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ARTIFICIALLY SWEETENING THE COLA

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For the second year in a row, Social Security recipients will not receive a cost-of-living adjustment (COLA) increase to their monthly benefits. Social Security benefits only rise when prices go up; in years with low price inflation, they remain steady. And although low price inflation benefits all consumers, Congress has proposed to give every Social Security beneficiary a $250 check, which could cost taxpayers $15 billion.[1]

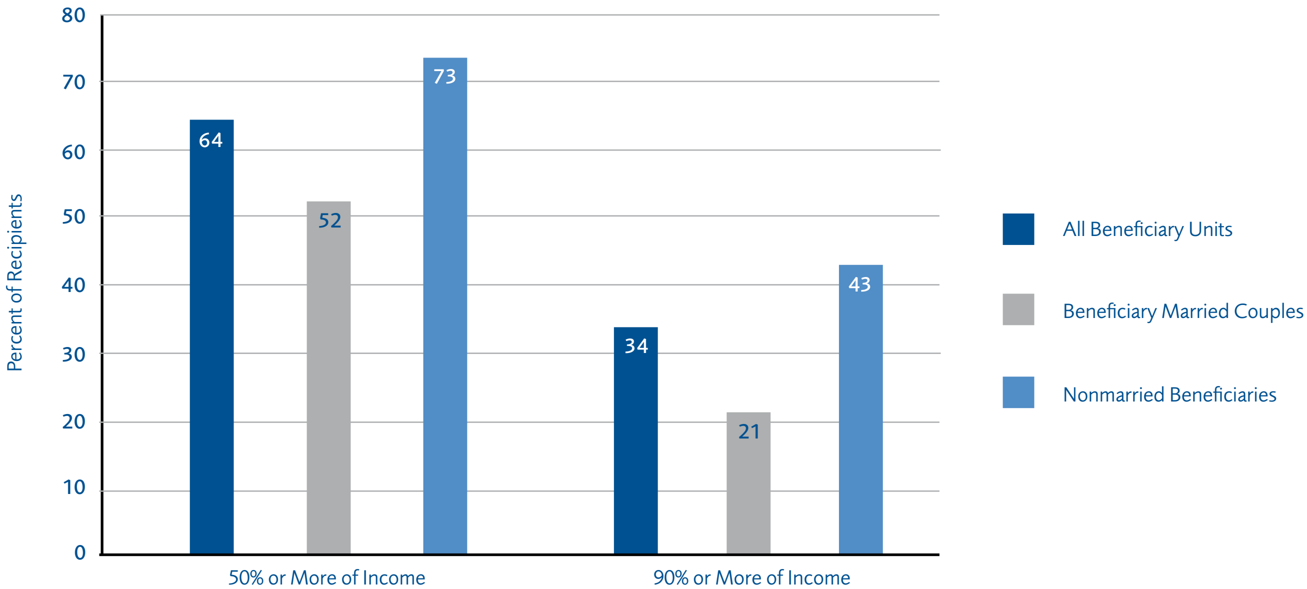
While it might sound reasonable or fair to give seniors a boost during tough economic times, giving in to such demands would be misguided and undermine the very reason for tying cost-of-living adjustments to the Consumer Price Index (CPI) in the first place—to prevent yearly interest-group lobbying for higher benefit increases and, as the name implies, only provide an adjustment when there's an actual CPI-measured increase in the cost of living. Providing a COLA or one-time payment beyond what is warranted by an increase in the CPI would actually increase "real" benefits, artificially sweetening the COLA.

THE SIGNIFICANCE OF SOCIAL SECURITY BENEFITS IN RETIREMENT

Millions of Americans rely on Social Security benefits for income protection. In fact, 64 percent of all beneficiaries rely on Social Security to provide 50 percent or more of their incomes, while 34 percent rely on benefits for 90 percent or more of their incomes (see figure 1).[2] For nonmarried beneficiaries, including widows, the reliance is higher with 73 percent relying on benefits for 50 percent or more of their incomes and 43 percent relying for 90 percent or more of their incomes.

