

# EPI BRIEFING PAPER

ECONOMIC POLICY INSTITUTE • JULY 1, 2011 • BRIEFING PAPER #320

## A PROTECTION, NOT A WINDFALL

### Proposed change to Social Security COLA would further erode retirees' financial security

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A perennial suggestion in the debate over the future of Social Security is to change the price index that is used to determine the annual cost-of-living adjustments (COLAs) to recipients' benefits. This change has wide appeal among policymakers for two reasons. First, the specific suggested change—using a “chained” consumer price index (CPI), described in more detail below—is all but guaranteed to lower growth in Social Security benefits, which could aid efforts to reduce the federal budget deficit. Second, these reductions would not be specifically legislated but would arise from what is characterized as a technocratic “improvement” in economic measurement.

This report analyzes the merits of changing the method for calculating the Social Security COLA in this way. It finds that the proposed changes to the Social Security COLA would produce the following outcomes:

- The proposed changes to the Social Security COLA would lead to benefit reductions over beneficiaries' lifetimes that are much larger and that would take effect more quickly than many appreciate. For example, a hypothetical medium earner with an average annual benefit of roughly \$18,204 in 2011 would collect a benefit that would be nearly \$1,800 lower by 2031.
- The current index used to calculate the Social Security COLA may already understate the true cost-of-living increases faced by retired and disabled beneficiaries because it fails to account for their higher-than-average proportion of spending devoted to health care and for health care prices that rise much faster than overall prices. In 2009, health spending accounted for

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12.9% of total spending by people age 65 and older but only 5.3% of total spending of people ages 25–64. And health care prices have risen 50% more than overall inflation since 1989.

- Due to faster rates of medical care inflation, the share of total Social Security benefits dedicated to paying Medicare Part B premiums rose by roughly 50% just between 2000 and 2010. Reducing the overall COLA would reduce the share of total Social Security benefits that can be devoted to non-health use even faster.
- The reduction in benefits arising from a new COLA combined with health care costs that rise faster than inflation and that rise with age would significantly erode the financial security of Social Security recipients, with the oldest Social Security recipients being the hardest hit. This would exacerbate the already serious problem of households outliving their non-Social Security sources of retirement income. Incomes for 75-and-older households are a full 33% less than for households aged 65-74. In a sense, even if the current COLA overstated inflation, as critics charge, this could be a useful feature if it helped mitigate the problem of incomes falling as retirees age.
- The wider debate over the best consumer price index to use to measure *economy-wide* changes in living standards—for determining tax brackets, for example—is not germane to the specific question of which consumer price index best tracks changes in the actual cost of living for the households receiving Social Security benefits.

## Consumer price indices and the Social Security COLA

One of Social Security’s most important features, especially given how long the program has been in existence, is that benefits are adjusted to keep up with rising living standards and costs. Indexing benefits to wages before eligibility and to a consumer price index after eligibility prevents most beneficiaries from falling into poverty, both in absolute terms and relative to wage earners. Despite this feature, retirement benefits remain very modest (averaging around \$14,000 in 2009), and older retirees and the long-term disabled are likely to face financial hardships.

Contrary to popular belief, there is no single “true” measure of inflation, but rather a range of indices used for different purposes and reflecting the price increases faced by different populations. The indices, which are all created and tracked by the Bureau of Labor Statistics, include the following:

- The CPI for all Urban Consumers, or **CPI-U**, which is the “headline” consumer price index—the one most often cited in press reports. It reflects the spending habits of roughly 87 percent of the population of the United States and was introduced in 1978. Federal tax brackets are tied to this index.
- The CPI for Urban Wage Earners and Clerical Workers, or **CPI-W**, which *excludes* retirees. It reflects the spending habits of around 32 percent of the U.S. population and is often used in collective bargaining agreements as well as to determine the Social Security COLA. It is the continuation of the original consumer price index introduced during World War I.
- **Regional and metropolitan area indices** based on the CPI-W and the CPI-U.
- The CPI for the elderly (**CPI-E**), which the BLS considers an “experimental” index. It is based on the CPI-U, but expenditure shares reflect the spending patterns of households age 62 and older.
- The **GDP Deflator**, which is used to measure real growth in the economy. It includes goods and services purchased by businesses as well as households.

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- The Core Personal Consumption Expenditures index, or **Core PCE**, which excludes volatile food and energy prices. It is used by the Federal Reserve to gauge long-term inflationary pressures.
  - The chained CPI for urban consumers, or **C-CPI-U**, another experimental index, adapted from the CPI-U by BLS to address the fact that there is substitution between goods (i.e., prices alter consumer consumption of certain goods, for example when rising prices on automobiles prompt some consumers to switch to public transportation). (See text box page 4 for a more detailed discussion of price index controversies and substitution bias).

Pegging the Social Security cost-of-living adjustment (COLA) to the CPI-W for wage earners, as is currently the case, is rather strange given that the CPI-U includes retirees and that the “experimental” CPI-E specifically tracks the price increases affecting elderly consumers. However, neither of these other indices was in existence when automatic cost-of-living adjustments were introduced to Social Security in 1975. In part *because* the CPI-W excludes retirees, it has actually risen more slowly than the other two measures, which reflect the higher inflation rates that retirees actually face (more on this argument is provided later in this paper).

Since the Social Security COLA is intended to preserve beneficiaries’ living standards, it should be based on a price index that reflects the spending patterns of beneficiaries rather than the general population or non-retirees. Among available indices, the CPI-E population most closely resembles the Social Security beneficiary population, even though it includes older households who are not beneficiaries and does not include disabled workers and other younger beneficiaries. Rep. Ted Deutch (D-Fla.) has introduced a bill that would base the Social Security COLA on the CPI-E.

