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“Social Security’s COLA Conundrum”

In a perfect world, Social Security would be a privatized system in which individuals manage their own retirement accounts and adjust the disbursement of their savings and investments — including factoring for inflation — themselves. But it isn’t.

As it is, Washington bureaucrats exert considerable control over the over 56 million Social Security recipients by controlling Social Security payments and subsequent cost of living adjustments (COLAs).

The current COLA system is deemed to cost too much. Hence, there is a proposal being mulled in Washington to change how COLAs are computed.

Right now, the Social Security COLAs are determined by year-over-year third-quarter percentage changes in the “fixed-weighted” Consumer Price Index (CPI for Wage Earners and Clerical Workers) over the most recent two years in which there has actually been an increase in the CPI. No increase or a decline in the CPI means no COLA.

The term fixed-weighted comes from a fixed “basket” of consumer goods and services — such as food, housing, transportation costs and other things — used to measure price fluctuations. The contents of this basket are only updated periodically.

Now there is a proposal to switch to a “chain-weighted” CPI measure — the CPI for All Urban Consumers — for computing COLAs in which the basket would be updated every year.

The logic for this change is that consumer purchases shift from high-priced to cheaper-priced goods and services over time. Consequently, by updating the basket of goods and services (the weights) each year, cheaper goods and services would receive a heavier weight than under the fixed-weighted system, inflation would be lower and the COLA would thus be reduced.

What does this mean to America’s retirees?

To answer this, take the average Social Security payment in 2005 — $12,024 — and run it through both fixed-weighted and chain-weighted COLA calculations. According to price data from the federal Bureau of Labor Statistics, Social Security income under the fixed-weighted COLA system would have paid out $95,174 between 2006 and 2012 (an average of $13,596 per year). Using the proposed chain-weighted method, the payout would have been $93,656 (or an average of $13,379 annually).

So, the average Social Security recipient would have received $1,518 less over the seven-year period under the chain-weighted alternative than under the fixed-weighted system — an average of $217 less per year.

If retirees have other savings to draw upon or want to do their part by getting a little less during this dark fiscal time, then chain-weighted sacrifice in their COLA may be acceptable. However, over one-third of all retirees rely on Social Security as their sole source of income. If this is the case, or close to it, a smaller COLA may be difficult to swallow.

How do we square this circle?

It may be acceptable for the federal government to adopt a chain-weighted method for computing Social Security COLAs, but not using the proposed broad CPI measures that may not necessarily reflect the types of purchases that retirees make.

As a compromise, Social Security recipients might request that the Consumer Expenditure Survey be used to identify annual baskets of goods and services the retirees purchase to test whether chain-weighted baskets produce smaller COLAs than those based on the current fixed-weighted basket.

If chain-weighted COLAs that are based on a retiree's basket of purchases are smaller than the fixed-weighted COLAs, but greater than chain-weighted COLAs based on the broad CPI measure, then it might represent an alternative Social Security recipients could consider.

As the nation's economic tumult continues without a foreseeable end, this is a conversation that aging Americans must have with their elected representatives, lest faceless bureaucrats in Washington end up doling out a tough new normal.

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