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Retirement Policy Outlook

A Diet COLA for Social Security? Not Really

By Andrew G. Biggs

Due to falling prices, Social Security will make no cost-of-living adjustment (COLA) to retirement benefits in 2010. Retirees, who feel their benefits are too low and believe the prices they pay are rising, are up in arms. Newspaper headlines announce, "Millions face shrinking Social Security payments," and seniors' groups are already pressuring Congress to pass an ad hoc COLA this year. But most retirees do not know that "no COLA" can actually translate into big benefit increases. When falling prices coincide with stable benefits, purchasing power increases. Moreover, Medicare premium increases are limited in years in which no COLA is paid. Combined, the typical retiree will be better off by almost $725 this year. Paying a COLA this year is unnecessary and would boost the long-term Social Security deficit.

Cost-of-living adjustments, colloquially known as "COLAs," are designed to compensate Social Security beneficiaries for the negative effects of inflation on the purchasing power of their benefits.[1] From Social Security's inception through the year 1950, no benefit adjustments were made to account for inflation. Beginning in 1950, when benefits were raised across the board by 77 percent, periodic ad hoc benefit increases were passed by Congress.

As inflation became a larger issue in the economy, pressure for automatic inflation adjustments increased. A provision in the Social Security Amendments of 1972 enacted automatic COLAs beginning in 1975.

Seniors have come to expect COLAs, and many see them as "raises" to their benefits rather than merely adjustments to maintain the same level of purchasing power.[2] Press reports often encourage this view, highlighting a large COLA as good news for seniors. In fact, seniors should care only about benefits' *real* purchasing power, not the nominal level.

COLAs are calculated by comparing the Consumer Price Index for Urban Workers (CPI-W) from the Bureau of Labor Statistics (BLS) in the third quarter of the current year to that of the prior year. If the index has increased, then the following January a COLA is paid. So long as we assume the CPI accurately measures inflation, it does not matter whether a COLA is 1 percent, 10 percent, or 100 percent: the purchasing power of benefits will remain the same.

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Key points in this *Outlook*:

- While many seniors believe that the lack of a COLA means their benefits are being cut, in fact the real purchasing power of Social Security benefits has risen.
- While there is disagreement over how the Consumer Price Index (CPI) should be measured, even if a CPI focused on the elderly were used, there would be no COLA paid in 2010.
- An ad hoc COLA payment is unnecessary and could lead to larger costs down the road.
- While current retirees come out ahead, the lack of a COLA could disadvantage near retirees.

In 2008, rising oil prices boosted the CPI by 5.8 percent relative to the third quarter of 2007. To compensate, a 5.8 percent COLA was paid in January 2009, the largest since 1982. But something unusual happened between the third quarter of 2008 and the beginning of 2009: prices fell, and fast. In fact, the CPI at the time the COLA was calculated was 4.7 percent higher than the CPI at the time the COLA was actually paid. In effect, a COLA was paid on inflation that no longer existed.

By law there cannot be a negative COLA.[3] Instead, Social Security will pay no COLA until prices rise to match the level as of the third quarter of 2008. The Social Security trustees and the Congressional Budget Office expect COLAs will not be paid in 2010 and 2011, with COLAs resuming in January 2012.[4]

As one would expect, both retirees' and seniors' groups have expressed frustration over the lack of a Social Security COLA in 2010. "I will promise you, they count on that COLA," said Barbara Kennelly, who heads the National Committee to Preserve Social Security and Medicare. "To some people, it might not be a big deal. But to seniors, especially with their health care costs, it is a big deal."[5] Similarly, an AARP official bemoaned, "Most seniors have never been through a year in which there was no Social Security COLA. . . . If, as expected, there is no COLA in Social Security next year but premiums for drug coverage increase, as expected, millions of beneficiaries will see their Social Security checks reduced for the first time."[6] Forbes.com's Joshua Zumbrun termed the lack of a COLA "an unfair freeze for Social Security."[7]

Seniors' groups have proposed that Congress pass an ad hoc COLA for 2010, and both Democratic and Republican members of Congress have responded with legislative proposals. Given both political parties' desire to garner seniors' support in the wake of the current controversy over health care reform, the temptation to deliver an ad hoc COLA will be strong.