The CPI-E, like the CPI-W, is an imperfect measure of rising costs faced by seniors. The Bureau of Labor Statistics (BLS) takes into account broad differences in spending shares between seniors and younger households rather than examining the specific goods and services purchased by seniors and how much seniors actually spend on them. So, for example, the CPI-E weights health care more heavily since seniors spend roughly twice as much of their incomes on health care, but it does not track whether specific medical expenses typically borne by seniors, such as costs for long-term care, are growing more slowly or rapidly than expenses borne by the general population.

Again, while no measure of inflation is perfect for all purposes, the most relevant question remains, “Which of the available indices is the best measure of Social Security beneficiaries’ rising cost of living?” A second relevant question is, “Should policymakers err on the side of a higher or lower COLA?” Recent research has shown that the protection that the current Social Security COLA provides against cuts to real living standards over time is probably *overstated* (see Goda, Shoven, and Slavov 2011). The remainder of this paper explains why the C-CPI-U is not the best index for calculating Social Security beneficiaries rising cost of living and argues that even further erosion of Social Security recipients’ protection against inflation through a lower COLA is the wrong way to go.

## **Implications of calculating COLA with the C-CPI-U**

Generally, the price index offered as an alternative to the CPI-W for calculating the Social Security COLA is the chained consumer price index for urban workers, or the C-CPI-U.

Proponents of such a change argue that it’s a simple technical improvement to the current price index (see text box, page 4, on the general arguments about why “chained” indices are better).

But switching to a price index that shows slower cost-growth over time will lead to large benefit cuts for long-time beneficiaries.

## Price index controversies and substitution bias

Economists have long debated how well traditional price indices capture changes in the true cost of living (Boskin et al. 1996, Baker 1998). A key issue in these debates is the degree to which traditional indices may overstate growth in the cost of living through *substitution bias*, which is the failure to account for the possibility that consumers substitute goods for one another as their prices relative to one another change.

### ***Weighting items in the “consumption basket”***

Traditional price indices—like the CPI-W used to calculate Social Security COLAs—measure the change in prices for a representative consumption “basket” of goods. This basket includes pretty much everything that consumers spend money on, but each component in the basket is not weighted equally. Because U.S. households spend much more money on automobiles than on haircuts, a 10% increase in the cost of cars would have a much greater effect on their cost of living than a 10% increase in the cost of haircuts. To reflect this, each component in a price index’s consumption basket is weighted, and the weight is simply the share of all consumer expenditures devoted to that specific component. So, if on average households spend 10% of every consumption dollar on automobiles and 1% of every consumption dollar on haircuts, then cars have a weight of 10% and haircuts have a weight of 1%. The combined weights of each “item” in the consumption basket must, by construction, sum to 100%.

The issue of substitution bias enters because the value of these weights is fixed over two-year intervals. So, the weight of automobiles in this example would be fixed at 10% for two years regardless of how much (or how little) the price of automobiles changed. But if the price of automobiles rose significantly, many households would likely choose transportation alternatives that had not increased in price as sharply; they would begin taking public transportation, or move closer to work, or would buy motorcycles. Substitution bias refers to this failure to account for the possibility of substitution *between* goods.<sup>1</sup>

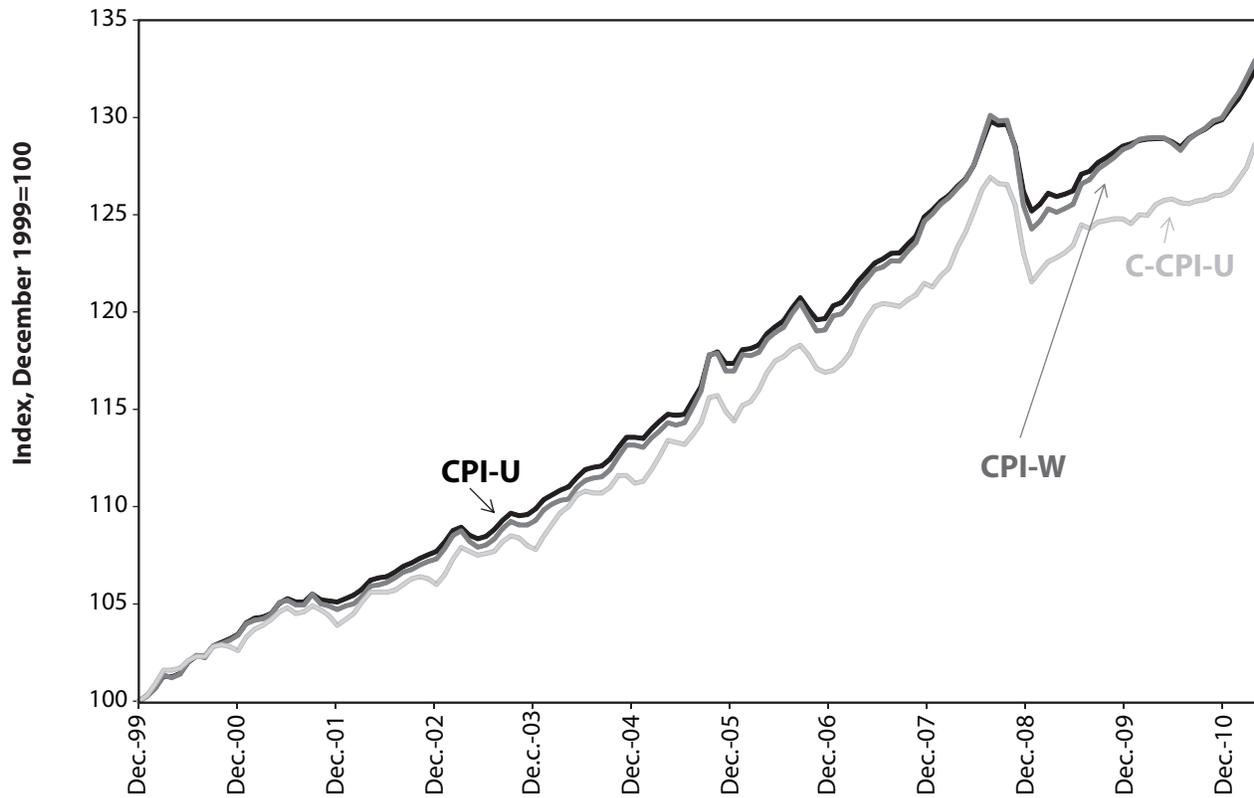
### ***The Chained Consumer Price Index***

