How Cost-of-Living Adjustments Affect Social Security Benefits

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You don't have to be collecting Social Security to benefit from inflation adjustments. Unclaimed benefits go up too. Here's how inflation factors into the benefit formula whether you're working or collecting.

Cost-of-living adjustments (COLAs) are very important to Social Security recipients. Regardless of what the official CPI (Consumer Price Index) registers, most retirees see a fairly steady increase in the cost of living from year to year. That's why, when their checks go up in January, most retirees are grateful for the bump in income—even though Medicare premiums may offset part of it.

While the effect of the COLA may be clear to people who are already receiving Social Security, what isn't so clear is how it affects people who haven't filed for benefits yet. How will their eventual benefit be affected by annual COLAs?

To answer this, we have to dig deep into the Social Security benefit formula. Stay with me here, because it's pretty interesting.

As you know, nearly everyone pays into Social Security. (Certain groups such as civil service employees that have opted out of the Social Security system are excluded from this discussion.) Your employer withholds 6.2% of your gross pay up to the maximum taxable wage base and sends it along to the Social Security Administration (SSA), along with another 6.2% from the employer's pocket, and a report of your W-2 earnings for the year. The money goes into the Social Security trust fund and is used to pay benefits to current retirees. The report goes into the SSA databank and is used to compile your earnings record.

When you turn 62, your earnings record is tallied up. First, each year's earnings are indexed to bring them into line with current wages. Let's use Boomer Bob as an example. He was born in 1951, which means he turned 62 in 2013. He has earned the maximum taxable Social Security wage base since 1973. In 1973 the maximum taxable wage base was $10,800. But when Bob's $10,800 earnings are indexed, they count for $61,236. The $13,200 he paid Social Security taxes on in 1972 counts as $70,644, and so on. Each successive year's earnings are multiplied by a gradually decreasing index until it reaches 1 at age 60. The $110,100 he earned in 2012 count at its nominal value.

After each year's earnings are indexed, the highest 35 years are identified. As it turns out, those early years, from 1973 through 1977 won't be counted because his highest 35 years of earnings were

1978-2012. Adding up all the indexed earnings from 1978 through 2012, Bob had lifetime Social Security earnings of $3,586,573. Dividing this by 420, which is the number of months in 35 years, Bob has average indexed monthly earnings (AIME) of $8,539.

To calculate his Social Security primary insurance amount (PIA), the $8,539 is divided into three "bend points." Each bend point is multiplied by a different percentage:

Bob's PIA =
0.90 x $791 +
0.32 x $3,977 +
0.15 x $3,771 = $2,550

This primary insurance amount is Bob's benefit when he turns full retirement age, or 66. So although it's calculated at age 62, it's not the benefit he would receive at 62. If he files at 62, his PIA would be reduced to 75%, giving him a monthly benefit of $1,912 ($2,550 x .75). Then in January of the following year, his benefit would be increased by the annual COLA.

But what happens if Bob doesn't file for his benefit at 62? Does he still somehow get the COLA increase? The answer is yes. The following year, Bob's PIA will go up by the amount of the COLA. And the following year his PIA will go up again. Notice that it is compounded. This is important when you are considering the lifetime value of Social Security benefits.

Incidentally, if Bob keeps working, his earnings record will be updated and his PIA will be recomputed each year. If he earns the maximum wage base, an earlier year of earnings will drop off and be replaced by the higher amount. This is why even maximum earners can continue to improve their Social Security benefit by continuing to work. But back to inflation.

How inflation affects Boomer Bob's Social Security benefit

The inflation adjustments on Boomer Bob's Social Security benefit happen in two ways: 1) the indexing factors that go into the initial calculation of his benefit at 62, and 2) the annual COLA adjustments that raise his PIA after it has been calculated at age 62 — whether or not he has started receiving benefits. These inflation adjustments are different for each age cohort. Boomer Betty, born in 1952, will have a slightly different PIA than Boomer Bob even if she is also a maximum earner.

The indexing factors that adjust Bob's early wages and determine the bend points are based on the national average wage index when he turns 60. The COLAs that raise his benefit each year after he turns 62 are based on the CPI-W. In other words, his benefit increases before age 60 are based on wage increases. After age 62 they are based on price increases. (There is no increase from age 60 to 62.)

The double whammy of COLAs and delayed credits

When doing Social Security planning, it is important to understand the value of potential benefits <u>over your lifetime</u> and maximize those benefits to the extent possible. This usually means delaying the start of benefits to full retirement age or later so there will be no permanent reduction in benefits. Then when COLAs are paid, they will go on top of the higher starting amount.

The following table shows what Boomer Bob's benefit will be if he applied in 2013 at 62, in 2014 at 63, and so on. The COLA-adjusted PIA shown in the third column assumes a starting PIA of $2,550 as noted above, increased by an annual 2.5% COLA.

Starting benefit including COLAs and actuarial reduction or delayed credits

Year	Age	COLA- adjusted PIA	Benefit as % of PIA if he applies this year	Starting benefit
2013	62	$2,550	75.0	$1,913
2014	63	$2,614	80.0	$2,091
2015	64	$2,679	86.7	$2,323
2016	65	$2,746	93.3	$2,562
2017	66	$2,815	100	$2,815
2018	67	$2,885	108	$3,116
2019	68	$2,957	116	$3,430
2020	69	$3,031	124	$3,759
2021	70	$3,107	132	$4,101

(Assumes 2.5% annual COLAs)

As you can see, there's a huge disparity between the $1,913 he'll receive in 2013 if he starts at 62, and the $4,101 he'll receive in 2021 if he starts at 70. So let's even things out a bit by looking at what his benefit will be in 2021, when he is 70, depending on when he started benefits.

Benefit at age 70 based on claiming age

Year	Age	Age benefit started	COLA-adusted benefit
2021	70	62	$2,330
2021	70	63	$2,486
2021	70	64	$2,693
2021	70	65	$2,900
2021	70	66	$3,107
2021	70	67	$3,355
2021	70	68	$3,604
2021	70	69	$3,853
2021	70	70	$4,101

(Assumes 2.5% annual COLAs)

So his income at age 70 will be substantially lower if he applies at 62 than if he applies at 70.

One of the points we like to make when encouraging clients to delay benefits is that COLAs magnify the disparity between early and late claiming. So let's see what Boomer Bob's COLA raise would be when he turns 71 depending on when he started benefits. Again, we'll assume 2.5%

Benefit Raise at Age 71 if COLA is 2.8%

Age benefit started	COLA- adjusted benefit at age 70	Monthly raise at age 71 if COLA is 2.5%	Annual raise at age 71 if COLA is 2.5%
62	$2,330	$58	$699
63	$2,486	$62	$746
64	$2,693	$67	$808
65	$2,900	$73	$870
66	$3,107	$78	$932
67	$3,355	$84	$1,007
68	$3,604	$90	$1,081
69	$3,853	$96	$1,156
70	$4,101	$103	$1,230

Note how much bigger the raises are on the higher benefit amounts. We can assume that all Social Security recipients celebrate when a generous COLA is announced. But some recipients celebrate more than others. These would be the ones who received higher raises because the annual increase is applied to a higher benefit amount.

In today's low interest-rate, low-return environment, the fixed Social Security formula that escalates the starting benefit for delayed claiming is looking like a better deal all the time. And when COLAs are applied to the higher amounts, annual raises become significant as well.

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