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Tuesday, August 25, 2009

A Pointless Lament About COLA [Jagadeesh Gokhale and Angela Erickson]

Social Security benefits are determined at the time when workers first apply for those benefits (they must be age 62 or older). Once benefits are determined, they are automatically increased every year to keep pace with the general increase in prices — this is known as the Cost of Living Adjustment (COLA), and it prevents the purchasing power of retirees’ monthly benefit checks from declining over time due to inflation.

The COLA is determined each year by the Social Security Administration based on observed inflation over the previous year. For example, the COLA applicable to Social Security benefits payable in January 2009 was 5.8 percent, calculated on the basis of inflation observed between 2007 and 2008.

This year, however, incoming data suggest that inflation will average about *negative 5* percent. Because nominal benefit amounts will remain unchanged, retirees will experience a 5 percent increase in the purchasing power of their Social Security checks. This is expected to happen next year, too, given forecasts of continued economic sluggishness. Assuming that next year’s inflation rate also comes in at negative 5 percent, the cumulative two-year increase in the purchasing power of retirees’ Social Security benefits will exceed 10 percent. A quick calculation shows that seniors’ real purchasing power (or the amount of additional consumption) from their Social Security benefits will increase by about \$1,280 over those two years.

On the other hand, with low consumer demand, high unemployment, and poor business profitability in most sectors, workers are unlikely to see any wage increases this year or next year. Indeed, with continuing layoffs, average wage growth is probably negative. Yet while workers are in a worse situation, we don’t hear as much about their plight. Retiree lobbies are much more organized and employ clever rhetoric to make us feel guilty about retirees’ difficulties in a down economy.

The complaint that seniors’ living costs are rising because they spend so much more on out-of-pocket health-care costs and premiums also rings untrue. What’s the story here? Medicare Parts A, B, and D require enrollees to pay premiums to finance a minor part of the government’s total expenditure on those benefits. According to the Centers for Medicare and Medicaid Services (CMS), the Medicare Part A premium will increase by 4.3 percent — in line with increases in the costs of inpatient hospital, skilled nursing, and other services covered under Part A. However, 99 percent of seniors do not pay Medicare Part A premiums because they are “fully insured” under Social

Security.

The premium for Medicare Part B was not increased in 2009 and probably won't increase next year despite positive health-care inflation in 2008. According to the Bureau of Labor Statistics, medical-care prices rose by 3.2 percent over the past 12 months. However, Part B's 2009 premium was not increased because the Supplementary Medicare Insurance (SMI) trust fund presently has a "more-than-adequate" reserve. This means that, for the same premium on Medicare Part B this year and next, seniors will receive medical benefits of larger value compared with non-medical goods and services.

According to the CMS, Medicare Part D premiums will increase only slightly (by \$2, on average) in 2009. However, the CMS notifies beneficiaries about how they can avoid paying more by shifting to alternative plans that provide the same or similar coverage at more competitive rates. Thus, the average cost increase per Part D beneficiary should turn out to be much smaller.

A recent study by Dartmouth economist Alan Gustman and his colleagues suggests that those who are likely to be most dependent on Social Security — those whose total wealth is below the national median — have at most 7 percent of their wealth tied up in stocks. Considering that few seniors sell or borrow against their homes, the recent decline in home values is also unlikely to reduce their consumption.

In summary, the failure of Social Security to increase COLAs at a time when medical inflation is positive, stock and housing markets are down, and the economy remains sluggish is unlikely to worsen the economic condition of today's retirees.

— *Jagadeesh Gokhale is a senior fellow and Angela Erickson a research assistant at the Cato Institute.*

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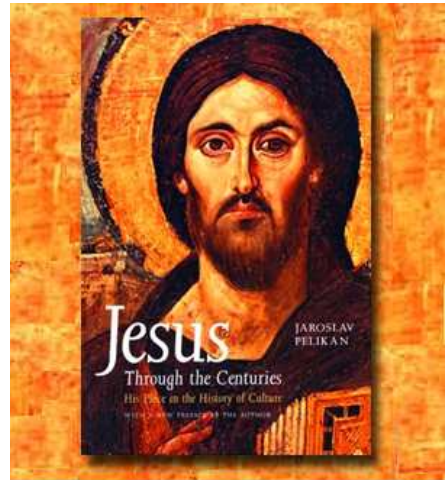
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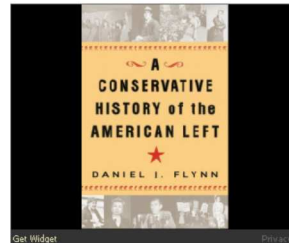
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