Effect of No COLA on Social Security Benefits

The effect of no COLA in 2010 and beyond on the nominal value of retirement benefits is straightforward: benefits will not change. The effect on the real purchasing power of benefits of not having a COLA depends upon the rate of inflation or deflation at the time.

Seniors are well aware that an unchanging benefit in light of rising prices denotes reduced purchasing power and a lower standard of living. The phrase "living on a fixed income" derived from the 1970s, when inflation had quickened but inflation indexing of retirement benefits had yet to become common.

Yet, the same logic applies when prices fall but benefits remain the same: in that case, the buying power of benefits *rises*. Due to falling prices in late 2008, today's Social Security benefits are about 4.7 percent higher in real terms than last year's. Since the average monthly retirement benefit is $1,160, this boosts the typical retirees' annual buying power by around $650.

In 2010 and 2011, benefits will remain higher in real terms than in 2008, though the difference will narrow as inflation resumes. It is not unreasonable to conclude that the typical retiree will collect over $1,000 in additional real Social Security benefits before COLAs resume in 2012.

Medicare Part B Premiums

Medicare Part B and Part D premiums are automatically deducted from Social Security benefits. Thus, the benefit check a retiree has deposited in his bank account reflects the Social Security benefit net of Medicare premiums.

Total Part B premiums, which pay physician services and other nonhospital treatments, by law must cover around 25 percent of the total costs of the Supplementary Medical Insurance program. The remaining 75 percent are funded out of general tax revenue. Thus, as per-capita program costs increase, Part B premiums should increase proportionately. The standard Part B premium for 2009 is $96.40 per month. The Medicare trustees project that the Part B premium should rise to $104.20 in 2010 and $120.20 in 2011.

Under law, however, Part B premiums for most beneficiaries cannot increase by an amount greater than the dollar increase in Social Security benefits generated by that year's COLA. This implies that the Social Security benefit net of Part B premiums cannot decline from year to year.[8]

In a year without a COLA, Part B premiums could not increase except for three classes of nonexempt beneficiaries.

- First, low-income retirees whose premiums are currently paid by Medicaid. Around 17–18 percent of beneficiaries are in this category. However, the costs of increased premiums would be passed on to the Medicaid program, not to the individual beneficiaries. While this would put a strain on state budgets, it would not impact individual beneficiaries.

- Second, high-income retirees. Beginning in 2007, high-income retirees were required to pay a greater share of their Part B costs, ranging from 35 percent for individuals with incomes over $85,000 to 80 percent for individuals with incomes exceeding $213,000. These high-income individuals are not exempt from paying higher Part B premiums. They constitute around 5 percent of total Medicare enrollees.

- Third, new retirees who did not receive Social Security benefits in a prior year. These individuals would pay the full Part B premium.

Overall, only around one in twenty *current* retirees would experience increased Part B premiums in 2010. The vast majority of individuals who will be exempt from Part B premium increases could reap significant savings. Instead of paying the $104.20 standard monthly premium projected for 2010 in the 2009 Medicare Trustees Report, most beneficiaries would continue to pay the 2009 premium of $96.40. This would save beneficiaries around $94 in 2010 with larger savings in 2011.

Medicare Part D Premiums

The Medicare Part D program provides subsidized prescription drug coverage for seniors. Individuals participating in the Part D program pay premiums, which in general are designed to cover 25 percent of the cost of their coverage. Low-income individuals, however, receive a subsidy toward their premiums.

Unlike Part B premiums, Part D premiums *can* increase by an amount greater than the COLA paid in a year. As Part D premiums are automatically deducted from Social Security benefits, this has led news headlines to declare, "Millions face shrinking Social Security payments."[9]

Yet these reports fail to mention how much benefit checks would shrink or to put this nominal reduction in benefits in the context of the real increase in purchasing power of Social Security benefits this year. In fact, the typical increase in Part D premiums for 2010 will be only $2 per month, according to the Center for Medicare and Medicaid Services, amounting to a nominal benefit reduction for the typical retiree of less than two-tenths of 1 percent.