To address the fact that there is substitution between goods, the Bureau of Labor Statistics began in 2002 to publish an experimental research series called the chained consumer price index for urban workers (C-CPI-U).

This index is “chained” because it uses a method of chain-weighting to solve the problem of substitution bias. Broadly speaking, the C-CPI-U allows expenditure weights to change each month and updates the price index using these updated (and ever-changing) expenditure weights to construct the final price index. So, in the C-CPI-U, very rapid price increases for cars that drove households away from purchasing them and into alternative forms of transit would be reflected in expenditure weights that changed each month: As the expenditure weights on cars fell as people switched away from them, the degree to which rising car prices drove overall inflation would also fall.

FIGURE A

Growth of the C-CPI-U versus the CPI-W and CPI-U,  
December 1999–December 2010



SOURCE: Bureau of Labor Statistics (BLS), Consumer Price Index program.

Since its introduction in 1999, the C-CPI-U has, as predicted, grown more slowly than the CPI-U, as well as growing more slowly than the price index that determines the annual COLA for Social Security benefits, the CPI-W (consumer price index for wage workers). **Figure A** charts this relative growth.

**Figure B** shows how average Social Security benefits would be reduced relative to current law if the C-CPI-U were used to calculate the Social Security COLA, assuming it rose 0.3% slower each year than the CPI-W, as it has historically done.

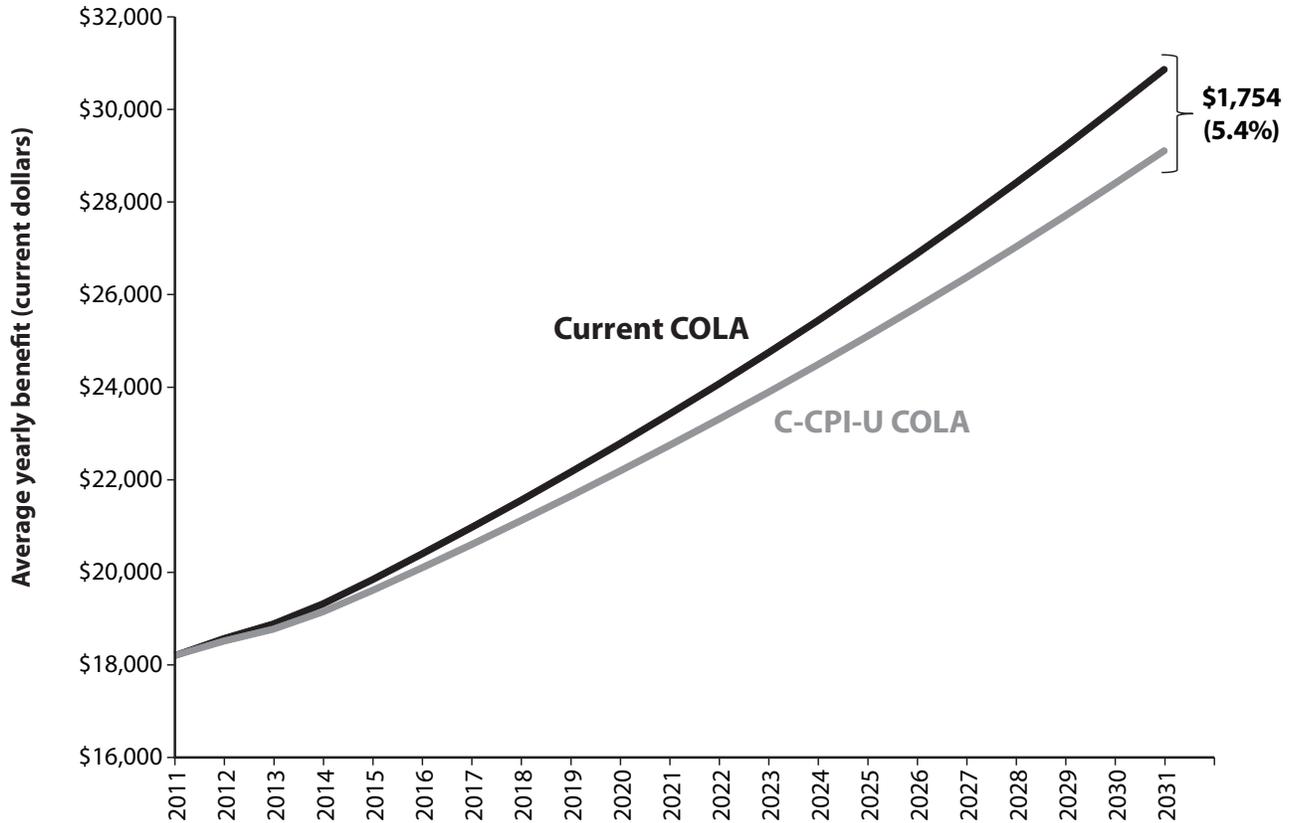
The figure uses Social Security benefits for a “scaled medium earner”<sup>2</sup> in 2011 and the Social Security Administration’s projections for growth in the CPI-W as the starting point. If a recipient begins collecting benefits in 2011 and continues to collect for another 20 years, the benefits would be roughly 5.4% (\$1,754) lower in 2031 if the C-CPI-U were used to calculate the COLA and it shaved 0.3% off the COLA each year, as is generally expected.

