A drop in Social Security's Average Wage Index could hurt 4 million people

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MarketWatch Blog by Alicia H. Munnell

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Fortunately, legislators are already proposing fixes

I understand that not everyone savors, with as much enthusiasm as I do, testimony by Steve Goss, Social Security's Chief Actuary. But I always find it very helpful. His most recent appearance before the House Ways and Means Subcommittee on Social Security touched on a number of ways that COVID-19 might affect the program and clarified the implications of a drop in the Average Wage Index (AWI) and how proposed legislation might address the problem.

The **2020 Trustees Report** projected that the AWI, which equals total wages in the year divided by the number of wage earners, would increase by 3.5 percent from 2019 to 2020. But, in the wake of COVID-19, the Average Wage Index in 2020 is likely to decline rather than increase.

As a result, those born in 1960 (who turn 60 in 2020) could see a permanent cut in their benefits. The problem arises because past earnings and the benefit formula are adjusted by Social Security's AWI.

More specifically, benefits are calculated in two steps. The first step is determining the worker's Average Indexed Monthly Earnings, which involves adjusting nominal earnings for each year up to age 60 by the AWI and identifying the highest 35 years for calculating the average. To the extent that the AWI declines, average monthly indexed benefits will be lower.

The second step involves calculating the Primary Insurance Amount – the benefit payable at the Full Retirement Age of 67 – by applying Social Security's progressive benefit formula to the worker's Average Indexed Monthly Earnings. The thresholds in the benefit formula are also indexed by the AWI. If the thresholds decline, workers will find more of their earnings in brackets with lower replacement rates.

So, what might happen to the AWI this year? Although no one knows for sure, experience so far in 2020 suggests that total wages will be about 10 percent lower than projected in the 2020 Trustees Report and the number of workers will be about 1 percent lower than projected. (The number of workers doesn't decline very much because AWI includes all wage earners even if they only worked for the month of January.) If these percentage declines play out, then the average wage index will be 9.1 percent (1 – 90/99) lower than projected for 2020.

One more calculation is required to get at the likely change in the AWI between 2019 and 2020. As noted, the assumptions in the 2020 Trustees Report imply that the AWI in 2020 would equal 1.035 of the AWI in 2019. However, because of the pandemic, the 2020 AWI will be only .909 (90/99) of the projected level. Therefore, the 2020 AWI would actually equal only .941 (.909 x 1.035) of the 2019 value – a decline of 5.9 percent.

Assuming these declines come to pass, about 4 million people will receive benefits that are 9.1 percent less than expected or 5.9 percent less than benefits awarded in 2019. These reductions apply throughout the beneficiary's lifetime. This loss is meaningful.

As a result, two bills have been submitted to offset these impending losses. While legislation could restore the entire 9.1-percent shortfall, both focus on eliminating the 5.9-percent drop in the AWI from 2019 to 2020. Senators Tim Kaine (D-VA) and Bill Cassidy (R-LA) introduced the "Protecting Benefits for Retirees Act." This bill would not allow the AWI to drop from one year to the next for benefit computation purposes, but instead would use the highest previous level – in this case the 2019 AWI. Congressman John Larson's (D-CT) "Social Security COVID Correction and Equity Act" would also eliminate the reduction in benefits due to the drop in the AWI, but only for those who become newly eligible two years after the decline. The bill, however, also provides one-year increases for many Social Security beneficiaries and Supplemental Security Income recipients in 2020. Neither bill would have a significant effect on the actuarial status of the program.

Fascinating, eh??