Present Policies and Methods Regarding the Long-Term Adjustment of Benefits

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If beneficiaries are to maintain their standard of living at a level close to what it was before they left the workforce, the payments they receive under the Social Security program must be periodically adjusted to account for changes in the cost of living. This article describes the policies and practices employed by the Social Security Administration to accomplish this objective. It describes the historical development of various automatic-adjustment provisions, how contributions are indexed to determine the initial benefit, and how the purchasing power of the benefit is adjusted as the result of changes in the Consumer Price Index. Other factors that will affect long-term benefits, such as changes in the normal retirement age and in the size of the delayed retirement credit, are also explored.

In the United States, Social Security benefits are indexed by changes in average wage levels up to the time of first eligibility to benefits and by increases in the cost of living (or prices) thereafter. First eligibility for retirement benefits occurs at age 62. However, benefits that begin at that age or at any time before the "normal retirement age," which is currently age 65, are actuarially reduced. The normal retirement age is the age at which full-rate, or unreduced, benefits may begin. Benefits that begin after the normal retirment age is reached are increased by the delayed retirement credit provision. Recent legislation has provided for future increases in the normal retirement age and in the size of the delayed retirement credit. These increases provide for greater incentives to delay retirement in the future.

Historical Development

Automatic adjustment, or indexing, of certain amounts under the Old-Age, Survivors, and Disability Insurance (OASDI) program began, on a very limited basis, with the Social Security Amendments of 1965. These amendments contained a provision for offsetting benefits paid to disabled workers and their families if the sum of such benefits and any workmen's compensation payments they received exceeded 80 percent of "average current earnings," as defined in the law. This measure of average current earnings was to be automatically updated every 3 years according to increases in average wage levels in the economy.

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After several years of deliberations, legislation was enacted in 1972 that broadened the use of indexing provisions to include automatic increases in (1) the maximum annual earnings base (that is, the maximum amount subject to contributions and creditable for benefit purposes), (2) the annual and monthly exempt amounts in the retirement earnings test, and (3) monthly benefit payments. Although the indexing provisions that were enacted in 1972 worked satisfactorily for adjusting these items, the law contained a serious technical flaw that made the relationship between future benefits and earnings for current and future workers highly dependent on the relationship between future rates of increases in wages and prices. Depending on the trends of prices and earnings, the future benefits of current workers could have increased more rapidly or more slowly than average earnings in general. (This was possible because benefits for current and future retirees were adjusted for increases in the cost of living as measured by the Consumer Price Index (CPI), and benefits for future retirees also reflected increases in general wage levels.) To restore stability to the benefit structure, the 1977 amendments extended the use of indexing by providing an indexed method for determining the initial benefit level for those eligible after 1978.

Automatic Adjustment of Benefits

Under the OASDI program as amended in 1977, those persons who reach age 62, or who become disabled or die before age 62, in 1979 or later ordinarily

will have their benefits based on their Average Indexed Monthly Earnings (AIME). The average indexed earnings used in the benefit computations for retirement cases are based, in the vast majority of the cases, on the highest "n" years of earnings after 1950. The value of n for persons attaining age 62 in 1975 or later is obtained by subtracting the year 1956 (or, if later, the year of attainment of age 27) from the year of attainment of age 62. For deaths or disabilities occurring before age 62, the year of death or disability is used instead. For example, a person reaching age 62 in 1984 has his or her average earnings computed using the highest 28 years of indexed earnings in the period beginning with 1951. (Note that the years of earnings used can be at any age, not just between ages 27 and 62.)

The concept underlying indexed earnings is to measure the individual's actual earnings in terms of the changes in the general level of wages from the year of the earnings to the period just before eligibility for benefits occurs. Because of the necessary administrative lag, the measuring point is the second year before eligibility. For example, for a retiree aged 62 in 1984, the base year for indexing is 1982. Any earnings occurring in and after the year in which the worker attains age 60 are included as earned (that is, they are not indexed).