While less than 20% of current Social Security beneficiaries have been collecting benefits for 20 years or longer, a woman who retires in 2009 can expect on average to live another 20 years, according to the latest report from the Social Security Board of Trustees.

Cuts would fall even harder on longer-lived beneficiaries. Half of 62-year-olds can expect to live to age 84, one-fourth will live to 90, and nearly one in 10 will live to 95. These beneficiaries will see benefits reduced by 7.9% at 90 and by 9.2% at 95. These older beneficiaries, disproportionately women, are also more likely to have exhausted their savings.

FIGURE B

**Average annual Social Security benefit for retirees first receiving benefits in 2011 under current (CPI-W) COLA vs. C-CPI-U COLA, 2011–2031**



SOURCE: Authors' analysis of data from the Social Security Administration (SSA 2011).

Acknowledging that the “oldest old” are more likely to face hardships, some advocates of tying the Social Security COLA to a chained CPI, including the co-chairs of the National Commission on Fiscal Responsibility and Reform, have suggested softening the blow with a 5% benefit increase phased in at 1% per year from the 20th through 24th years after initial eligibility. But there is nothing magical about the 20-year mark, and this would preserve 70% of the COLA cut while introducing an odd bend in the benefit formula. The vast majority of beneficiaries would still be worse off than without any change in the COLA and a benefit “bump.”

It is also important to step back a minute and think more broadly of what it means to base initial Social Security benefits on wage growth over a worker’s lifetime but to base COLA adjustments to their benefits only on price growth (i.e., the standard practice today for Social Security). Essentially, this pattern entitles a worker to “lock-in” a standard of living that rose during their working lifetime, but then freezes them out of overall growth in living standards that happens during their years of retirement. That is, by allowing benefits to grow only with prices, the Social Security COLA protects beneficiaries’ absolute standard of living, but allows their standard of living to fall relative to the working population.

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Anything that places a larger wedge between growth in absolute living standards and growth in relative living standards (like, for example, a new COLA that provides for smaller yearly increases in benefits) will exacerbate the fall of retirees' living standards relative to the rest of the population's.

## **High health costs of older households also mean that the C-CPI-U is not a better COLA for Social Security**

While all participants in the Social Security debate acknowledge that adopting the C-CPI-U would lead to benefit cuts, proponents of replacing the current COLA argue that the C-CPI-U is the better measure of what is *actually happening*

### **'Chained' price index may make sense for income tax brackets but not for Social Security COLA**

The proposal to switch to a "chained" price index for computing the Social Security COLA is often paired with a proposal to use a chained price index to adjust income tax brackets for inflation each year. Because adopting chained price indices will result in lower rates of reported inflation, the thresholds for tax brackets will rise more slowly year after year. As a result, tax collections will increase as more household incomes grow past the thresholds and enter higher tax brackets.

Both switches to chained price indices would reduce the budget deficit. On the Social Security side, a chained index will cut benefits while on the income tax side, a chained index will lead to higher tax revenues.

These changes are often presented as a single recommendation: Use a more advanced price index that better reflects the economy's trajectory. However, this bundling of recommendations does not make much economic sense.

If the goal is to more accurately measure the growth in overall cost of living being generated by the economy, then the move to a chained index based on economy-wide consumption patterns makes sense. One can certainly argue that this is roughly the goal of adjusting tax brackets for inflation: These brackets, since they apply to *all* taxable income, should rise in tandem with overall cost-of-living growth to keep the government from being starved of revenue simply because the more accurate measure of economy-wide inflation was not being used.

However, as argued at more length in the paper, if the goal is to measure the growth in cost of living for a specific segment of the population—say, elderly households, who make up a large majority of Social Security recipients—then a chained index based on *overall* economy-wide spending patterns is likely inappropriate. Given that even today's Social Security COLA is based on overall spending patterns and thus likely understates cost-of-living growth for the program's beneficiaries, adopting an index that then shaves even more off of each year's already too-low COLA will exacerbate this problem.

