How The Chained Consumer Price Index Would Affect Social Security Benefits

By Mary Johnson

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Introduction

The purpose of the annual Social Security cost-of-living adjustment (COLA) is to protect beneficiaries from a loss of buying power due to rising prices.[1] According to a paper from the Social Security Office of Retirement and Disability Policy, without accurate adjustments, the purchasing power of benefits erodes as prices increase. This loss of buying power in Social Security benefits requires beneficiaries to spend other sources of income, such as pensions and retirement accounts, more rapidly than expected to cover rising costs. People who don't have other resources, and who depend on Social Security for the majority of their income, often go into debt, and may turn to federal safety net programs like Medicaid and food stamps for assistance, or they may go without. This may lead to foregoing basic necessities like food and medicine and to poorer health.

The consumer price index (CPI) affects what older and disabled Americans receive in Social Security income, and because it is used in the tax code, what they pay in taxes. It is used to adjust not only Social Security benefits for inflation but also many other federal programs, including military and federal worker retirement programs. It is also used to set the income thresholds that determine eligibility for safety net programs that include food stamps, Medicare Savings Programs and Medicaid. Finally, the CPI is used to adjust the tax code, including tax brackets and the standard deduction.

The U.S. Bureau of Labor Statistics (BLS) maintains a number of price indexes that represent the spending of various population groups with different "market baskets." The BLS has also constructed a new index, known as the chained CPI, which uses an alternate means of measuring the standard of living, and grows more slowly than traditional CPIs.

The Congressional Budget Office (CBO) has estimated that using the chained CPI to index Social Security and other federal programs would reduce federal spending by $182 billion through 2026.[2] The proposal is a major provision in plans to reform Social Security as well as negotiations to cut federal spending. Adopting the chained CPI to index Social Security benefits would result in lower benefits for more than 66.9 million beneficiaries.[3]

Inflation Depends On The Market Basket That's Measured

Inflation can be experienced differently by different groups of people. This is due to the "market basket" or the specific item expenditures and the portion of income that individuals expend on those items — known as the "weighting." The U.S. Bureau of Labor Statistics (BLS) maintains a number of traditional price indexes that represent the spending of certain consumer groups. Those CPIs differ primarily in the weighting used to compute the index. For example, older consumers spend more of their budgets on healthcare and housing than younger workers. Younger workers spend more on commuting costs, such as gasoline.

The Social Security COLA is indexed to Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Ironically, the CPI-W is based on the spending patterns of urban workers, who are working people *younger than age 62* — not on the spending patterns of retirees, most of whom are *older than age 62,* or the younger disabled adults, most of whom no longer work due to severe disability. The CPI-W gives less weight, for example, to housing and medical costs. Those two costs, however, tend to grow faster than overall inflation in most years, and require a greater portion of the household budgets of both older and disabled beneficiaries. Thus, the CPI-W does not fully capture the inflation experienced by retirees and disabled adults.

Nevertheless, some analysts have argued that the CPI-W overstates inflation because it does not fully account for how consumers substitute lower cost items as prices change. For this reason, they argue that COLAs "*tend to increase, rather than merely maintain, the purchasing power of benefits over time.*"[4] They say the new index called the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) would be a "more accurate" cost-of-living index.

Other analysts, most beneficiaries, and advocates, including The Senior Citizens League, say that there is no evidence to suggest that COLAs maintain the purchasing power of benefits, let alone increase purchasing power. In fact, according to an ongoing study by The Senior Citizens League, price data indicate that the traditional CPI-W *understates* inflation for people over the age of 62 and disabled beneficiaries, the two groups who make up the vast majority of Social Security recipients. In 2017, the study found that Social Security benefits have lost 30 percent of buying power since 2000.[5] The Senior Citizens League believes the Consumer Price Index for Elderly Consumers (CPI-E), which more closely reflects the spending patterns of older Americans, would provide a more appropriate index for calculating the COLA.

