS account for roughly 70-75 percent of total personal income recorded in the NIPAs. Some of the difference reflects measurement error and income under-reporting in the CPS. However, much of the discrepancy is the result of conceptual differences in the definition of income between the CPS and the national accounts. The main CPS income definition ("money income") focuses on cash income directly received by households, a measure that is closely related to the income that would be reported on tax returns. The NIPA measure of (gross) personal income is much broader. We make adjustments to the NIPA estimate of personal income to align it more closely with the concept of money income used in the CPS. Once these adjustments are made, income underreporting appears to represent a much smaller problem in the household surveys. Our estimates show, however, that underreporting causes earned income to be understated by about 10 percent in the CPS and income from capital and pensions to be understated by a larger and more variable amount. Although earned income underreporting appears to represent a less serious problem in the SCF, we show that underreporting of government transfer income is a more serious problem in that survey than it is in the CPS. On the whole, incomes appear to be much better reported at the top of the income distribution in the SCF and better reported at the bottom of the income distribution in the CPS.

Along with previous analysts who use standard income definitions and analyze the relative well-being of the young and the old, we find that households headed by an aged person have lower money incomes than households headed by someone who is nonaged. (All of our calculations adjust incomes to reflect differences in household size, since smaller households require less income than larger households to enjoy the same standard of living.) Except in the lowest ranks of the income distribution, the money incomes of aged households are lower than those of nonaged households which occupy the same relative position in the distribution of nonaged household income.

Our more interesting findings shed light on the impact of using a more comprehensive income definition in order to measure the relative positions of households headed by younger and older persons. Money income is a meaningful but incomplete measure of the resource flow available to households in order to support consumption. About two-thirds of U.S. households live in a house or apartment that is owned by an occupant. Residents of these households obtain a flow of services that is not counted in money income but that does free up part of their money income to be spent on other items. One of our adjustments adds the implicit income flow from owner-occupied housing to the money incomes reported in the CPS and SCF surveys.

Pension income is substantially underreported in both the CPS and SCF surveys. Even if all payments from defined-benefit (DB) pension plans were accurately reported in household surveys there would remain a problem with the way defined-contribution (DC) pension accounts and IRAs are treated in the money income statistics. Most withdrawals from DC pension and IRA plans are excluded from reported money income. If we compare two workers, one enrolled in a DB plan and another enrolled in a DC or IRA plan, the treatment of their withdrawals from their pension accounts differs greatly under the current definition of money income. Regular pension payments from a DB plan are included in the definition of money income. However, withdrawals from a DC or IRA plan are only included if they represent a regular income flow. For most workers, withdrawals from a DC plan or from an IRA are too erratic to be classified as a regular income flow. Consequently, a large fraction of withdrawals is intentionally excluded from money income. This conceptual limitation in the definition of money income leads to a substantial understatement of DC pension plans' contributions to the resources available for financing consumption in old age.

Households headed by an older person have typically accumulated far more savings in a DC or IRA plan than households headed by a nonaged person. In addition, older households have also accumulated more financial assets outside of pension accounts. Much of this savings is intended to help pay for consumption in old age. A second adjustment we make to the standard income definition is to convert households' savings accumulation in DC and IRA accounts and in other financial assets into a level annuity that lasts for the lifetime of the family head. If the household head is married, we calculate the joint survivor annuity that the household could buy with its DC and IRA plan accumulations and other financial assets.

In both the CPS and SCF files, the relative position of aged households is worse when income is measured using the money income definition than it is under more comprehensive definitions. The relative income position of aged households appears much better under the broadest income definition. Using the money income definition, the median and average income of aged households are each considerably lower than the corresponding income amounts for nonaged households. For example, in the CPS the median money income of aged households is 28 percent lower than the overall median income; the median money income of nonaged households is 4 percent higher than the median money income in the entire population. In contrast, under the broadest definition of income, which includes an estimate of the annuity on financial assets as well as returns on net home equity, the median incomes of aged and nonaged households are essentially the same. Under the money income definition, the average income of members of aged households is substantially below the average income in nonaged households. Under the broadest income definition, it is substantially higher than the average income in nonaged households. Each of these conclusions is confirmed in our analyses of 2000 incomes based on income reports in the CPS and income and wealth reports in the SCF.

In sum, the relative position of aged households depends crucially on whether money income or a broader income definition is used to estimate household incomes. When income is measured using the Census Bureau's money income definition, aged households appear considerably worse off than nonaged households. In contrast, under the broadest measure of household income, aged and nonaged households appear to have similar incomes in the middle of the income distribution, and aged households have higher incomes than the nonaged in both the top and bottom quarters of the income distribution. Two major goals of U.S. public policy are to increase homeownership and encourage savings in private retirement accounts. In comparison with other industrialized nations, the United States has achieved high homeownership rates and its workers have accumulated large reserves in private, funded pension plans. Under the standard definition of money income used by the Census Bureau, very little of the income flow that is generated by these forms of wealth is included in household income. Using a broader income definition that includes these income flows, the relative position of the nation's elderly is substantially improved. Under the broadest definition of income we consider in our paper, the economic status of America's aged appears to be approximately the same if not better than that of nonaged households.

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