Journal of Business and Economics, ISSN 2155-7950, USA
October 2016, Volume 7, No. 10, pp. 1581-1586
DOI: 10.15341/jbe(2155-7950)/10.07.2016/001

http://www.academicstar.us

Social Security Cost of Living Adjustments: The COLA Controversy Examined

Joseph A. Giacalone
(St. John's University, USA)

Abstract: The Cost of Living Adjustment (COLA) for most Social Security payments is based on an index number, the Consumer Price Index. The Consumer Price Index (CPI) is constructed by the United States Bureau of Labor Statistics and comes in several different series. Currently, it is projected that the 2016 Cost of Living Adjustment for Social Security payments will be zero (Franklin, 2015). This will be the third time in recent years that this has happened. Not surprisingly, Social Security recipients and senior citizen organizations are not pleased with this situation. They claim to be experiencing increases in their cost of living yet the numbers do not confirm this. So, what is going on? This paper will examine the way the COLA is calculated. It will evaluate the relevance of the methodology used in comparison with the spending patterns of most Social Security recipients. Consideration will then be given what alternative measures are available or could be constructed. These will include the experimental CPI for Americans 62 and older, the so-called CPI-E.

Key words: social security; COLAs; CPI-W; CPI-E
JEL code: H55

1. Private and Public Fiscal Implications of COLAs

The notion that individuals should have their purchasing power protected from inflation is not a new one and is a fixture in many private and public fiscal matters. At the very least, keeping pace with increases in the cost of living is deemed to be a matter of equity. Thus, a cost of living adjustment (COLA) is embedded in many private contracts and public policies. The adjustment is a function of a price index used to measure inflation and the consequent change in the cost of living. Indexation relies on a man-made statistical measure, a price index, which is subject to statistical biases and other errors that may undermine its accuracy and its suitability for the purpose at hand. The price index at the heart of the COLA controversy is the Consumer Price Index as used in the matter of adjusting Social Security benefits so as to offset inflation in the cost of living.

2. A Little History

The Social Security Act was passed in 1935. Until 1972, any increase in benefits was the result of legislative action by the U.S. Congress. In 1972, the Congress authorized a cost-of living adjustment (COLA) based on a price index and the first CPI-based COLAs were granted in 1975. The Consumer Price Index (CPI) was deemed

Joseph A. Giacalone, Ph.D., Professor of Economics, St. John's University; research areas/interests: public policy, industry studies, health care economics. E-mail: giacaloj@stjohns.edu.

the appropriate metric for the purpose of protecting the purchasing power of Social Security payments from being eroded by inflation. A given year's COLA was based on a prior period's changes in the CPI. Ultimately, the prior period was deemed to be the end of the third quarter of year y-2 through the end of the third quarter of y-1.

The CPI is an index number produced by the Bureau of Labor Statistics. The most widely used variations of the index are the CPI-W (Consumer Price Index for Urban Wage Earners and Clerical Workers) and CPI-U (the Consumer Price Index for All Urban Consumers).The CPI-U represents the spending habits of 87% of the U.S. population. The CPI-W is a subset of the CPI-U and represents about 32% of the US population. *It is the CPI-W that is used for the Social Security cost-of-living adjustments.*

The issue of measuring the "cost of living" has always been somewhat controversial. Most economists concede that there is no perfect measure of changes in the cost of living for any sub-set of the population Limitations of one kind or another can be found in whatever metric is used. The BLS position is that the CPI is only a proxy for the cost of living and that changes in the CPI are an upper limit of the cost of living (Burdick & Fisher, 2007).

3. Boskin Commission

However, while the elderly and their advocates believed the CPI-W underestimated the cost-of-living faced by Social Security recipients, there was some concern that the opposite was true. Thus, the Senate Finance Committee formed an advisory commission to study the CPI as a cost of living measure. The Commission was chaired by Michael Boskin, Chairman of the Council of Economic Advisors under President H. W. Bush. The Commission concluded that bias in the CPI likely overstated increases in the cost of living by 1.1 percentage points annually.

The sources of bias in the CPI as a cost of living index are widely known. There is substitution bias wherein consumers substitute one good for another in response to a relative price change. There is also the ability to change shopping outlets in response to price changes. Biases can also arise from new products which enter the measured market basket only after a delay and after their price has fallen. Changes in quality tend to confound the index as well, especially in an area like health and medical care which are experiencing significant technological changes.

The BLS has responded to the Boskin Commission report and made various adjustments to its methodology. These changes have been estimated to have slowed the rate of growth in the CPI by about .2 of a percentage point.

4. The Experimental CPI-E

However, as it pertains to the elderly population, the issue is more than a theoretical one. From the perspective of this population segment, the CPI-W seems to underestimate its perceived increases in the cost of living.

