Review of
"Social Security's Five OASI Inflation Indexing Problems"
by Michael Lovell

As the Social Security programs face the retirement wave of the baby-boom population and the issue of program solvency, this paper is a timely piece of research. It adds to the body of research and analysis that shows that minor changes to program parameters can make significant contributions to the long term solvency of the program, and even make the program more equitable and efficient. Viewed in another context, the paper also shows how complicated the retirement decision really is and, to some extent, how the "luck of the draw" (in terms of birth year and economic conditions during the year of attainment of age 60) plays in determining how an individual will fare in lifetime retirement income.

The paper refers to the 5 identified issues as "problems", although it may be more accurate to refer to them as anomalies or, perhaps, imperfections, rather than problems. Clearly no index is perfect and all are subject to inherent shortcomings[1]. The important finding is that there are 5 issues inherent in the indexing scheme used to stabilize replacement rates under the Social Security program that could affect benefit equity and adequacy and, if corrected, could result in program savings and improved long term solvency. Decisions, made on the basis of convenience or computational simplicity when the 1977 Amendments to the Social Security Act were implemented, have resulted in small, but significant, impacts on program benefits and long term solvency.

The paper builds the case for the size of the indexing problem based on simulations of benefits for individuals born in 1930, using the benefit calculation formulas that were in place for individuals eligible to retire in 1992. This permits the author to estimate the amount of the individual's retirement benefit from age 62 up to age 75. The simulations use 4 exemplary cases with different levels of lifetime earnings (minimum wage, median earnings, mean earnings and Social Security Taxable maximum earnings).

There are some caveats worth noting about the analysis. The author's estimates cover the range of earnings levels, but the exemplary cases should be viewed with some caution because, unlike the simulation cases, an individual's earnings rarely stay at a fixed level over the entire working lifetime and actual earnings history of retired workers may yield quite different results[2]. The time period under study (the cohort eligible to retire in 1992) may yield somewhat different results than other periods, particularly because more recent cohorts who face both larger actuarial reductions for early retirement and larger delayed retirement credits for work beyond full retirement age. The estimates also tend to focus on the impact of the indexing method on benefits in the case where an individual continues to work until age 75. The reader should keep in mind that this represents a rare case in the real world, with Social Security data showing that, of the 2 million persons

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[1] One often cited example is the Consumer Price Index and its inability to fully account for substitution in the market basket as relative prices change.
[2] It would be difficult to do some of the calculations in this paper using actual earnings histories because most individuals retire well before the 75 year age limit in the study.

entitled to retirement benefits in 2006, only 32,000 waited until age 70 or older to accept retirement benefits (fewer than 6000 were age 75 or older). By comparison, nearly a million (48% of retirees) retired at age 62, the earliest age for reduced benefits. Moreover, while the paper indicates that there are large returns to delaying retirement, the statistics show that those retiring at age 70 or older actually have lower average benefits than those retiring at the full retirement age[3]. Thus the number of individuals who fit the pattern that is the focus of much of this article is, in reality, very limited. This should not detract, however, from the findings that the indexing method produces some anomalies that may affect the adequacy and equity of benefits, as well as the incentive structure to seek benefits. Looking at these scenarios in terms of actuarial fairness over the lifetime would help in assessing the equity and incentives associated with the overall benefit structure.

The paper simulates benefits under 3 alternative indexing proposals (wage indexing beyond age 60, Consumer Price Indexing (CPI) indexing after age 60, and CPI indexed lifetime earnings) which provide interesting options for policy makers. All 3 alternatives tend to hold down benefits, particularly among those not opting for early retirement. While this is helpful in terms of program solvency, the reductions for those working longer could be viewed as "penalties" and encourage persons to opt for earlier retirement rather than work to older ages. This reviewer was surprised by the small effect that CPI indexing of lifetime earnings had on the size of the benefit amount as compared to the estimated impact that CPI indexing has on program solvency. It would be helpful if the author indicated whether this indexing alternative included CPI indexing only of the individual's earnings in the calculation of the average indexed monthly earnings (AIME) measure, or whether the CPI indexing was also applied to the bend points in the primary insurance amount (PIA) formula. This reviewer suspects that only earnings were indexed and the PIA formula bend points continue to be indexed by the average wage index (AWI). Since the AWI generally increases faster than the CPI, the earnings measure will be lower but more of the earnings will be replaced at higher levels as the bend points increase more quickly with AWI indexing, thus slowing the reduction in the benefit. If this is the case, the author might consider adding one more alternative: CPI indexing of both earning in calculating the AIME and in adjusting the PIA formula bend points.

The third indexing 'problem', relating to the lag in adjusting benefits for increases in the cost of living due to annual cost-of-living adjustments, does not seem to merit the level of attention of the 4 other issues analyzed in the paper. Forward looking estimates of inflation, as suggested, may not be accurate and could require benefit adjustments going forward which could lower benefits and create financial and political problems. Another alternative would be to do monthly benefit adjustments based upon monthly measures of the CPI; however, that would add unpredictability to the benefit amount that beneficiaries can expect and could result in large monthly swings in the benefit payable including, if recent history is any indication, reductions in benefits from month to month. The small

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[3] See table 6.A.4 in the Annual Statistical Supplement. While one might expect high earners to delay receipt of retirement benefits, this is not entirely the case. Older individuals lacking insured status until older ages and widows who need not opt for a workers benefits until they reach the maximum delayed retirement credit are likely to receive a small benefit and hold down the average.

impact of annual cost-of-living adjustments during times of relatively tame inflation would not seem to have too large a detrimental effect on the adequacy of benefits.

There is one section on page 23, i.e., section 5. Wage and Price Indices, that requires some editing. It appears that references to Table 2 were inadvertently dropped in 2 places. Citations to columns 1 and 2 in Table 2 appear to relate to columns 6 and 7.

Overall, this paper is an important contribution to the literature and its findings warrant a place in discussions about Social Security reform. It highlights the ability of small changes to the program to make significant contributions to solvency and, at the same time, addressing issues of adequacy, equity, and incentives. I would recommend publication.