Social Security also lifts millions of people out of poverty. While it is important to note that the existence of Social Security likely causes people to save less than if the program did

FIGURE 1: RELATIVE IMPORTANCE OF SOCIAL SECURITY, 2008



Source: Social Security Online, "Fast Facts & Figures About Social Security, 2010," U.S. Social Security Administration, 7, http://www.ssa.gov/policy/docs/chartbooks/fast_facts/2010/fast_facts10.pdf.

not exist,[3] one study suggests that up to 19.8 million people would be considered poor without Social Security benefits, including 13 million seniors, 5 million adults under age 65, and 1 million children under age 18.[4]

THE IMPORTANCE OF AN AUTOMATIC COLA

An important component for keeping Social Security beneficiaries out of poverty is the COLA. In order to keep inflation from eroding purchasing power, benefits are purposefully designed to increase with price inflation and without political interference. Legislation enacted in 1972 required that beginning in 1975, future cost-of-living adjustments to Social Security and Supplemental Security Income (SSI) benefits be tied to the Consumer Price Index.[5] This also ensures that COLA increases are not tied to the direction in which the political winds blow.

The Social Security Act specifies that any COLA be based on the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) from the 3rd quarter of the previous year to the 3rd quarter of the current year. If a COLA is warranted, it shows up in benefit checks beginning the following January. If there is a decrease in the CPI, or deflation, no COLA is provided. Further, no COLA can occur in subsequent years until the CPI exceeds the previous high point. Though benefits can increase, it is important to note that Social Security benefits never decrease, even during periods of deflation and a decline in the CPI.[6]

Even though the United States is experiencing tough economic times with a slow recovery, high unemployment, and unsustainable levels of debt, Social Security benefits have already appropriately increased purchasing power for retirees. Table 1 shows that in 2009, beneficiaries received a 5.8-percent COLA, the largest since 1982. This large COLA increase was primarily a result of significant increases in the price of gas and energy during the spring and summer of 2008, such as when gasoline reached $4 per gallon. Since then gas and energy prices have declined, resulting in a lower CPI, but Social Security recipients are still benefitting from the increased purchasing power afforded by the 5.8-percent COLA.

TABLE 1: CPI CHANGES BY YEAR

YEAR	CPI-W	% CHANGE	EFFECTIVE COLA IN FOLLOWING JANUARY	CPI-E	% CHANGE	CHAINED CPI	% CHANGE
2007	203.6	2.3	2.3	224.8	2.6	120.4	2.0
2008	215.5	5.8	5.8	236.3	5.1	126.7	5.2
2009	211.0	-2.1	0	233.0	-1.4	125.1	-1.2
2010	214.1	1.5	0	235.2	1.0	126.3	1.0

Source: The Committee for a Responsible Federal Budget, "More on COLAS (and the CPI-E)," http://crfb.og/blogs/more-colas-and-cpi-e.

MEDICARE PREMIUMS

Many Social Security beneficiaries also rely on Medicare to cover their health costs. Medicare Part B and Part D premiums are automatically deducted from beneficiaries' Social Security benefits.[7] In the absence of a COLA, however, for most Social Security beneficiaries, Medicare Part B premiums are not allowed to rise.[8] This hold-harmless provision applies to all but the richest beneficiaries.[9] Additionally, the CPI is designed to capture increases in medical care, including prescription drugs, medical supplies, physicians' services, eye care, and hospital services.[10] Thus, the absence of a COLA increase would have a negligible effect on Social Security beneficiaries on Medicare.