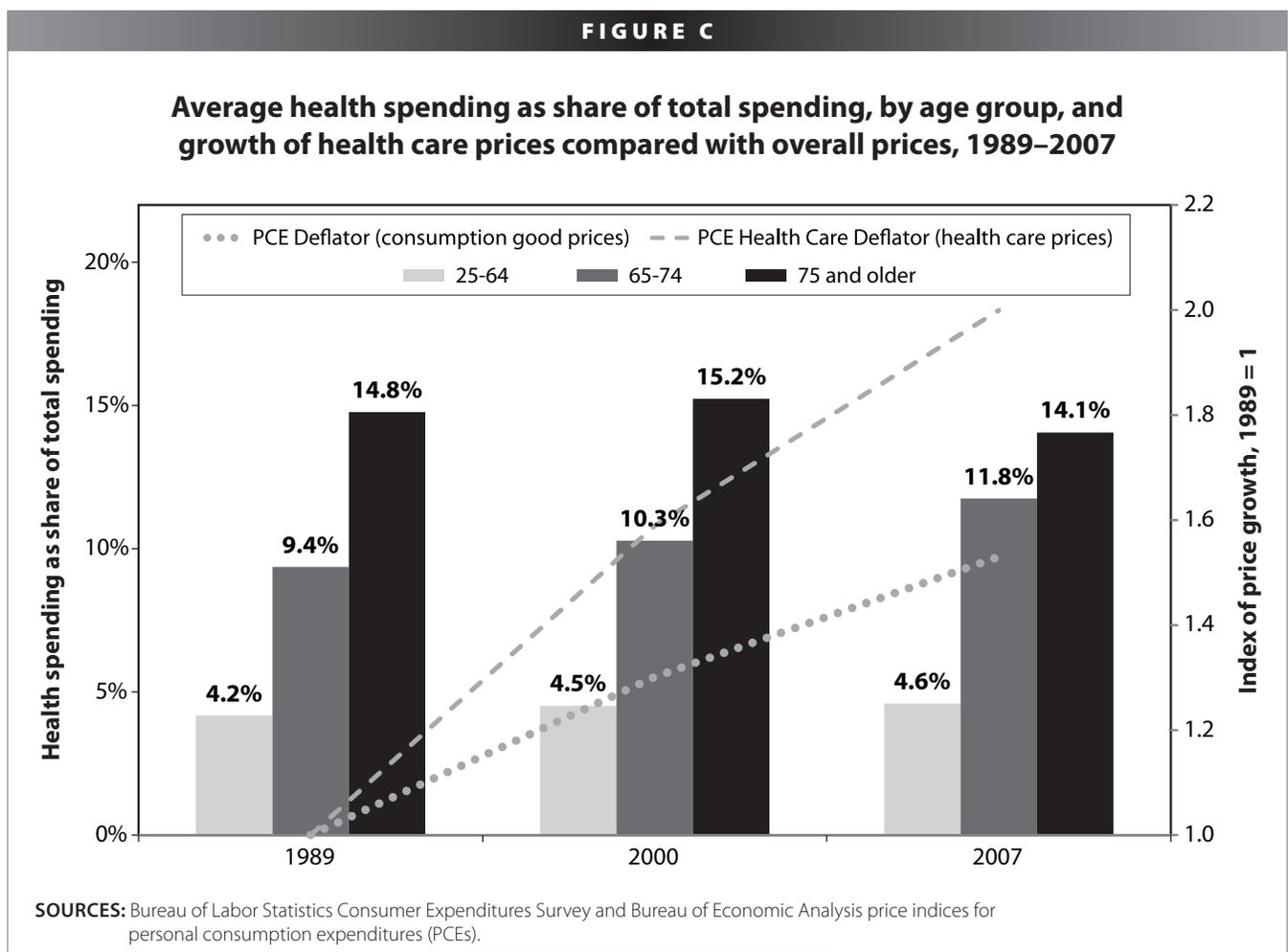
In short, bundling the policy changes of adopting new price indices for income tax bracket adjustment and Social Security COLAs may sound like a reasonable political compromise, but there is no compelling economic reason to go that route. Rather, the optimal change would be to adopt an economy-wide chained index for tax brackets but continue developing a price index to accurately reflect changes in the cost of living for elderly households (such as the experimental CPI-E) and use that for the Social Security COLA.

to living standards. They say that, in effect, Social Security recipients have been getting a windfall for decades because Social Security's benefit increases exceeded what was needed to hold living standards stable.

This is far too strong a claim. There is, in fact, ample evidence that the current CPI-W *understates* the true cost-of-living for the Social Security beneficiary population. While the case for using the C-CPI-U to make economy-wide judgments about living standards growth is on quite firm ground, it absolutely does not follow that it should be applied to all populations receiving benefits that require cost-of-living adjustments (see the text box page 7 for an explanation of when adopting the C-CPI-U as an inflation measure is and is not appropriate).

The reason why the C-CPI-U might make a more accurate economy-wide price index but is ill-suited for calculating Social Security COLAs is straightforward—Social Security recipients consume a different “basket” of goods than what is consumed in the overall economy. Specifically, some of the goods that Social Security recipients disproportionately consume—health care in particular—have faster-than-average cost growth. In short, by putting too low a weight on health spending that is seeing much faster cost-growth than other goods, a move to the C-CPI-U could well understate how fast the cost-of-living is actually rising for Social Security recipients.

**Figure C** shows how much more of Social Security recipients' spending is devoted to health care and how price growth in health care outstrips price growth in other goods. It shows average health-care spending as a share of total spending for households age 65 and older compared with households headed by people age 24-64 (referred to here as under-65 households). For the rest of this paper, 65-and-older households will be examined when we refer to the



consumption basket of Social Security recipients. The large majority of Social Security benefit payments are indeed retirement benefits (either to direct beneficiaries or to their surviving relatives). And while some Social Security outlays do not simply provide pension income, the under-65 populations that receive Social Security are often also quite likely to have higher medical spending than a representative household, as much of the non-pension Social Security outlays go to persons with disabilities.

In 2007, under-65 households saw less than 5% of total spending go to health care, while this share was 11.8% and 14.1% for populations aged 65-74 and 75 and over, respectively. In short, the 65-and-older households spend roughly three times what the rest of the population does on health care, measured as a share of total spending. Further, between 1989 and 2007, prices for health care have risen nearly twice as fast as overall inflation—growing 100% over that time-span, compared with 53% growth in overall prices of consumption goods.

## Medicare premiums and Social Security Benefits

Premiums for the Part B and Part D programs of Medicare (which pay for visits to doctors' offices and pharmaceutical drug coverage, respectively) are deducted from Social Security benefit checks for most recipients. Beneficiaries who are very low-income are an exception because they qualify for free Part B and Part D benefits.

Because these Medicare premiums are tightly linked to growth in underlying medical care costs, they generally have risen at a faster percentage rate than overall inflation for years. This has meant that the inflation-adjusted non-Medicare portion of Social Security recipients' benefits have been rising more slowly than the CPI-W would indicate for quite some time. In 2010 and 2011, there was no COLA at all for Social Security recipients, yet Medicare Part B and Part D premiums increased.