How the Consumer Price Indexes Differ

Inflation is traditionally calculated by measuring the percentage of change in prices of specific items or services from one time period to the next. The BLS has developed an alternate inflation measure that computes changes in the standard of living (rather than prices alone) known as the chained CPI. That index does not measure price increases directly, but rather the substitution behavior of consumers when prices increase. The chained CPI assumes consumers shift to lower-priced goods across different categories. For example, if beef becomes too expensive, consumers may buy more chicken. Thus, the index grows more slowly than traditional CPIs.

According to the CBO, the chained CPI has grown about 0.25 percentage points more slowly per year over the past decade than the traditional CPI.[6] Had COLAs been calculated using the chained CPI since the data first became available in 2001, Social Security benefits would be about 5 percent lower than they are today (See Table 1, page 6). For example, average monthly Social Security benefits of $850 in 2001 would be more than $56.80 lower today. Overall benefit growth would be almost $6,148.00 lower.

Since 2001 the CPI-W increased benefits a total of 35.1 percent, compared with the chained CPI, which increased 31.4 percent. In contrast, the CPI-E increased 37.7 percent over the same period, as shown in the following table:

How Cost of Living Adjustments Using Three CPIs Compare Since 2001

	Total Percentage Of Increase	Average Difference from CPI-W Per Year
Consumer Price Index For Urban Wage Earners and Clerical Workers (CPI-W)	35.1%	
Chained Consumer Price Index for All Urban Consumers (C-CPI-U)	31.4%	0.2% slower per year
Consumer Price Index For the Elderly (CPI-E	37.7%	0.2% faster per year

Switching to the chained CPI for indexing all government programs would lower benefits in other programs, and fewer people would qualify for low-income benefits as federal poverty level income thresholds grow more slowly over time. The CBO estimates that using the chained CPI to index Social Security and other federal programs would reduce federal spending by $182 billion through 2026.[7] The proposal is a major provision in plans to reform Social Security as well as negotiations to cut federal spending. Using the chained CPI to index Social Security has featured in budget negotiations over the past decade, but the proposal has never passed.

Recent tax reform legislation mandates the use of the chained CPI to adjust the parameters of the tax code. Income tax brackets and the standard exemption would rise more slowly over time, meaning a growing number of taxpayers are expected to pay more in taxes over time.

Drawbacks For Using the Chained CPI To Index Benefits

Using the chained CPI for indexing purposes is problematic. Unlike the traditional CPI in which the final data are available when released, the Bureau of Labor Statistics initially releases only estimates of the chained CPI data. The estimates are subject to multiple revisions with final data posted 10 to 16 months after the initial release[8]. Using initial data to index the COLA would subject benefit adjustments to estimation error. According to the CBO, initial values of the chained CPI have generally been lower than final values.[9] If initial data were used

to index Social Security benefits and final data were be higher than the initial data indicate, benefits would be permanently lower, despite the final actual data.

Reduction in COLAs would compound over time, hitting the beneficiaries who have received benefits over longest period of time the hardest. The biggest reductions would occur toward the end of life at the time when many retirees tend to have spent or gone through much of their resources and need the income the most.

According to projections for The Senior Citizens League, had the chained COLA taken effect January 1, 2018, the average Social Security benefit of $1,300 would be about $175 per month lower at the end of a 30-year retirement period, and the overall benefit income would be $25,675 (about 7 percent) lower over the period.

Conclusion

The purpose of indexing Social Security and other federal benefits for inflation is to prevent the loss of purchasing power of benefits over time as prices rise. However, studies by The Senior Citizens League indicate that Social Security benefits are losing buying power even under current law as indexed by the CPI-W. Since 2000, Social Security benefits have lost 30 percent of their buying power. Using the chained CPI would make this problem worse.

The methodology used to calculate the chained CPI deviates from the original intent to protect the buying power of Social Security benefits when prices increase, because it does not directly measure rising prices. The chained CPI attempts to measure more subjective consumer substitution behavior. The chained CPI in essence measures how the standard of living drops when prices go up or improves as prices go down. A Social Security paper on the chained CPI explains it as determining *"the cost at this month's market prices, of achieving the standard of living actually attained in the base period."*[10] The report goes on to note that the cost of achieving a living standard "cannot be observed directly and can only be approximated."[11]

The Senior Citizens League believes that COLAs can be improved legislatively through three means:
1. Indexing with the Consumer Price Index for the Elderly (CPI-E).
2. Providing a modest one-time bump – up in monthly benefits to remedy the past 9 years of record low inflation (2010- 2018) when COLAs averaged 1.2 percent.
3. Providing a guaranteed minimum COLA of 3 percent.

