GAO
Accountability·Integrity·Reliability
Highlights

Highlights of GAO-06-804, a report to congressional addressees

September 2006

SOCIAL SECURITY REFORM

Implications of Different Indexing Choices

Why GAO Did This Study

The financing shortfall currently facing the Social Security program is significant. Without remedial action, program trust funds will be exhausted in 2040. Many recent reform proposals have included modifications of the indexing currently used in the Social Security program. Indexing is a way to link the growth of benefits and/or revenues to changes in an economic or demographic variable.

Given the recent attention focused on indexing, this report examines (1) the current use of indexing in the Social Security program and how reform proposals might modify that use, (2) the experiences of other developed nations that have modified indexing, (3) the effects of modifying the indexing on the distribution of benefits, and (4) the key considerations associated with modifying the indexing. To illustrate the effects of different forms of indexing on the distribution of benefits, we calculated benefit levels for a sample of workers born in 1985, using a microsimulation model. We have prepared this report under the Comptroller General's statutory authority to conduct evaluations on his own initiative as part of a continued effort to assist Congress in addressing the challenges facing Social Security. We provided a draft of this report to SSA and the Department of the Treasury. SSA provided technical comments, which we have incorporated as appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-06-804.

To view the full product, including the scope and methodology, click on the link above.
For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

Indexing currently plays a key role in determining Social Security's benefits and revenues, and is a central element of many proposals to reform the program. The current indexing provisions that affect most workers and beneficiaries relate to (1) benefit calculations for new beneficiaries, (2) the annual cost-of-living adjustment (COLA) for existing beneficiaries, and (3) the cap on taxable earnings. Some reform proposals would slow benefit growth by indexing the initial benefit formula to changes in prices or life expectancy rather than wages. Some would revise the COLA under the premise that it currently overstates inflation, and some would increase the cap on taxable earnings.

National pension reforms in other countries have used indexing in various ways. In countries with high contribution rates that need to address solvency issues, recent changes have generally focused on reducing benefits. Although most Organisation for Economic Co-operation and Development (OECD) countries compute retirement benefits using wage indexing, some have moved to price indexing, or a mix of both. Some countries reflect improvements in life expectancy in computing initial benefits. Reforms in other countries that include indexing changes sometimes affect both current and future retirees.

Indexing can have various distributional effects on benefits and revenues. Changing the indexing of initial benefits through the benefit formula typically results in the same percentage change in benefits across income levels regardless of the index used. However, indexing can also be designed to maintain benefits for lower earners while reducing or slowing the growth of benefits for higher earners. Indexing payroll tax rates would maintain scheduled benefit levels but reduce the ratio of benefits to contributions for younger cohorts. Finally, the effect of modifying the COLA would be greater the longer people collect benefits.

Indexing raises considerations about the program's role, the treatment of disabled workers, and other issues. For example, indexing initial benefits to prices instead of wages implies that benefit levels should maintain purchasing power rather than maintain relative standards of living across age groups (i.e., replacement rates). Also, as with other ways to change benefits, changing the indexing of the benefit formula to improve solvency could also result in benefit reductions for disabled workers as well as retirees.