Part B premiums have a "hold harmless" component to them; for the large majority of recipients, the nominal value of their Social Security benefits net of Medicare Part B payments is not allowed to decrease. The rise in Medicare Part B premiums thus is not reflected in lower payments for most Social Security beneficiaries even in years where there is no COLA. However, by law, Part B premiums must cover 25% of total costs. What this has meant in recent years is that the small share of Part B beneficiaries who are not covered by the "hold harmless" provision must absorb the entirety of the rise in Medicare Part B premium costs, leading to very large increases in Part B premiums for this group.

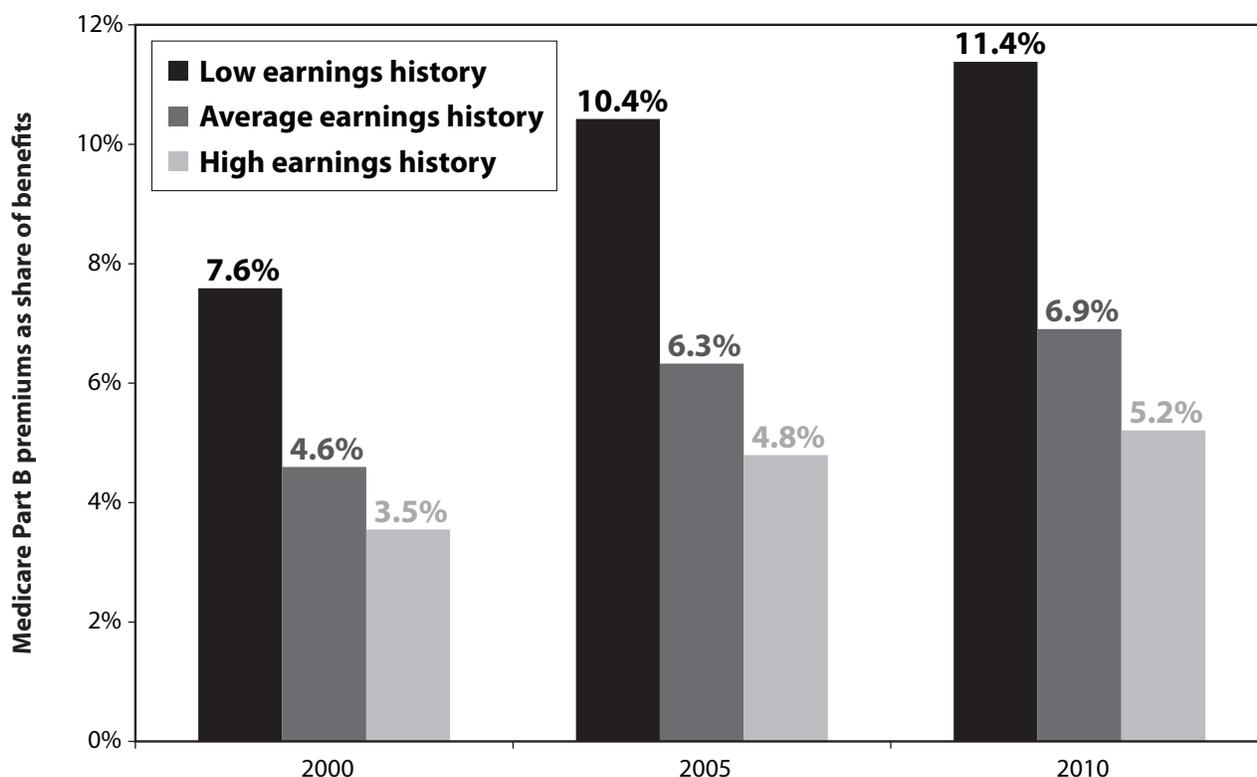
Before 2010 there was never a year in which the rise in Part B premiums accounted for the entire Social Security COLA. And before 2006, the entire Medicare Part B population was covered by the "hold harmless" provision. So, before 2007, Medicare Part B premiums were the same for each and every recipient. Since then, as the "hold harmless" provision and very low Social Security COLAs have combined to push more and more of the overall Part B costs on the small group not covered by the "hold harmless" provision, there has been a large increase in the variability of Part B premiums.

Lastly, very low-income beneficiaries are also not covered by the "hold harmless" provision, but they do not pay the cost of Part B premiums anyway—these are generally covered by the Medicaid program. As Social Security COLAs become insufficient to pay for rising Part B premiums, these costs are absorbed by Medicaid, which is largely funded by state governments. So, besides high-income beneficiaries seeing larger burdens stemming from the interaction between low Social Security COLAs and rising Part B premiums, state governments (which raise tax revenue through mechanisms that are generally less progressive than at the federal level) will bear a larger cost.

Part D premium growth that is larger than the overall Social Security COLAs are not covered by any "hold harmless provision"—any excess of this growth over the annual COLA reduces beneficiaries' take-home incomes dollar-for-dollar.

**FIGURE D**

**Medicare Part B premiums as share of Social Security benefits, 2000, 2005, and 2010**



**SOURCES:** Author's analysis of data from the Social Security Administration (SSA 2011) and the Centers for Medicare and Medicaid Services (CMS2011).

In short, because the 65-and-older population spends two to three times more of their consumption basket on health care, and because health care prices are rising so much faster than the average, applying a price index that measures economy-wide spending patterns will very likely understate the cost-of-living growth faced by the 65-and-older group.