The AIME is used with a benefit formula to yield the Primary Insurance Amount (PIA). This is the amount payable to a worker retiring at the normal retirement age or becoming disabled at any age, not including any additional benefits for eligible family members. The PIA formula is dynamic and varies for each cohort of persons attaining age 62 (or dying or becoming disabled before age 62) in each future year. For persons who became newly eligible for benefits in 1979—the first cohort to use a formula based on the AIME—the formula is:

90% of the first $180 of AIME, plus
32% of the AIME in excess of $180 but not in excess of $1,085, plus
15% of the AIME in excess of $1,085.

The "bend points" in the 1979 PIA formula are the two AIME figures—$180 and $1,085.

The PIA formula for subsequent cohorts is obtained by automatic adjustment of the bend points in the above formula; the percentage factors are not changed. Specifically, for a given year after 1979, each of the bend points in the benefit formula is determined by multiplying the corresponding bend point in the 1979 benefit formula by the ratio of the average wage for the calendar year 2 years before the given year to the average wage for 1977, with the resulting product rounded to the nearest dollar.

Wage indexing of earnings produces a rational, stable benefit structure. For contributors, the automatic-adjustment provision guarantees increases in protection that keep it up to date with wages and thus with long-run improvements in the general standard of living. As table 1 shows, wage indexing eventually produces stable replacement rates, as measured at the time of retirement, for workers with similar earnings histories.

Beginning with the year in which an individual becomes eligible for a benefit, the purchasing power of the benefit is protected by automatic increases indexed to the cost of living, as measured by the Consumer Price Index (CPI). In 1975-82, automatic cost-of-living adjustments (COLA's) occurred in June of each year. Under legislation enacted in 1983, the effective month for the COLA's was changed from June to December of each year, beginning in 1983. Benefit increases in 1984 and later will generally be based on the CPI increase from the third quarter of the preceding year through the third quarter of the year in which the benefit increase becomes effective.

The 1983 amendments also contain a provision for modification of the COLA during periods of low trust fund balances. If, at the beginning of a year, the trust fund ratio—that is, the ratio of the combined assets of

Table 1.—Projected replacement rates under OASDI for persons retiring in selected years under various age and earnings-level assumptions in the 1983 Trustees Report

Year of retirement	Replacement rates [1] for workers retiring at—		
	Age 62	Age 65	"Normal retirement age" [2]
	Persons with average earnings in every year		
1990	34	41	41
2000	34	41	41
2010	32	39	41
2020	31	38	41
2030	30	36	41
2040	30	36	41
2050	30	36	41
	Persons with maximum creditable earnings in every year		
1990	20	24	24
2000	21	25	25
2010	21	25	27
2020	21	26	27
2030	20	24	27
2040	20	24	27
2050	20	24	27

[1] The replacement rate is defined as the first year's yearly benefit amount, after any actuarial reduction for retirement before the normal retirement age and excluding any supplementary benefits for eligible family members, as a percentage of the previous year's earnings.

[2] The normal retirement age is the age at which unreduced benefits are first available. Under present law, the normal retirement age is being raised from age 65 to age 67; see table 2.

Note: The above projections are based on the intermediate (Alternative II-B) assumptions in the **1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds**, Social Security Administration, June 24, 1983.

the OASI and DI Trust Funds to estimated annual expenditures—falls below a specified level, the COLA for that year will be limited to the lower of the increases in wages or prices. This specified level is 15.0 percent for benefit increases for December of 1984 through 1988, and 20.0 percent for benefit increases for December 1989 and later. If the trust fund ratio falls below the specified level, the COLA will be the smaller of (1) the increase in prices as measured by the CPI (the same benefit increase that would apply if the trust fund ratio were not below the specified level), or (2) the increase in average wages in the previous year as compared with the second preceding year.

The new law also provides for "catch-up" benefit increases for those beneficiaries whose benefit increases were reduced as a result of this provision. Specifically, when the combined assets of the OASI and DI Trust Funds exceed 32.0 percent of estimated annual expenditures, additional increases in benefits are provided, to the extent that funds are available above the 32.0-percent trust fund level, until benefits are increased to the level at which they would have been if all increases had been based on the CPI.