Net Effects on Purchasing Power

On net, the typical retiree will experience a purchasing power almost $725 higher next year than had inflation been positive. Retirees will receive additional increases in purchasing power in following years until COLAs are restored. The increase in real Social Security benefits would decline as inflation narrows the gap between the current price level and the price level in the third quarter of 2008. However, the benefit of fixed Medicare Part B premiums would rise, as Part B premiums would otherwise grow quickly over time.

None of this is to say that it is easy for a low earner to survive on Social Security alone. Social Security benefits are not generous, and, as I have argued elsewhere, many retirees receive lower benefits than is commonly understood.[10] Yet the level of benefits is a different question from how benefits should be adjusted to compensate for inflation.

Comparing CPI Measures

Government surveys of retail goods and services show that the CPI-W declined significantly from the third quarter of 2008 to the beginning of 2009, when the latest COLA was paid. However, seniors argue correctly that the CPI-W used to calculate COLAs is based on the buying habits of working-age Americans. Since seniors spend more on health care, which has become more costly, it is possible that inflation was negative for younger Americans but positive for retirees.[11]

Buttressing this view is an experimental price index for the elderly called the CPI-E, which over the period 1999–2007 reported annual inflation around 0.2 percentage points higher than the CPI-W used to calculate Social Security COLAs.

However, even if the CPI-E were used to track inflation, there would be no COLA payment in 2010. While the CPI-W fell by 4.5 percent from the third quarter of 2008 through January 2009, the CPI-E fell by 3.1 percentage points. Moreover, using the CPI-E, the COLA paid in January 2009 would have been only around 5.1 percent, versus 5.8 percent based on the CPI-W, due to the smaller role of energy costs in the CPI-E.

In addition, the BLS itself stresses that the CPI-E is not a fully developed inflation measure.[12] The CPI-E does not directly track the purchases of the elderly. Rather, it reweights prices gathered as part of the CPI-U (CPI for urban populations) survey, to match the allocation of items seniors purchase more closely.[13] If seniors tend to shop at lower-cost outlets or to avail themselves of seniors' discounts, such information will not be recorded by the CPI-E.

Retirees also have more time to shop for better prices. Mark Aguiar and Erik Hurst found that seniors consume food of similar quality and quantity to working-age Americans but spend 17 percent less. The reason is that seniors devote significantly more time to shopping for and preparing food.[14]

Moreover, many economists believe conventional CPI measures, including the CPI-E, *overstate* true inflation. The so-called Boskin Commission in 1996 estimated that the CPI overstated the true rate of inflation by approximately 1.1 percentage points.[15] Since then, the BLS has altered its methodology to reduce measured inflation by 0.2 percentage points.[16]

However, a principal issue raised by the Boskin Commission remains unresolved. Conventional CPI measures do not account for how consumers alter their purchasing habits as prices change. Instead of continuing to purchase an item whose price has risen, consumers often buy a substitute item at a lower price. A recently introduced CPI series, known as the Chained Consumer Price Index for All Urban Consumers or C-CPI-U, addresses this issue by allowing for a varying basket of goods as prices change. The C-CPI-U, says the BLS, "is designed to be a closer approximation to a cost-of-living index than other CPI measures."[17] Over the period 1997–2007, the C-CPI-U reported average inflation 0.3 percentage points *lower* than the CPI-W used in calculating Social Security COLAs. Burdick and Fisher note that "the newly developed chain weighted (C-CPI-U) provides strong evidence that the methodology used to construct both the CPI-W and CPI-E implies a substantial upward bias in the measurement of inflation. A correction of this upward bias in the measurement of inflation would actually imply smaller COLAs, not larger ones."[18]

To be clear, no inflation measure is perfect. Individuals purchase a unique basket of goods and services whose price differs by what they buy, the retail outlet they frequent, and the part of the country where they reside. Nevertheless, within the constraints of a national-level program like Social Security, it is likely that a truly accurate CPI dedicated to spending by the elderly would not produce recorded inflation significantly higher than the CPI-W currently used for calculating COLAs and could show even lower inflation.

None of this is to say that it is easy for a low earner to survive on Social Security alone. Social Security benefits are not generous, and many retirees receive lower benefits than is commonly understood. Yet the level of benefits is a different question from how benefits should be adjusted to compensate for inflation.