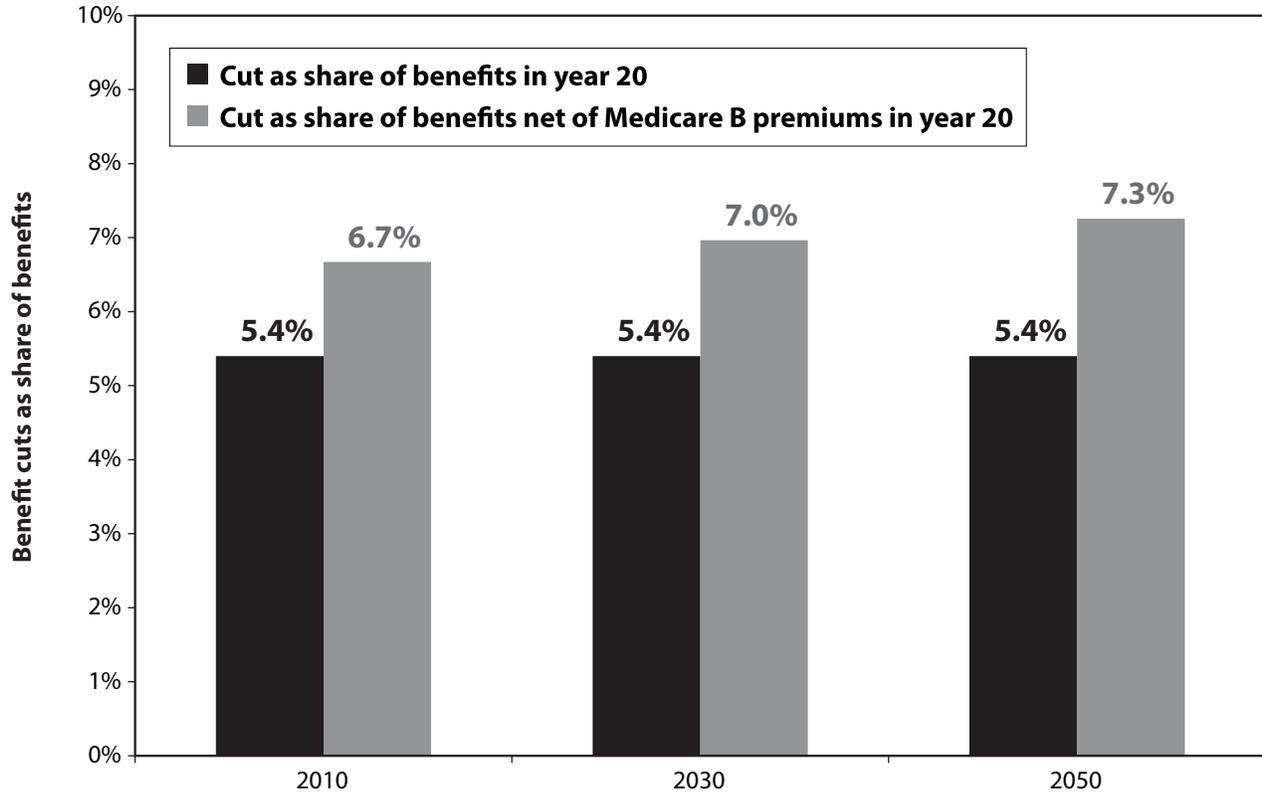
***Impact of Medicare premium growth on Social Security benefits shows why C-CPI-U is not best COLA***

By examining the interaction between Social Security benefits and Medicare premiums, we can illustrate how rising health care costs depress the living standards of Social Security recipients. As Medicare premiums (like nearly all health care related prices) outpace overall inflation, they claim a growing share of Social Security benefits. This became quite clear to most recipients in the past two years, when low rates of CPI-W inflation eliminated COLA increases for Social Security while Medicare premiums rose. (See text box page x for more on the relationship between Medicare premiums and Social Security benefits.)

**Figure D** shows the share of Social Security benefits that went to Medicare Part B premiums between 2000 and 2010, for beneficiaries with varying benefit levels (corresponding to pre-retirement earnings patterns). The faster rate of health care price growth means that Part B premiums took a rising share of Social Security benefits for all beneficiaries.

**FIGURE E**

**Benefit cut in year 20 of Social Security receipt under a COLA based on C-CPI-U, for successive cohorts**



**SOURCES:** Author's analysis of data from the Social Security Administration (SSA 2011) and the Centers for Medicare and Medicaid Services (CMS2011).

For workers with low pre-retirement earnings histories, Part B premiums accounted for 7.6% of their Social Security benefits in 2000 but rose to 11.4% in 2010. For workers with high pre-retirement earnings histories, Part B premiums accounted for 3.5% of Social Security benefits in 2010, rising to 5.2% in 2010.<sup>3</sup>

**Figure E** shows how the dynamic of rising health care prices depressing purchasing power for non-health-care goods is exacerbated if the overall COLA adjustment to Social Security benefits is reduced.

The figure shows benefit cuts in year 20 for cohorts retiring in 2010, 2030, and 2050. The first bar for each cohort shows the average cut as a share of Social Security benefits if the C-CPI-U were adopted (shaving 0.3% off of the COLA's growth each year) relative to what benefits would have been under current law and COLA assumptions. The second bar shows the average cut under C-CPI-U as a share of benefits net of Medicare Part B premiums. As the figure shows, the adoption of the C-CPI-U would cut 5.4% off of benefits in the last year of benefit receipt for each group. Further, this 5.4% benefit cut in year 20 of benefit receipt actually grows over time for successive cohorts when calculated as a share of Social Security benefits measured net of Medicare premiums. For the cohort retiring in 2010, this cut in year 20 of benefit receipt is 6.7% of benefits net of Medicare premiums, while it rises to 7.0% of benefits net of Medicare B premiums in 2030 and 7.3% of Medicare B premiums in 2050.

