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In praise of indexing

by Stephen G. Kellison

The U.S. Social Security system faces a significant long-term financial deficit. Historically, the traditional approach to addressing such shortfalls has been to legislate benefit reductions, payroll tax increases, or both.

However, since benefit reductions and tax increases are politically unpopular, the debate's focal point has shifted to other approaches such as investment of a portion of the trust funds in equities or partial privatization into individual accounts. These concepts were developed into three full-blown proposals by the 1994-96 Advisory Council on Social Security, and they have been widely discussed.

The purpose of this article is to outline a possible alternative framework to help bring financial stability to the system and restore public confidence in it. This framework is indexing — specifically, greater indexing of the system to key economic and demographic variables that drive the system's costs.

Indexing, of course, is nothing new, having been introduced in 1972. Initial benefits at retirement are determined by a complex formula involving preretirement wage indexing, while the benefits thereafter are tied to the Consumer Price Index.

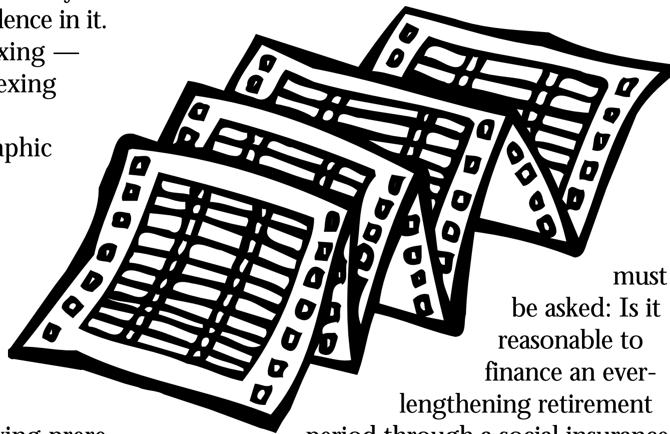
As hoped, these indexing features reduced the frequency of ad hoc changes to the program by Congress and increased the predictability of the benefits the system would provide. They were not specifically designed to stabilize the system's financial structure. To help bring such stability, major amendments were required in 1977 and 1983, and again today the system is out of close actuarial balance.

Toward financial stability

Perhaps greater indexing would stabilize the financial structure of the program as economic and demographic factors change. Conceivably, a structure might even be devised that would virtually place the program on "autopilot" — that is, without requiring Congressional intervention — while preserving the defined benefit nature of the program.

3 avenues to explore

The obvious first candidate would be an index linking the normal retirement age to increases in life expectancy. While many objections would be raised, a fundamental question of social policy



must be asked: Is it reasonable to finance an ever-lengthening retirement period through a social insurance program funded by payroll taxes, or should such a program only be asked to provide benefits for a final portion of total life expectancy?

A second candidate for more sophisticated indexing would be the benefit formula itself. The key economic factor in Social Security financing is real wage growth, which is closely linked to productivity increases. If the economy can produce higher productivity gains, then as a society we can afford a richer social insurance program. Conversely, if productivity gains are lower, then a leaner program is needed to preserve intergenerational equity between workers and retirees.

Finally, the third major variable driving the cost of the system is the fertility rate. In fact, the current financial threat is largely attributable to the baby boom being followed by the baby bust. Historically, U.S. fertility rates have varied a fair amount, but they have been relatively low and stable since the 1970s. The financial risk to Social Security would rise if U.S. fertility declined to levels seen in several European countries. Finding an acceptable indexing approach for this variable would pose a challenge. A key question would be whether the dependency ratio should include only retirees or children as well as retirees. Failure to account for declining fertility trends means either higher taxes or lower benefits for future generations.

The advisory council's proposals contain several innovative concepts that have prompted a healthy public debate about this most important intergenerational social contract called Social Security. These concepts and proposals deserve careful consideration. As the public debate on the U.S. Social Security system continues, indexing deserves consideration as well.

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