Born 1960 or Later? COVID Could Wreck Your Retirement

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In recent years, some pundits have pointed to the Social Security Trust Fund and referred to it as a "ticking time bomb." The idea is that the amount of money in the Trust Fund will start going down soon, and will eventually be exhausted, resulting in lower Social Security benefits for everyone. Maybe. But as we discussed in previous articles, that particular time bomb isn't scheduled to explode until 2035.

But there's something more pressing that hasn't gotten nearly as much attention. And this time bomb is scheduled to go off much sooner. Due to COVID-19, it's a pending reduction in Social Security benefits payable to anyone born 1960 or later. According to a recent study by the Wharton Pension Research Council, for people born 1960 or later, the drop in benefits eventually received will be as much as 13 percent. The culprit in this case is what's known as "wage indexing."

HOW INDEXING WORKS

Since 1951, the Social Security Administration (SSA), has "indexed" past earnings to adjust for inflation. The SSA uses the "National Average Wage Index," or AWI, to calculate a revised income figure for past earnings.

Over time the AWI is used to adjust previous years' incomes to more reasonable modern amounts. For example, according to SSA figures, the AWI was $12,513.46 in 1980, and $52,145.80 for 2018, which is the most recent year available. They then use the indexed figures to adjust earnings from previous years upwards and calculate the Social Security benefit in today's dollars. Without such an adjustment, your Social Security benefit would be minuscule in today's dollars.

But it's important to note that indexing stops once you reach age 60. Once the last set of calculations is made, they are fixed for the individual's lifetime. They are not recalculated when the AWI subsequently continues to change. Also note that Cost of Living Adjustments (COLAs) don't begin until age 62.

The AWI is developed by the Social Security Administration based on the data it receives from the IRS. Basically, it is total wages divided by total wage earners. Enter COVID-19. The recent pandemic has caused a sudden jump in unemployment, and with it a significant drop in total wages paid. This will have an impact on AWI, and thus the indexing of past wages.

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So for anyone born in 1960, this is especially bad news. They all turn 60 this year. A drop in employment this year means that your last indexed figure will likely go down. And all your past earnings, starting with what you earned decades ago, will be adjusted downward. Through no fault of your own, your Social Security benefit will drop as a result.

Many people track their projected Social Security benefit over time. If you enroll online (at SSA.gov), you can get your most recent statement from SSA, plus they notify you on an annual basis when the statement gets automatically updated. The updated statement becomes available early in the year, once your previous year's earnings are tabulated.

In recent years, many people have seen their projected Social Security benefit go up from one year to the next, even if they make the same amount of money. This is partly because of indexing. Earnings from earlier years, which had already been adjusted, will normally go up slightly more when the new data comes in.

Right now, most people have no idea of the pending drop, and they won't know anything until early 2022. That's just the way the government does it. The information becomes available every year in mid-November, 11 months after the end of the previous year. So the new employment figures for this year will be reflected in the data published in November 2021. And the projected reduction in benefits will be reflected on Social Security statements that go out early the following year.

HOW BAD WILL IT BE?

A little bit of history here. Wages have been indexed by the SSA since 1951. The AWI varies from year to year, but it has only been negative once. During the "Great Recession," AWI was $41,334.97 in 2008, but went down to $40,711.61 the following year. The lower AWI resulted in a lower future Social Security benefit for everyone then age 60 and under. The drop was reported in November of 2010, affecting Social Security benefits for those reaching age 62 in 2011.

Although the index went down by approximately 1.5 percent, the actual drop in benefits was more severe. And once it went down, the AWI never caught up to the projections that were in effect before 2009.

Worse than that, it turned out that as a result of the Great Recession, everyone born 1949 or later experienced a reduction in benefits. But the people born in 1949 had to bear the full brunt. This is equivalent to what's known as "sequence of returns" risk. When you retire, the final year's returns on your assets carry a huge burden. And if that last year is negative, you may not be able to generate as much income as you first thought. When it comes to Social Security, the same concept applies to wage indexing.

The current problem has not gotten a lot of public attention, but it has been noticed. An article in *The Wall Street Journal* discussed the issue on May 11. "Before averaging past earnings, Social Security 'indexes' those earnings to the growth of national average wages up to the year in which he turns 60. Nominal earnings in any past year are multiplied by the ratio of the national average wage in the year the worker turns 60 to the national average wage in the year the earnings took place."

A 1.5 percent drop in the index may not seem like much, but it's more complicated than that. The index is used to calculate your Average Indexed Monthly Earnings (AIME). "Bend Points" are then applied to the AIME to calculate the actual benefit. The math is beyond the scope of this article, but keep in mind that a drop in the index devalues not just this year's earnings, but every year's earnings since you started working.

Not many people realize that the benefit listed in your official Social Security statement is just a projection. There are implicit assumptions that affect the numbers you see. Among them: an assumption that you will continue to make the same amount of money every year from now until you retire, and an assumption that the wage index will rise every year by 3.5 percent. So if the AWI goes down by 1.5 percent, that's actually a net drop of 5 percent. This is made clear by studying the 2009 data.

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The results would likely be similar should AWI drop by a comparable amount in 2020. The 2009 AWI decrease of 1.5 percent was caused by the financial crisis of 2007-2008, while our current situation has been caused by the pandemic. With a full recovery we can eventually expect the AWI to start going up again in future years, but it will set a new lower "track." In other words, even if the index resumed growing by 3.5 percent once again next year, it would never catch up to the previous estimate. This is exactly what happened back in 2009.

In its paper published April 2020, "How the Coronavirus Could Permanently Cut Near-Retirees' Social Security Benefits," the Wharton School noted that "due to how the Social Security benefit formula interacts with the sharp economic downturn due to the Coronavirus, some groups of near-retirees are likely to suffer substantial permanent reductions to their Social Security retirement benefits." The study goes on to note that a middle-income worker born in 1960 could have their annual Social Security benefits in retirement reduced by around 13 percent, with losses over the retirement period in excess of $70,000.

WHAT CAN BE DONE?

It is an open question as to whether the SSA can change the indexing formula without congressional approval. If they can, they might be able to switch from an annual calculation to a five-year moving average. That would likely smooth out some of the "bumps." Another possibility is simply to not allow negative figures. This is exactly how Social Security COLAs work.

Of course, not all of the employment data is in yet for 2020. And there is hope for an employment recovery. People age 60 and under have a lot riding on that.

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