“Cost-of-Living Adjustments” and Federal Benefits

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Purpose of Benefit Adjustments

• What “level” do we intend to maintain?
  1) Standard-of-living increases?
  2) Pure price increases?
  3) Modified price increases?
  4) Price increases for the elderly?

• Adjustments across generations
  ➢ Social Security: Standard-of-living increases
  ➢ SSI: Modified price increases (lowered)

• Adjustments after an individual’s benefit starts
  ➢ Both: Modified price increases (lowered)
What Level Do We Intend to Maintain?

1) Standard-of-living increases
   - Change in average earnings level of workers
   - Reflects “real” income growth (about 1.1 percent per year)
     • Ability to increase consumption in line with workers
     • Consistent with lifetime income hypothesis
     • Maintain relative income position in the society
   - Social Security maintains *initial* benefit replacement rate across generations
What Level Do We Intend to Maintain?

2) Pure price increases
   – Old-style CPI, without adjustments
   – “Fixed market basket”
     • Nothing added for new items we purchase, but prices drop a lot after introduction
     • No effect for changing purchase weights
     • No effect for increasing average real income
   – What we had in the 1970’s when automatic COLAs started
What Level Do We Intend to Maintain?

3a) Modified price increases (lowered)
   – Current CPI-W, includes some adjustments
   – Presumes substitution within strata (categories)
     • Still nothing added for new items we consume, but dropping prices after introduction are reflected even more
     • Presumes shift to items inflating less; not necessarily from steak to hamburger, but to whatever has less price increase!
     • No effect for increasing average real income
   – What we have now with “geometric means” adjustment within each of the 211 strata of goods and services
     • This has slowed CPI increase by about 0.2 percent per year
What Level Do We Intend to Maintain?

3b) **Further** modified price increases (lowered)
   - Chained CPI-U, includes *more* adjustments
   - Presumes substitution within *and across* strata
     * Still nothing *added* for new items we consume, but dropping prices after introduction are reflected much more
     * Incorporates any shift across *non-substitutable* strata
       - Reflects shifts by *all urban consumers*
       - Not necessarily from luxuries to staples, but whatever happens
     * No effect for increasing average real income
   - What we can have assuming that overall changes in distribution of consumption across broad strata of goods and services apply equally to beneficiaries
     * This would further slow CPI increase by about 0.3 percent per year
What Level Do We Intend to Maintain?

4) Price increases for those aged 62+
   – CPI-E reflects “market basket” across 211 strata for those age 62+ (more medical and housing)
   – Presumes substitution within strata
     • Still nothing *added* for new items we consume, but dropping prices after introduction are reflected more
     • Same weights and presumed substitution within strata as for all urban consumers; might be different for those age 62+
     • No effect for increasing average real income
   – Experimental? Sample too small for CPI-E?
     • 2006 (BLS)  CPI-W 37%  CPI-E 16%
     • 2009-10 (BLS) CPI-W 33%  CPI-E 24%
     • 2020  CPI-W 30%?  CPI-E 30%?
Benefit Adjustment Options:
What do we intend and what is appropriate?

1) **Standard-of-living increase?** (average earnings increase)
   - Increase benefits at same rate as for workers
   - Annual increase 1.1-percent more than current CPI-W

2) **Pure price increase?** (old-style CPI)
   - Would not presume behavioral shift to slower inflating items
   - Annual increase 0.2-percent more than current CPI-W

3a) **Modified price increase?** (current CPI-W)
3b) **Further modified price increase?** (chained CPI-U)
   - Reflects overall shifts across non-substitutable categories
   - Annual increase 0.3-percent less than current CPI-W

4) **Price increase for elderly?** (CPI-E)
   - Would reflect the actual market basket consumed by those age 62 and over; possibly more appropriate for disabled as well?
   - Annual increase 0.2-percent more than the current CPI-W
Increase in Benefit Levels Depends on Intended Adjustment Goal

Comparison of Social Security Retirement Benefit Levels with Different Annual Benefit Adjustments

- 1) Standard-of-Living Increase (average earnings)
- 2) Pure Price Increase (old CPI)
- 3a) Modified Price Increase (current CPI-W)
- 3b) Further Modified Price Increase (Chained CPI-U)
- 4) Elderly CPI (CPI-E)

Monthly Benefit

Age (with eligibility at age 62)

- $1,200
- $1,600
- $2,000
- $2,400
- $2,800
- $3,200
- $3,600

- 24% higher than Current Law
- 4% higher
- 6% lower
Effects on Benefit Levels Accumulate with Age
(with time since eligibility)

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Percent of Present Law Benefit

Age (with eligibility at age 62)