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Should Social Security's Cost-of-Living Adjustment Be Changed?

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What is Current Law?

Social Security's annual cost-of-living adjustment (COLA) is intended to protect the purchasing power of benefits against erosion by price inflation. When Congress enacted automatic Social Security COLAs in 1972, the Bureau of Labor Statistics (BLS) produced only one consumer price index (CPI). It measures inflation experienced by urban wage earners and clerical workers (about 32% of the population). The 1972 amendments used this CPI as the measure of inflation and it remains the basis for determining Social Security COLAs today.

What Other CPIs Are Available Now?

In 1978, BLS expanded the CPI to cover all urban residents (about 87% of the population, including most retirees) and named it the CPI-U (the original CPI was renamed the CPI-W). The CPI-U is used to index personal income tax brackets and poverty thresholds, but is not used to determine Social Security COLAs. In 1988, BLS launched a third, experimental index, the CPI-E, which reflects the spending patterns of persons age 62 and older (about 18% of the population). All of these indexes measure changes over time in the price of a representative market basket of goods and services purchased by their respective populations. In 1999, BLS slowed the growth of all the indexes by accounting for *consumer substitution among similar items*, such as apples, for example. Experts agreed that through substitution – buying fewer items that rose more in price (say Granny Smith apples) and more of those whose prices rose less or fell (say Golden Delicious apples)[1] – consumers could lessen the increase in their cost of living caused by inflation.[2]

In 1999, BLS began tracking a "chained" version of the CPI-U. A chained index reflects the extent to which consumers make changes in their purchasing patterns across *dissimilar categories of items* – such as spending more on fuel and less on food – in response to relative price changes. Since 1999, the chained CPI-U has risen about 0.3 percentage points more slowly per year than the revised CPI-W.[3]

Current Proposals

Some budget analysts and policymakers recommend shifting to the chained CPI-U to adjust Social Security benefits and other federal benefits and taxes. Others call for BLS to develop an improved CPI for the elderly for the purpose of adjusting Social Security benefits.

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Switching to the Chained CPI-U

In November 2010, the Bipartisan Policy Center's Debt Reduction Task Force, co-chaired by Pete Domenici and Alice Rivlin, recommended shifting to a chained CPI to determine COLAs in Social Security and in other federal benefits that use COLAs, and to index income tax brackets.[4] Erskine Bowles and Alan Simpson, co-chairs of the President's Fiscal Commission, recommended a similar change as part of a package endorsed by 11 of 18 commission members.[5]

Why do some favor a chained CPI? Proponents of the chained CPI describe it as a technical correction that would make the COLA more accurately reflect the cost of living, according to prevalent economic measurement theory. Yet empirical evidence neither proves, nor disproves, that consumers maintain their living standards when they shift purchases across major spending categories in response to price changes.[6] Some favor a chained CPI because it would lower Social Security outlays. Others favor a chained CPI only if it is used broadly as a deficit reduction measure to index federal income tax brackets and all federal inflation-adjusted benefits, not just Social Security.

How would the chained CPI affect Social Security benefits and outgo? The Chief Actuary of Social Security estimates that the chained CPI will continue to rise about 0.3 percentage points more slowly per year than the CPI-W.[7] A COLA that is 0.3 percentage points lower each year would produce a monthly benefit that is about 8.4% lower by the time a retiree reaches age 92. Similarly, an individual who begins receiving disability benefits at age 35 would receive a benefit that is about 8.4% lower by age 65. The chained CPI would thereby reduce Social Security outgo over the next 75 years by 0.5% of taxable payroll, about one-fourth of the program's long-term shortfall.[8]

Do Social Security beneficiaries have the same flexibility as other households do to change what they buy in response to price changes and still maintain their standard of living? The claim that a chained CPI would more accurately measure elders' living costs is based on an assumption that the elderly can lessen the negative impact of price increases on their standard of living by changing their purchases to a similar extent as the general population. Yet the elderly, on average, have lower incomes and about 27% lower expenditures than other households, and more of their purchases are for necessities.[9] No empirical evidence documents whether or not less affluent households – or beneficiaries in particular – are able to lessen the impact of price increases on their standards of living by shifting purchases across dissimilar categories to the extent that other households do.[10]

Would a chained CPI produce a timely COLA? Because a chained CPI requires the collection of data on changes in spending patterns between the beginning and the end of the measurement period, it is not final until two years after the end of the measurement period. In contrast, the other CPIs are available almost immediately.[11] Ideally, the CPI used to adjust Social Security benefits would be final on a timely basis. In an era of stable inflation rates, basing the Social Security COLA on an increase in prices that happened as long as two years earlier might not be problematic. In times of accelerating inflation, however, delayed adjustments would result in declines in the real value of the benefits, and could compromise public faith in the fairness and adequacy of the COLA.[12]

Switching to a CPI for the Elderly

Three bills introduced in the 112th Congress call for using a special price index for the elderly to adjust Social Security benefits. H.R. 1086, introduced March 15, 2011, by Representative John Duncan (R-TN) and nine co-sponsors, requires BLS to establish a new consumer price index for senior citizens to serve as the basis for a more accurate Social Security COLA. H.R. 798, introduced February 18, 2011, by Representative Peter DeFazio (D-OR) and 20 co-sponsors, directs BLS to prepare a monthly CPI for elderly consumers and amends Title II of the Social Security Act to use the new index for Social Security COLAs. H.R. 456, introduced January 26, 2011, by Representative Charles Gonzalez (D-TX) and 16 co-sponsors, has similar provisions.