Changes in the Normal Retirement Age

The 1983 amendments provide that the normal retirement age will be gradually increased from the current age of 65 to age 67. The increase will occur in two steps. Under the first step, it is gradually increased to age 66 at the rate of 2 months for each year of attainment of age 62 after 1999. Thus, persons attaining age 62 in 2000 are the first cohort affected, and their normal retirement age—the age at which exactly 100 percent of their PIA will be payable—is 65 years and 2 months. The level increases by 2 months for each cohort of workers reaching age 62 in the succeeding years, until a normal retirement age of exactly age 66 is reached for persons attaining age 62 in 2005. The age-66 level continues to apply for persons attaining age 62 in each year through 2016. For the next cohort—those reaching age 62 in 2017—the second step raises their normal retirement age to 66 years and 2 months. As under the first step, the level again increases by 2 months for each succeeding year of age 62 attainment, reaching the ultimate normal retirement age of 67 for persons attaining age 62 in 2022 or later.

Although the normal retirement age increases from 65 to 67, the minimum eligibility age for retirement benefits remains at age 62. However, as the normal retirement age increases, the percentage reduction for initial receipt of benefits before that age also increases. The amount of reduction will be 5/9 of 1 percent for each of the first 36 months of early retirement, and 5/12 of 1 percent for each month in excess of 36. Thus, the percentage of the PIA payable at age 62 will be 75 percent for persons attaining age 62 in 2005–16 and, ultimately, 70 percent for persons attaining age 62 after 2021.

The delayed retirement credit, which applies to persons who retire after the normal retirement age, up to a maximum age of 70, is gradually increased from 3 percent for each year of delayed retirement to 8 percent for

Table 2.—Increases in normal retirement age and delayed retirement credits, with resulting benefit, as a percent of Primary Insurance Amount (PIA), payable at selected ages, for persons reaching age 62 in 1986 or later

Year of birth	Age 62 attained in—	"Normal retirement age"	Credit for each year of delayed retirement after normal retirement age	Benefit, as a percent of PIA, beginning at age—				
				62	65	66	67	70
1924	1986	65	3	80	100	103	106	115
1925-26	1987-88	65	3 1/2	80	100	103 1/2	107	117 1/2
1927-28	1989-90	65	4	80	100	104	108	120
1929-30	1991-92	65	4 1/2	80	100	104 1/2	109	122 1/2
1931-32	1993-94	65	5	80	100	105	110	125
1933-34	1995-96	65	5 1/2	80	100	105 1/2	111	127 1/2
1935-36	1997-98	65	6	80	100	106	112	130
1937	1999	65	6 1/2	80	100	106 1/2	113	132 1/2
1938	2000	65, 2 mo.	6 1/2	79 1/6	98 8/9	105 5/12	111 11/12	131 5/12
1939	2001	65, 4 mo.	7	78 1/3	97 7/9	104 2/3	111 2/3	132 2/3
1940	2002	65, 6 mo.	7	77 1/2	96 2/3	103 1/2	110 1/2	131 1/2
1941	2003	65, 8 mo.	7 1/2	76 2/3	95 5/9	102 1/2	110	132 1/2
1942	2004	65, 10 mo.	7 1/2	75 5/6	94 4/9	101 1/4	108 3/4	131 1/4
1943-54	2005-16	66	8	75	93 1/3	100	108	132
1955	2017	66, 2 mo.	8	74 1/6	92 2/9	98 8/9	106 2/3	130 2/3
1956	2018	66, 4 mo.	8	73 1/3	91 1/9	97 7/9	105 1/3	129 1/3
1957	2019	66, 6 mo.	8	72 1/2	90	96 2/3	104	128
1958	2020	66, 8 mo.	8	71 2/3	88 8/9	95 5/9	102 2/3	126 2/3
1959	2021	66, 10 mo.	8	70 5/6	87 7/9	94 4/9	101 1/3	125 1/3
1960 or later	2022 or later	67	8	70	86 2/3	93 1/3	100	124

each such year. The increase in the delayed retirement credit begins with persons attaining age 62 in 1987, for whom the credit increases from 3 percent to 3-1/2 percent. For those persons attaining age 62 in each second succeeding year after 1987, the delayed retirement credit increases by 1/2 percent per year of delayed retirement after the normal retirement age, until the ultimate delayed retirement credit of 8 percent per year is reached by persons attaining age 62 in 2005 or later. The combined effects of these changes in the normal retirement age and delayed retirement credit are shown in table 2.