In response to this concern, in 1987 Congress directed the Bureau of Labor Statistics to develop an index that was to be designed to reflect the spending patterns of the elderly. Thus was born the CPI-E, the Experimental CPI for Americans 62 Years of Age and Older. It is widely acknowledged that the "market basket" reflecting the spending patterns of the elderly has some significant differences from that of the population sampled for the CPI-W. Expenditures on medical care and housing are two of the most prominent differences. The CPI-E is now available dating back to late 1982. However, it remains experimental and is not published.

5. New York Federal Reserve Bank Study

According to a study by the New York Fed (Hobijn & Lagakos, 2003), a major weakness of the CPI is that benefit changes are linked to price movements more attuned to the working population and not to retirees. As mentioned above, medical care and housing are a much larger component of expenditures for seniors. The article asks the question as to how adoption of the CPI-E to index Social Security benefits would impact the level of benefits paid and, importantly, what would happen to the Social Security Trust Fund. The authors argue as follows:

"Our calculations suggest that introduction of the CPI-E would present policymakers with a serious trade-off: By choosing to maintain the purchasing power of seniors over time, they would accelerate the projected insolvency of the social security trust fund, known officially as the Old-Age and Survivors Insurance (OASI) trust fund."

With minor exceptions, the authors argue that, in their data set, CPI-E inflation was higher than CPI-W inflation. They attribute this difference largely to the weights used for various components of the respective indices. Seniors spend significantly more on medical care and housing, than their younger counterparts. On the other hand, education, transportation, and food had smaller weights for the elderly. The net result, according to the authors, would be that the adoption of the CPI-E would be higher benefits to seniors.

6. Comparisons among CPI-W, CPI-U, and CPI-E

Stewart (2007) reports that for the 25 years in his study (1983-2007), "the CPI-E for all items rose at an annual average rate of 3.3 percent, compared with increases of 3.1 percent and 3.0 percent for the CPI-U and CPI-W, respectively." Stewart points out that the difference between the higher rate of increase measured for the CPI-E relative to the CPI-U and CPI-W over the period from December 1982 to December 2007 largely attributable due to the medical care and shelter components of the index. As has been previously noted, the elderly spend more on medical care and shelter than younger population cohorts. Inflation in the medical care sector rose more rapidly that overall inflation throughout the study period. Shelter, also is an expenditure category where the elderly spend more and have faced costs rising more rapidly than the overall inflation rate.

For the most part, Stewart's study (2007) supports the findings of Hobijn and Lagkos (2007), that the CPI-E results in a higher inflation rate for the elderly and using it to index Social Security benefits would have generated higher incomes for this segment of the population. Yet, there are still other considerations that come into play, including another version of the CPI as explained below.

6.1 Enter the Chained CPI-U

The BLS also produces a chain-weighted measure of consumer prices, the Consumer Price Index for all Urban Consumers (Burdick & Fisher, 2007). This index targets the substitution bias in the CPI by changing the timing of expenditure weight changes from biennial to monthly. This method provides for a better tracking of changing expenditure patterns. The resulting index tends to provide a lower rate of price inflation than the CPI-W. This is in line with the conclusion of the Boskin Commission report and contrary to the findings with respect to the CPI-E.

It would appear that basing the Social Security cost-of-living adjustment on the CPI-E would result in larger benefits to recipients. However, the larger benefits would impact the Social Security Trust Fund negatively.

Indexing with the Chained C-CPI-U would generate the smallest COLA, not a desirable outcome for Social Security recipients and strongly opposed by senior groups such as the National Committee to Preserve Social Security and Medicare. The group's May 2013 position paper is highly supportive of the CPI-E as the COLA index of choice.

7. Limitations of the Alternatives to the CPI-W

A further complication derives from the fact that both the CPI-E and the Chained CPI-U have significant limitations of their own. Stewart (2007) presents several of these measurement biases. The CPI-E suffers from higher sampling error than the official indices since the sample size is much smaller. A second consideration is that the CPI-E uses the same geographic areas and the same retail outlets as the CPI-U which may not be representative of the location and types of stores used by the elderly, like retirement communities. Thirdly, the items selected for pricing might be more representative of the urban population than of the elderly population that the CPI-E hopes to capture. Fourthly, prices used do not reflect the discounted prices ("senior discounts", for example) that tend to be more widespread in the shopping activities of the elderly.

Another problem with the CPI-E is that the sample includes people in the 62-64 age bracket that are not receiving Social Security benefits. In this respect, it is like the CPI-W which does not include people whose primary source of income is retirement benefits (Stewart, 2007)

Burdick and Fisher (2007) point to limitations faced in the construction of the chained CPI-U. Specifically, it relies on expenditure data that has a significant time lag such that the values of the index are not final when published. These final values are not published for up to two years after the initial values are released. For annual COLAs, such a time lag is just not workable.