Why do some favor an improved CPI for the elderly? Advocates of switching to a special price index for the elderly to adjust Social Security benefits believe that current indexes do not accurately measure the actual living costs of the elderly, including their health care costs. While the experimental CPI-E reflects the spending of households age 62 and older, it is based on a relatively small sample. To obtain more robust estimates, BLS would need to survey a larger sample of households and survey shopping outlets specifically used by the elderly.

How would a COLA based on an improved CPI for the elderly affect Social Security benefits and outgo? A definitive answer would depend on the new measure developed for this purpose by BLS. The Chief Actuary of Social Security estimates that the CPI-E will rise about 0.2 percentage points faster than the CPI-W. If an improved CPI for the elderly were to increase at this rate, it would yield a monthly benefit that is about 6% higher by the time a retiree reaches age 92. This would increase Social Security outgo over the next 75 years by 0.34% of taxable payroll, or about one-sixth of the program's long-term shortfall.[17]

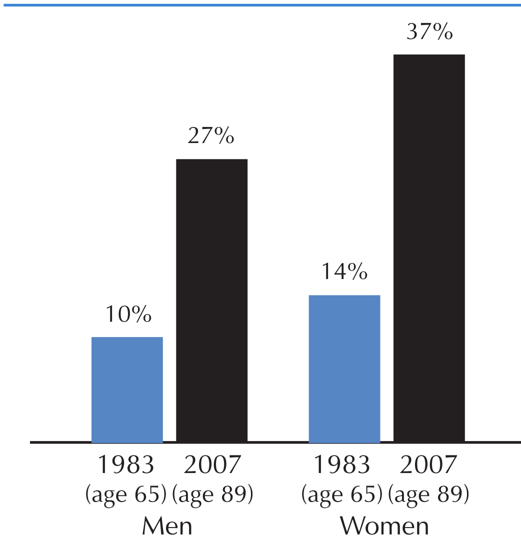
Living Costs of Seniors

How do living costs for seniors compare to those for other households? Living costs for seniors are rising faster than for other households because seniors use more medical care, and health care prices are growing faster than prices for other goods and services.

- Households headed by an individual age 65 or older spend two to three times as much of their budgets on medical care as younger households do – 14.1% compared to 5.6%, according to the 2008 Consumer Expenditure Survey.[13] Disabled individuals under age 65 spend a larger share of their income on health care than do the elderly age 65-74, although they spend a somewhat smaller share of their income than do elders age 75 and older.[14]
- Health care costs have risen faster than prices for other goods and services for more than three decades – 5.5% per year on average, compared to 3.1% for non-medical goods and services.[15] Monthly premiums for Medicare Part B, which rise with the cost of health care (and which are deducted from Social Security benefits), have grown more than fifteen-fold since 1976 – from $7.20 to $115.40 in 2011.

How does out-of-pocket health spending compare to Social Security benefits over time? A recent study examined the extent to which Social Security benefits have kept pace with out-of-pocket health spending as retirees grow older.[16] The authors estimated out-of-pocket health spending, including Medicare premiums, for persons who turned age 65 in 1983 and reached age 89 in 2007 (Figure 1). For men, average health spending amounted to 27% of the average Social Security

Figure 1. Out-of-Pocket Health Spending as Percent of Social Security Benefit
Cohort Age 89 in 2007

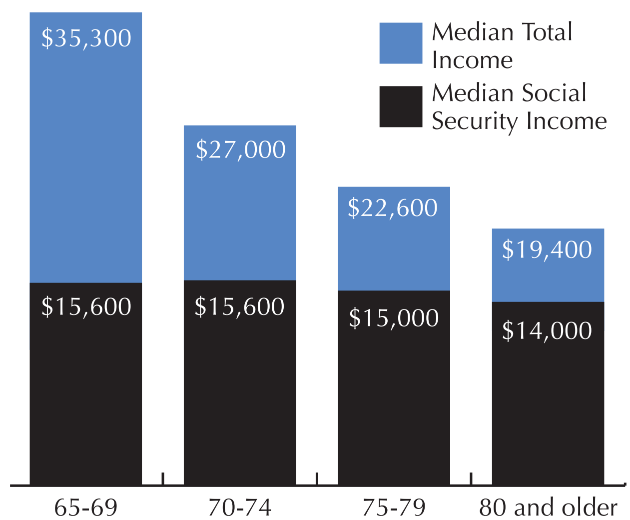


Source: Author's calculations based on Social Security Administration, 2010a and Goda, Shoven, and Slavov, 2010.