POLICY IMPLICATIONS

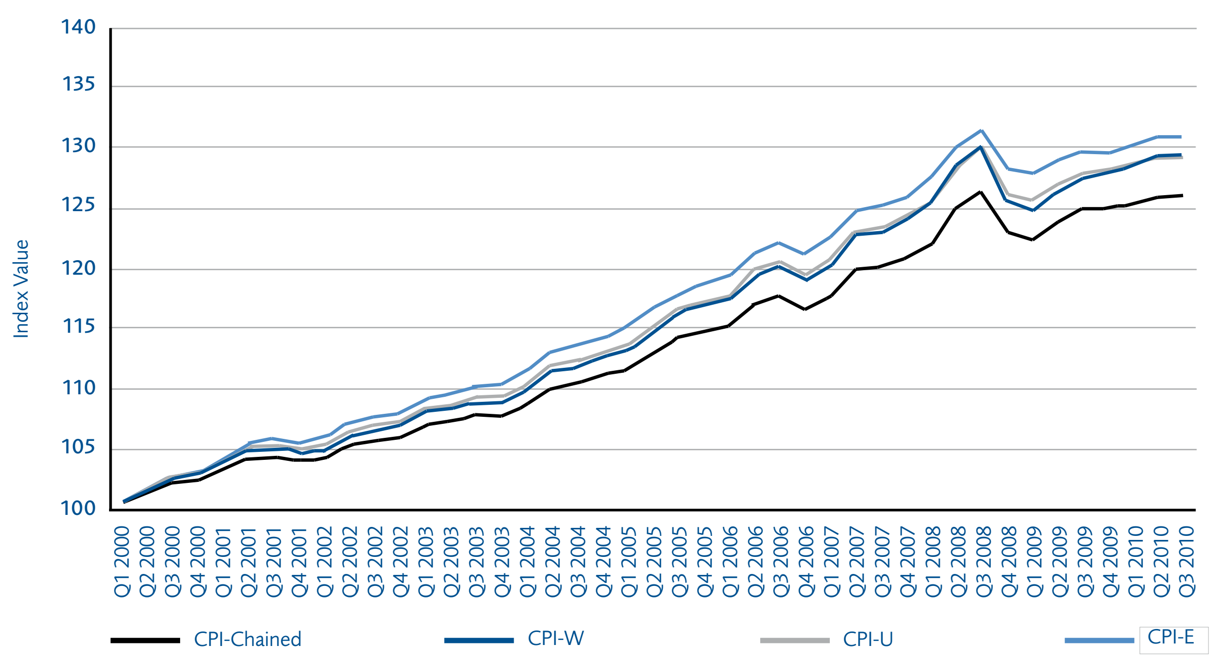
A legislated COLA or any payment in lieu of a COLA will just increase real benefit levels above and beyond increases in prices at the expense of additional federal debt that will ultimately have to be paid by future generations. Some have proposed switching the index on which a COLA is based to a different index that applies greater weight to items that have greater impact on seniors, such as health-care costs.[11] One possible index is the CPI-E (Elderly). This index is experimental, and the Bureau of Labor Statistics warns that the CPI-E has significant methodological limitations.[12] For example, the sampling weights used for the CPI-E are subject to higher sampling error, and the CPI-E does not accurately measure what the elderly purchase or where they shop.[13] Regardless of these limitations, the CPI-E actually closely tracks the other common measures of price inflation, the CPI-W and Chained CPI (see figure 2).[14]

Congress has introduced legislation that would tie future adjustments to the CPI-E, as well as provide a $250 payment in years in which there is no automatic COLA.[15] The Social Security Administration's Office of the Chief Actuary estimated that basing future adjustments on the CPI-E would provide average annual COLAs of 3.0 percent per year, or about 0.2 percentage points higher than adjustments based on the current CPI-W.[16] Referring back to table 1, it is worth noting that if cost-of-living adjustments had been based on the CPI-E, there would actually have been a smaller COLA increase in 2008 and there still would not have been a COLA increase in 2009 or 2010.