Costs of Ad Hoc COLA

Some have proposed paying a one-time ad hoc COLA in 2010. The National Committee to Preserve Social Security has proposed either a 1 percent ad hoc COLA or a $150 lump sum payment to all retirees. Senator Bernie Sanders (I-Vt.) has proposed making a $250 lump sum payment to all retirees. Several Republican lawmakers, including representatives Walter Jones of North Carolina and Rodney Alexander of Louisiana, have proposed paying an ad hoc COLA of around 3 percent next year.

While the evidence presented above makes clear that an ad hoc COLA is not needed to maintain retirees' purchasing power, the costs of such a payment, around $20 billion for a single-year 3 percent COLA, would nevertheless be small relative to recent government expenditures.

The difficulty comes in making an ad hoc COLA truly temporary. If an ad hoc COLA increased retirement benefits by 3 percent in 2010, can we expect beneficiaries—and perhaps more important, seniors' groups—to remain silent when benefits are cut by 3 percent in 2011?

It is easy to imagine legislators succumbing to pressure to build an ad hoc COLA into the benefit base for current retirees. That is, future COLAs would be built on top of the ad hoc COLA paid in 2010, resulting in a permanent benefit increase for current retirees. In this case, costs would rise to over $400 billion, increasing the long-term Social Security deficit by over 7 percent.

Of course, this would disadvantage new retirees, who would not receive this benefit increase. If a 3 percent ad hoc COLA were built into Social Security's permanent benefit base, such that it increased benefits both for current and new retirees, the costs would increase Social Security's long-term deficit by almost one-quarter.

Who Are the Losers?

Public perceptions to the contrary, the vast majority of current retirees will be winners due to the lack of a COLA over the next several years. By contrast, many near retirees may come out behind.

The first way near retirees can lose is through Medicare Part B premiums. While current retirees will pay the 2009 premium of $96.40 for the next several years, new retirees will pay significantly more but receive the same benefits. A new retiree in 2010 will pay $104.20, and a new retiree in 2011 will pay $120.20.

But this is not the worst of it. Remember that by law, premium income must equal 25 percent of Part B costs. If most retirees are not paying the proportionate premium, then under current law there is no alternative other than forcing others to pay more.[19] This would imply very large increases in premiums for high-income, nonexempt retirees. Premium increases for high-income retirees would be so large that legislation to address this inequity would be likely.

The second way near retirees can lose is through reduced Social Security benefits. Recall that the initial round of deflation produced a roughly 4.7 percent real benefit increase for current retirees, which is gradually clawed back by not paying COLAs until the overall price level rises by 4.7 percent. Individuals who are age sixty-two this year would not have received the original windfall COLA but nevertheless will receive no COLAs to their benefits for several years. As a result, their annual benefits will be around 4.7 percent lower than they otherwise would have been.

Moreover, these reductions remain even after COLAs resume and last throughout retirees' lives. For a typical couple age sixty-two, the lifetime benefit loss would be equivalent to a lump sum tax today of over $18,000. This creates a "notch" in Social Security benefits that affected individuals will seek—and deserve—to have addressed through legislation. This issue will be addressed in greater detail in a forthcoming *Retirement Policy Outlook*.

Conclusion

Falling prices, coupled with a prohibition on negative COLAs and restrictions on Medicare premium increases in excess of the dollar value of the COLA, will combine to increase significantly the purchasing power of net Social Security benefits over the next several years. Assuming a beneficiary population of around 40 million and total per-beneficiary savings of $1,000 over the next two years, the aggregate cost of the recent deflationary episode would reach $40 billion.

Yet proposals to address this misperceived crisis could be far more expensive. If Congress chooses to pay an ad hoc COLA next year, despite evidence that current seniors are not being harmed by the lack of a COLA, pressure to turn it into a permanent increase in the Social Security benefit base would be strong. In this case, the long-term costs to the Social Security program, which is already underfunded by trillions of dollars, would be significant.

Notes

1. Gary Sidor, *Social Security: The Cost-of-Living Adjustment in January 2009*, Congressional Research Service Report for Congress, October 16, 2008.