The evidence also suggests that the gap between the CPI-W and the CPI-E has been narrowing in recent years. This is at least partially due to the improvements made in the CPI-W made by the BLS.

8. Some Recent Findings

Goda, Shoven, and Slavof (2012) conclude their study as follows: "We have shown that Social Security benefits may not be as safe from inflation as commonly believed. Because medical costs have been rising over time, and because the elderly spend a larger fraction of their income on medical care than workers do, the CPI-W does not properly reflect the inflation experience of Social Security beneficiaries. This is partly reflected in the fact that premiums for Medicare Part B, in which most retirees participate, have risen much faster than Social Security benefits. It is compounded by the fact that retirees often have substantial out-of-pocket medical expenses, which increase as they age. Even experimental measures like the CPI-E may not fully compensate for inflation because they are intended to reflect the inflation experience of the average elderly person from year to year, rather than the experience of a given cohort. Given the state of Social Security's finances, it would not be fiscally prudent to raise legislated benefits for all retirees to keep pace with the CPI-E or to maintain average real net-of-medical benefits. However, most Social Security reform proposals attempt to protect very low-income retirees, and the alternative indexing schemes discussed in this chapter can provide guidance on how to accomplish this goal."

Scrimgeour and Gorry (2015) use a different methodology to estimate the cost of living for the elderly. Instead of a price index, they measure the rate of increase in the elderly's cost of living based on drifts in food

Engel curves.

They conclude that, based on household survey data, an observed decline in food expenditures by the elderly results in a slower rate of increase in the cost of living for the elderly households than for the nonelderly households. Their data suggests that, at least since the late 1980s, this results in a overall upward bias in the CPI of 0.8% tp 1% per year. Interestingly, this is an order of magnitude similar to that found for the CPI-W by the Boskin Commission. They conclude that it would not be appropriate to compensate the elderly for a faster rate of inflation.

9. Summary and Conclusions

Compared to the CPI-W, the CPI-E would provide higher cost-of-living adjustments to Social Security recipients. However, it would also deplete the Social Security Trust Fund more quickly. On the other hand, the CPI-U would provide a lower COLA but push back the depletion of the Trust Fund.

Despite the fact that the CPI-W has known shortcomings, it is evident that alternative COLA measures have limitations as well. The construction of an index that overcomes all the limitations would take time and funding, funding that Congress has not been inclined to provide. Moreover, there are indications that other methodologies such as Engel curve analysis might provide a more appropriate cost of living measure than price indices. More research is needed on this.

Of course, there is some political risk in not adopting a CPI measure that is friendlier to the elderly population which tends to vote at a higher rate than the overall voting population. However, the longer term issue of the Social Security Trust Fund's depletion probably will trump any short-term change in the COLA arrangements. This and related Medicare and Medicaid issues will require major legislative action, despite reluctance on the part of politicians to address the matter.

Despite a zero COLA for 2016, the 2015 Trustees report of the Social Security Trust Fund projects annual increases in the COLA in the range of 2.5% over the next few years. This will probably reduce the political pressure to change the COLA formula.

References

Amble Nathan and Kenneth J. Stewart (1994). "Experimental price index for elderly consumers", *Monthly Labor Review*, May.

Burdick Clark and Lynn Fisher (2007). "Social security adjustments and the consumer price index" , *Social Security Bulletin*, Vol. 67, No. 3.

Franklin Mary Beth (2015). "Social security cost-of-living adjustment unlikely for 2016", *Investment News*.

Goda Gopi Shah, John B. Shoven and Sita Nataraj Slavov (2012). "How well are social security recipients protected from inflation?", in: David Wise (Ed.), *Investigations in the Economics of Aging*, University of Chicago Press, pp. 119-139.

Hobjin Bart and David Lagakos (2003). "Social security and the consumer price index for the elderly", *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, May.

Hurd Michael D. (2012). "Comment on 'how well are social security recipients protected from inflation?'", in: David Wise (Ed.), *Investigations in the Economics of Aging*, University of Chicago Press, pp. 139-143.

National Committee to Preserve Social Security and Medicare (2013). "Social security and the COLA controversy", "The CPI-E — A better option for calculating social security COLAs", May, available online at: http://www.lawyers.com.

Scrimgeour Dean and Gorry James (2015). "Using Engel curves to estimate CPI bias for the elderly", *Economics Faculty Working Papers*, p. 45, available online at: http://commons.colgate.edu/econ_facschol/45.

Stewart Kenneth J. (2008). "The experimental consumer price index for elderly Americans (CPI-E): 1982-2007", *Monthly Labor Review*.

Stewart Kenneth J. and Joseph Pavalone (1996). “Experimental CPI for Americans 62 years of age and older”, US Bureau of Labor Statistics, December 3.

US Bureau of Labor Statistics (2015), “COLAs & AWI increases under the intermediate assumptions of the 2015 Trustees Report”, Official Social Security Website.