REFORMING SOCIAL SECURITY

Option: Recalculate The COLA

Social Security benefits generally keep up with inflation through a cost-of-living adjustment, or COLA. Since 1975, Social Security has based such adjustments on the Consumer Price Index (CPI), which measures changes in the prices of consumer goods and services. One option to modify Social Security would be to use an alternative price index for calculating the COLA. Options include:

- **Chained consumer price index:** By applying a different formula to the same goods and services data, this index aims to account for ways consumers change their buying habits when prices change. Experts predict that the annual COLA would be on average 0.3 percentage points lower under this new formula. For example, if the current formula produced a 3.0 percent annual COLA, the chained consumer price index might yield a 2.7 percent COLA. The effect of a lower COLA would compound over time, reducing the benefit by 3 percent after 10 years and 8.5 percent after 30 years. Permanently reducing the size of the benefit adjustment every year is estimated to fill 23 percent of the gap.

- **Elderly index:** This method aims to reflect specific spending patterns of older Americans, in particular the greater amounts they spend on health care costs. Experts predict that the annual COLA would be on average 0.2 percentage points higher under this formula. For example, if the current formula would produce a 3.0 percent annual COLA, the elderly price index might yield a 3.2 percent COLA. In addition, the effect of a higher COLA would compound over time, increasing the benefit by 2 percent after 10 years and 6 percent after 30 years. Permanently increasing the size of the benefit adjustment every year is estimated to increase the funding gap by 16 percent.

**Argument for the Chained CPI:**

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**Argument for an Elderly Index:**

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The purpose of Social Security’s annual Cost of Living Adjustment (COLA) is to protect retirees against inflation reducing the purchasing power of their monthly benefits. Thus, the index used to set the annual COLA must provide the most accurate estimate of inflation. Unfortunately, Social Security does not use the best available inflation index. However, this problem could be easily fixed by basing the annual COLA on a better index known as the “chained CPI”.

Back in 1972, when annual automatic COLAs replaced irregular benefit increases passed by Congress (usually during election years), there was only one inflation measure available, the Consumer Price Index (CPI). It measures the inflation experienced by urban wage workers and clerical workers. This index, which was later renamed CPI-W (for worker) represents only about 32 percent of the total population.
That original index is still used to calculate Social Security COLAs although a better measure has existed since 1978. It is known as CPI-U (for urban), and measures the inflation experienced by all urban workers and most retirees. CPI-U covers almost 87 percent of the population.

Using CPI-U would be better, but both it and the current index have a serious weakness in that they fail to account for changes in the way that people buy products and services when the prices of similar items change. For instance, if the price of apples tripled while the price of oranges dropped by half, both indices assume that people would buy the same amounts of both that they would have bought before the prices changed.

Similarly, if the price of gasoline goes up, while overall food prices drop, both inflation indices assume that consumers will buy the same amount of both gas and food. In reality of course, the amounts would change, as would the amounts of many other items as consumers seek to make the best use of their limited income dollars. This more realistic type of behavior can be measured in a “chained” index, and such a measure has been available since 1999. This more accurate measure shows that in reality, inflation is about 0.3 percentage point a year less than is shown by the original measure.

Some people in Washington argue that instead the COLA should be based on a new elderly index. This is the wrong approach because people of all ages receive Social Security benefits, not just the elderly and it would increase Social Security’s financial problems.

Inflation for COLAs should be measured using the chained version of CPI-U, which both measures the inflation experienced by a larger part of the population than the current index and better represents the way that real people react to price changes. Using this index instead of the current outdated index, would better protect seniors against seeing the value of their monthly benefits eroded by inflation. What’s more, the more accurate measure would also reduce the cost of that protection to taxpayers like their children and grandchildren.

**Virginia Reno**

The purpose of Social Security’s COLA is to maintain the buying power of benefits when prices rise because of inflation. While some say that switching from the present COLA to one based on a chained CPI would more accurately measure inflation on average, it would *not* be more accurate for older people, who differ from younger households because older people spend more out of pocket for health care costs (which rise faster than average inflation).

The present COLA already understates the inflation experienced by older people. A COLA based on the chained CPI would make things worse, cutting benefits for all current and future beneficiaries by 0.3 percentage points each year, on average. The cuts would compound over time so that the oldest beneficiaries, who are predominantly women, would experience the biggest cuts. Beneficiaries rely heavily on Social Security at advanced ages as pensions are eroded by inflation, earnings end, and assets are spent. Someone living to age 95 would see her benefits reduced by more than 9 percent because of this change. Cumulative losses over a lifetime would be substantial. For someone with a monthly benefit of $1,100 (the average for single elderly women in 2009), the lifetime loss would add up to more than $15,000 by age 90 and to nearly $20,000 by age 95.
Instead of adopting the chained CPI, policymakers should consider basing the COLA on a consumer price index that reflects the buying patterns of older people, in particular. COLAs based on a CPI for older people would go up 0.2 percentage points faster than the current COLA and 0.5 percentage points faster than a COLA based on the proposed chained index. If the purpose of the COLA is to maintain the buying power of Social Security for beneficiaries—no more, no less—an inflation measure that undercounts older people’s costs would not meet that goal; a CPI for older people would.

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NOTE: The estimated solvency effects in this Perspectives report are based on the intermediate assumptions in the 2011 Social Security Trustees Report.