2. Martin Crutsinger, "Biggest Social Security Raise in over 25 Years," *San Francisco Chronicle*, October 17, 2008.

3. Social Security Administration Office of the Actuary, "Cost-of-Living Adjustment Must Be Greater Than Zero," Social Security Administration, available at www.socialsecurity.gov/OACT/COLA/positivecola.html (accessed October 5, 2009).

4. Social Security Administration Office of the Actuary, "COLA Estimates," Social Security Administration, available at www.ssa.gov/cgi-bin/bri.cgi (accessed October 5, 2009); Douglas W. Elmendorf, "Why CBO Projects No Social Security COLA for 2010 to 2012 under Current Law," Congressional Budget Office Director's Blog, available at htpp://cboblog.cbo.gov/?p=235 (accessed October 5, 2009).

5. Stephen Olemacher, "Millions Face Shrinking Social Security Payments," Associated Press, August 23, 2009.

6. Robert Pear, "Social Security Benefits Not Expected to Rise in '10," *New York Times*, May 2, 2009.

7. Joshua Zumbrun, "An Unfair Freeze for Social Security," Forbes.com, August 24, 2009, available at www.forbes.com/2009/08/24/social-security-deflation-business-washington-index.html

8. In most years, this provision would not apply, as Social Security benefits are large relative to the size of potential increases

in Part B premiums. For instance, a 3 percent COLA applied to the typical retirement benefit of $1,160 would allow for a Part B premium increase of up to $35 per month. When COLAs are smaller, however, this "hold harmless" provision would tend to apply to lower-income beneficiaries. For instance, a 1 percent COLA applied to a monthly Social Security benefit of $500 would allow for only a $5 increase in Part B premiums.

9. Stephen Olemacher, "Millions Face Shrinking Social Security Payments."

10. Andrew G. Biggs, "Will Your Social Insurance Pay Off? Making Social Security Progressivity Work for Low-Income Retirees," AEI *Retirement Policy Outlook*, no. 1 (January 2009), available at www.aei.org/outlook/29198.

11. For a survey of CPI measurement issues, see Clark Burdick and T. Lynn Fisher, "Social Security Cost-of-Living Adjustments and the Consumer Price Index," *Social Security Bulletin* 67, no. 3 (2007): 73–88.

12. U.S. Department of Labor, Bureau of Labor Statistics (BLS), "The Limitations of the Unpublished Experimental Consumer Price Index for Americans 62 Years of Age and Older," BLS, available at www.bls.gov/opub/ted/2008/may/wk4/art03.htm (accessed October 5, 2009).

13. The weights are obtained from the consumption patterns of Americans age sixty-two and older from the Consumer Expenditure Survey. See Kenneth J. Stewart, "The Experimental Consumer Price Index for Elderly Americans (CPI-E): 1982–2007," *Monthly Labor Review* 131, no. 4 (2008), available at www.bls.gov/opub/mlr/2008/04/art2exc.htm (accessed October 5, 2009).

14. Mark Aguiar and Erik Hurst, "Consumption versus Expenditure," *Journal of Political Economy* 113, no. 5 (2005): 919–48.

15. Senate Finance Committee, *Toward a More Accurate Measure of the Cost of Living: Final Report to the Senate Finance Committee Advisory Commission to Study the Consumer Price Index*, 105th Cong., 1st sess., 1997, available at www.ssa.gov/history/reports/boskinrpt.html (accessed October 5, 2009).

16. Clark Burdick and T. Lynn Fisher, "Social Security Cost-of-Living Adjustments and the Consumer Price Index."

17. U.S. Department of Labor, Bureau of Labor Statistics, "Frequently Asked Questions about the Chained Consumer Price Index for All Urban Consumers (C-CPI-U)" BLS, available at www.bls.gov/cpi/cpisupqa.htm (accessed October 5, 2009).

18. Clark Burdick and T. Lynn Fisher, "Social Security Cost-of-Living Adjustments and the Consumer Price Index."

19. The Medicare trustees are clear on this point. See U.S. Department of Health and Human Services, Centers for Medicare and Medicaid Services, *The 2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, 25, available at www.cms.hhs.gov/reportstrustfunds/downloads/tr2009.pdf (accessed October 5, 2009).