While these measures would cost the system more, The Senior Citizens League supports finding new revenues by lifting the taxable maximum wage limit to apply the 12.4 percent Social Security payroll tax to all wages and modestly increasing the overall payroll tax rate.

Appendix

Table 1

How Benefit Growth Compares With the CPI-W Using the Chained CPI

Year	Average Monthly Benefit CPI-W	COLA CPI-W	Average Monthly Benefit C-CPI-U	COLA C-CPI-U	Monthly Difference	Yearly Difference
2001	$850.00	2.60%	$850.00	2.10%	$0.00	$0.00
2002	$872.10	1.40%	$867.85	1.30%	($4.25)	($51.00)
2003	$884.31	2.10%	$879.13	2.00%	($5.18)	($62.13)
2004	$902.88	2.70%	$896.71	2.50%	($6.17)	($73.98)
2005	$927.26	4.10%	$919.13	3.40%	($8.13)	($97.50)
2006	$965.28	3.30%	$950.38	3.10%	($14.89)	($178.71)
2007	$997.13	2.30%	$979.84	2.00%	($17.28)	($207.41)
2008	$1,020.06	5.80%	$999.44	5.20%	($20.62)	($247.46)
2009	$1,079.23	0.00%	$1,051.41	0.00%	($27.81)	($333.77)
2010	$1,079.23	0.00%	$1,051.41	0.00%	($27.81)	($333.77)
2011	$1,079.23	3.60%	$1,051.41	2.90%	($27.81)	($333.77)
2012	$1,118.08	1.70%	$1,081.90	1.60%	($36.18)	($434.10)
2013	$1,137.09	1.50%	$1,099.21	1.30%	($37.87)	($454.47)
2014	$1,154.14	1.70%	$1,099.49	1.60%	($54.65)	($655.82)
2015	$1,173.76	0.00%	$1,117.08	0.00%	($56.68)	($680.16)
2016	$1,173.76	0.30%	$1,117.08	0.60%	($56.68)	($680.16)
2017	$1,177.28	2.00%	$1,123.79	1.80%	($53.50)	($641.99)
2018	$1,200.83		$1,144.01		($56.82)	($681.80)
Totals		35.10%		31.40%		($6,147.99)
Total difference	3.70%					
Average	0.22%					
Source of starting benefit: Social Security Administration						
Source of CPI data: Bureau of Labor Statistics						

[1] Social Security Cost-of-Living Adjustments and the Consumer Price Index, Burdick and Fisher, Social Security Bulletin, Vol.67 No.3, 2007, https://www.ssa.gov/policy/docs/ssb/v67n3/v67n3p73.html.

[2] Options For Reducing The Deficit: 2017 to 2026, Congressional Budget Office, December 2016.

[3] Social Security Administration data through December 2017.

[4] Social Security Cost-of-Living Adjustments and the Consumer Price Index, Burdick and Fisher, Social Security Bulletin, Vol.67 No.3, 2007.

[5] The 2017 Loss of Buying Power Study, Mary Johnson, The Senior Citizens League.

[6] Options For Reducing The Deficit: 2017 to 2026, Congressional Budget Office, December 2016.

[7] Ibid.

[8] Frequently Asked Questions About the Chained Consumer Price Index for All Urban Consumers (C-CPI-U), Bureau of Labor Statistics, accessed on January 23, 2018.

[9] Using the Chained CPI to Index Social Security, Other Federal Programs, and the Tax Code for Inflation," Testimony of Jeffrey Kling, Congressional Budget Office, Before the U.S. House Subcommittee on Social Security, Committee on Ways and Means.

[10] Ibid.

[11] Social Security Cost-of-Living Adjustments and the Consumer Price Index, Burdick and Fisher, Social Security Bulletin, Vol.67 No.3, 2007.