benefit at age 89, up from a 10% share of the average benefit when the men were 65. For women, the health care bite is larger because benefits are lower and health spending is higher. Average health spending was 37% of the average benefit for 89-year-old women in 2007, up from 14% of their average benefit when they were 65. This increase occurs for two reasons: first, as people age, they have more health problems that require more medical care; and second, over time, prices for medical care rose faster than Social Security benefits. It is clear that the existing COLA does not keep up with the costs of medical care for Social Security beneficiaries as they grow older.

How important is it that Social Security benefits keep pace with seniors' cost of living? It is critically important that benefits keep up with the cost of living because other sources of income decline with age (Figure 2). At ages 65-69, median total income was $35,300 for all units (couples and unmarried individuals); by age 80 and older, it was $19,400 in 2008.[18] As other sources of income decline with age, Social Security becomes more important. At ages 65-69, median Social Security income was about 44% of median total income. At ages 80 and older, Social Security was nearly three-quarters (72%) of median total income. In brief, as elders grow older, their other sources of income decline, and they rely ever more on Social Security.

Figure 2. Income from Other Sources Declines with Age
Median Income by Age, 2008
Couples and Unmarried Persons



Source: Social Security Administration, 2010b. Tables 3.A1 and 5.A1.

Conclusion

Social Security becomes increasingly important at advanced ages as pensions are eroded by inflation, employment options end, spouses cope with widowhood, and savings are depleted. As Social Security makes up an ever greater share of elders' income, even minor erosions of the real value of their benefits are a public policy concern. Moreover, as seniors age, out-of-pocket health spending takes a growing bite out of their Social Security benefits. Elders do not appear to be overcompensated for inflation as they grow older.

The CPI-W that is now used to determine Social Security COLAs undercompensates beneficiaries for increases in their living costs to the extent that it does not fully reflect their out-of-pocket health care expenses. To shift to the chained CPI-U would appear to undercompensate them even further by lowering COLAs based on empirically unproven assumptions about the ability of the elderly and the disabled to maintain their standard of living by changing what they buy in response to inflation.

The CPI-E comes closer to reflecting the cost of living of the elderly, who make up about two-thirds of all beneficiaries. Because it weights health care expenses more than the other CPIs do, it also better approximates the typical living costs of the disabled. The accuracy and robustness of the CPI-E would be enhanced if BLS were funded to survey a larger sample of the elderly and to survey prices and shopping outlets specifically used by that population. This would produce an improved CPI for the elderly that both is statistically representative and closely tracks changes in their cost of living.

Endnotes

1 Dalton, Greenlees, and Stewart, 1998.
2 Boskin et al., 1998: pp. 5-11
3 Bureau of Labor Statistics, 2010.
4 Debt Reduction Task Force, 2010.
5 National Commission on Fiscal Responsibility and Reform, 2010.
6 National Research Council, 2002.
7 Goss, 2011.
8 Goss, 2010.
9 Cashell, 2010a.
10 Dumagan and Mount, 1997; National Research Council, 2002.
11 Meyerson, 2010.
12 Cashell, 2010b.
13 Duggan, 2010.
14 AARP Public Policy Institute, 2009.
15 Stewart, 2008; Bureau of Labor Statistics, 2011. The data cited here are from the CPI-E; CPI-W data exhibit a very similar pattern.
16 Goda, Shoven, and Slavov, 2010.
17 Social Security Administration, 2011.
18 Social Security Administration, 2010b: Tables 3.A1 and 5.A1.

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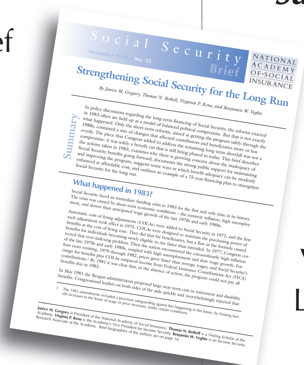

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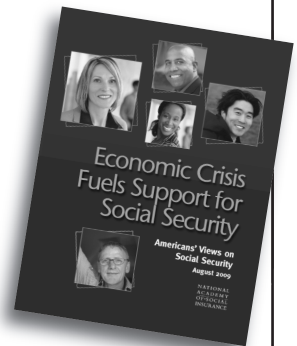

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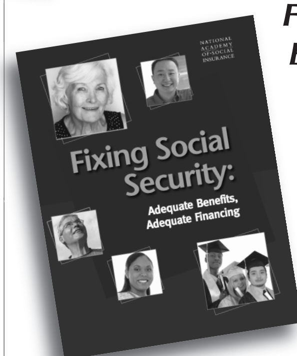

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