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The same increase in cuts would arise from other, non-Medicare forms of health spending. In short, there is *already* downward pressure on the non-health care consumption possibilities of Social Security recipients over time. Anything that amplifies this pressure—such as a reduction in the current COLA—is unwarranted.

## **Reducing the Social Security COLA intensifies existing pressures on aging retirees**

As Figure B showed, the impact of a COLA change snowballs over the course of a recipient's retirement, with cuts rising each year. This facet of the COLA change is especially unwelcome, given that retirees already face numerous financial pressures that increase each year in retirement—specifically, with age, health care costs rise steeply and incomes from non-Social Security sources decline.

### ***Health care costs rise as retirees age***

As noted earlier, because people age 65 and older face higher medical costs than the general population, cost indices based on economy-wide spending patterns likely understate cost-of-living increases confronting retirees. But, even *within* the 65+ population, health costs rise with age. Figure C, shown earlier, displayed health spending as a share of total spending for the 65- to 74-year-old population as well as the population age 75 and older. For the 75 and older group, health spending in 2007 was 14.1% of total spending, compared with 11.8% for the 65-74-year-old population (a roughly 20% difference). Further, because health care costs rise as people age, the understatement of cost-of-living increases confronting Social Security recipients stemming from any price index that does not appropriately weigh their medical spending will grow as well. A number of authors (e.g., Goda, Shoven, and Slavov 2011) have found that this is already a problem using the traditional CPI-W: The understatement of health care cost growth found in any economy-wide (i.e., not Social Security population-specific) cost index actually gets larger and larger for any particular beneficiary as they age.

Goda, Shoven, and Slavov (2011) show that Social Security recipients already receive less and less protection from the existing CPI-W COLA as they age and health care costs steadily consume a larger and larger share of their overall consumption basket. This deteriorating protection against inflation would accelerate if the C-CPI-U were adopted instead.

### ***While health care costs rise, incomes fall as retirees age***

Worse, this deteriorating protection against inflation occurs as aging Social Security recipients' other sources of income are declining. The median income of households age 65–69 is almost twice as high as that of households age 85 and older. Poverty rates for households age 65–74 are 8.1%, but these rates rise to 9.8% for the 75 and older cohort. The fact that incomes decline and poverty rises as people age is striking, given that almost two-thirds of beneficiaries age 65 and older rely on Social Security benefits for more than half their incomes and these benefits are adjusted for inflation. This implies that other sources of income decline significantly as seniors age.

Widespread recognition that retirees risk outliving the savings they amassed during their working lives has led to many proposals to boost Social Security benefits 20 years after initial eligibility, often by the same people who are calling for a reduced COLA. It seems odd to argue on one hand that Social Security recipients do indeed need more financial protection as they age, while simultaneously arguing for a policy shift that would just accelerate the already underway deterioration of the COLA protection over recipients' lifetimes.

The twin pressures of rising health care costs and falling non-Social Security income as people age can be summarized by examining data on health care costs as a share of total income (Figure C, displayed previously, showed health spending as a share of total spending). In 2007 health spending took up 11.8% of income for the 65- to 74-year-old cohort but 14.1% of spending for the 75 and older cohort—a 26% difference that is even larger than the 20% difference in health spending expressed as a share of total spending (rather than income).

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In short, rising health care costs and falling incomes already provide large pressures on Social Security beneficiaries' incomes as they age. Reducing the COLA adjustment would just apply one more economic pressure that grows over their retirement.

## **Conclusion**

There is a serious analytical case to be made in favor of changing the price index used to track economy-wide growth in potential living standards and specifically favoring adoption of the chained CPI experimental series compiled by the BLS for this purpose. Thus, for example, the inflation rates used to adjust income-tax brackets may better be calculated with the chained CPI-U.

However, it is a long and incorrect leap to extrapolate from this argument that the price index used to calculate cost-of-living increases faced by Social Security recipients ought to be changed in the same way. In fact, the current price index used to calculate Social Security COLAS seem more likely to be understating, not overstating, the actual cost-of-living increases recipients face—largely because of how much they spend on medical care, a very high-inflation sector.

Given the rise in health care costs as people age and the interactions between Social Security COLAS and Medicare premiums, it seems that even the existing COLA provides Social Security recipients with insufficient protection from rising health costs. Worse, this declining COLA protection occurs as non-Social Security sources of income tend to fall as retirement extends. Given this, it would be a huge mistake to compound these problems by switching to a price index that is guaranteed to lower the Social Security COLA over time.

If policymakers want to make an analytically grounded change to the Social Security COLA, they should consider switching to the CPI-E, a price index that closely tracks the costs of actual price increases faced by older populations, rather than to the C-CPI-U.

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## Endnotes

1. Since 1999, the CPI-W (and other traditional price indices) have actually allowed for substitution at the *intra-item* level. For example, while the weight for a good like automobiles is fixed in the consumption basket, the price index does allow for the possibility that consumers may shift away from models with large price increases to models without large increases. This is important because this kind of “lower-level” substitution was actually identified as the most important potential driver of substitution bias, by a factor of nearly two to one, by critics of traditional price indices, such as the Advisory Commission to Study the Consumer Price Index (Boskin et al. 1996). Therefore much of the historical debate over substitution bias has already been resolved, lessening the scope for further refinements in traditional price indices to address this bias.
2. The “scaled medium earner” is a hypothetical worker whose career earnings equal 100% of the average wage of workers of the same age as them. This hypothetical worker actually receives benefits that are higher than what the typical beneficiary receives.
3. Workers with low pre-retirement earnings histories may be eligible for aid in paying Part B premiums through Medicaid. Conversely, Medicare beneficiaries with higher incomes (who would tend to be workers with higher pre-retirement earnings histories) may have to pay more than the standard Medicare Part B premium.

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