CONCLUSION

During tough economic times, everyone can use a few extra dollars, especially those on fixed incomes. But Social Security benefits are doing their job keeping Americans out of poverty and maintaining their purchasing power when prices rise or fall. Though legislation to allow for an automatic cost-of-living adjustment based on the CPI-E might be good politics, further improvement to the methodology of the CPI-E is necessary before we know whether it is good policy. Any supplemental payment for Social Security recipients based on the grounds that it is needed to protect beneficiaries from current low inflation cannot be justified. Low inflation benefits all consumers, including Social Security beneficiaries. For now, any additional legislated COLA increase or one-time $250 payment is just artificially sweetening the COLA.

FIGURE 2: COMPARISON OF ALTERNATIVE MEASURES OF CPI



Note: January 2000=100.
Source: Author's calculation based on information provided by the Bureau of Labor Statistics.

ENDNOTES

1. "Buying the Senior Vote," *The Wall Street Journal*, October 18, 2010.

2. Social Security Online, "Fast Facts & Figures About Social Security, 2010," U.S. Social Security Administration, 7, http://www.ssa.gov/policy/docs/chartbooks/fast_facts/2010/fast_facts10.pdf.

3. Charles P. Blahous III, *Reforming Social Security for Ourselves and Our Posterity* (Westport, CT: Praeger, 2000), 13.

4. Paul N. Van de Water and Arloc Sherman, *Social Security Keeps 20 Million Americans out of Poverty: A State-By-State Analysis* (Washington, DC: Center on Budget and Policy Priorities, August 11, 2010), http://www.cbpp.org/files/8-11-10socsec.pdf.

5. For a history of COLA increases, see U.S. Social Security Administration. "The History of COLA," http://www.ssa.gov/cola/automatic-cola.htm.

6. See U.S. Social Security Administration, "Cost of Living Adjustment," http://www.ssa.gov/OACT/COLA/colasummary.html.

7. See, for example, Jim Hahn and Alison Shelton, *The Effect of No Social Security COLA on Medicare Part B Premiums* (Washington, DC: Congressional Research Service, October 20, 2009), http://www.house.gov/list/press/ca28_berman/ss_cola/medicareb.pdf.

8. See Social Security Administration, "Under the Law No Social Security COLA for 2011," news release, October 15, 2010, http://www.ssa.gov/pressoffice/pr/2011cola-pr-alt.pdf.

9. For more information, see Andrew G. Biggs, *A Diet COLA for Social Security? Not Really*, Retirement Policy Outlook No. 5, American Enterprise Institute, October 2009, http://www.aei.org/docLib/05%20RT%20Oct-g.pdf.

10. Bureau of Labor Statistics, "Consumer Price Index: FAQ," http://www.bls.gov/cpi/cpifaq.htm#Question_7.

11. Stephen C. Goss, letter to The Honorable Ted Deutch, October 8, 2010, http://www.ssa.gov/OACT/solvency/TDeutch/20101008.pdf.

12. Kenneth J. Stewart, "The Experimental Consumer Price Index for Elderly Americans (CPI-E): 1982–2007," *Monthly Labor Review*, April 2008.

13. Ibid.

14. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by consumers for a market basket of consumer goods and services. Variations on the weighting and components of the market basket are used for different purposes. For example, the most common measure of price inflation is the CPI-U, Consumer Price Index for All Urban Consumers. Other commonly referenced indexes are: the CPI-W (Consumer Price Index for Urban Wage Earners and Clerical Works) and Chained CPI-U (Chained Consumer Price Index for All Urban Consumers), which employs a formula that reflects the effect of substitution that consumers make across item categories in response to changes in relative prices. For more information, see Bureau of Labor Statistics, "Consumer Price Index: FAQ," http://www.bls.gov/cpi/cpifaq.htm.

15. See, for example, *Preserving Our Promise to Seniors Act*, H.R. 5834, 111th Cong. (July 22, 2010).

16. Stephen C. Goss, letter to The Honorable Ted Deutch.

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