IN FOCUS

May 17, 2022

Social Security: Cost-of-Living Adjustments (COLAs) and the System's Projected Financial Shortfall

Recent news articles have suggested that the historically large 5.9% cost-of-living adjustment (COLA) payable in January 2022 will have a negative impact on the projected financial shortfall of the Social Security programs. If inflation persists, another large COLA may be payable in January 2023. This In Focus provides a brief description of the Social Security program, its projected financial shortfall, and an overview of the annual COLA. It then addresses how the COLA is financed and how the COLA affects the projected financial status of the Social Security programs.

Social Security Background and Projected Financial Shortfall

Social Security is a social insurance program that protects insured workers and their eligible family members against a loss of income due to the worker's retirement, disability, or death. The program is comprised of Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) and is referred to on a combined basis as OASDI. In 2022, about 178 million workers will be employed in Social Security–covered employment, and the program is expected to pay benefits to more than 65 million beneficiaries.

Social Security is primarily self-financed through dedicated payroll taxes (90.1% of total income in 2021). The remainder of the program's income comes in the form of federal income taxes paid by about half of beneficiaries on a portion of their benefits and interest earned by assets held in the trust funds. In 2021, 99.0% of total expenditures went toward monthly benefit payments.

Social Security's costs currently exceed income. Because of this annual deficit, assets held in the trust funds (excess revenues from prior years) are used to augment program income. Annual deficits are projected to continue throughout the program's 75-year projection period. As a result, trust fund assets are projected to decline steadily from $2.9 trillion in 2021 to zero in 2034. Following the depletion of trust fund assets, scheduled tax revenues are projected to be sufficient to pay 78% of scheduled benefits initially, declining to 74% by 2095 (under the intermediate assumptions in the 2021 Annual Report of the Social Security Board of Trustees, the trustees' best guess of future experience).

Wage and Price Indexing in Social Security Benefit Calculations

The original benefit formula used to calculate Social Security benefits separated a worker's average monthly wages—average of *nominal* earnings from all years of employment—into brackets and applied a replacement rate to each bracket. The parameters used to calculate benefits

were not indexed, and ad hoc legislation was required to create new brackets. So long as wage and price growth remained relatively stable, this approach kept *initial* benefits aligned with wage growth (to maintain replacement rates) and *current* benefits (benefits already in payment) aligned with price growth (to maintain purchasing power). Inflationary conditions in the 1970s led to higher-than-expected benefits as price growth outpaced wage growth.

Through several amendments, Congress *decoupled* the effect of wage and price growth. Under the current-law benefit formula, a worker's past earnings (up to age 60) and the bend points in the formula used to progressively replace earnings are *indexed to the average wage index (AWI)*. Thus, initial benefits—which can be collected at the earliest eligibility age (EEA) of 62—tend to increase with increases in average wages. If benefits are claimed after the EEA, the initial benefit is also *indexed to prices* as measured by the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Specifically, the initial monthly benefit is adjusted based on the Social Security COLA for the period from benefit eligibility to benefit receipt. In addition, benefits already in payment are adjusted annually based on the Social Security COLA. Thus, after the EEA, benefits tend to increase with increases in average prices.

The Social Security COLA is based on the increase (if any) in the CPI-W over a specified measurement period—that is, the increase in the CPI-W from the third quarter average for the base calendar year (typically the previous calendar year) to the third-quarter average for the current calendar year. The COLA becomes effective in December of the current year and is payable in January of the following year. (Monthly benefits reflect the benefits due for the preceding month.) In some years, there may be a decrease in the CPI-W over the measurement period. Such was the case for COLAs computed in 2009, 2010, and 2015 (for benefits payable in 2010, 2011, and 2016, respectively). Social Security benefits are protected from a decrease in average prices (i.e., a COLA cannot be negative). In those years, benefit amounts remained unchanged.

A 5.9% COLA was payable in January 2022, as announced on October 13, 2021, by the Social Security Administration. For a retired worker receiving the average monthly benefit of $1,565 in 2021, the COLA resulted in about a $91 increase in benefits, to $1,656. Thus, COLAs result in higher benefit amounts for beneficiaries and lead to higher program costs. The 2021 Annual Report, submitted to Congress on August 31, 2021, projected a COLA of 2.4% for 2023 (under the intermediate assumptions). The President's FY2023 budget, submitted to Congress on March 28, 2022, projects a COLA of 4.3% for 2023. From

1976, when the first COLA was payable, to 2022, COLAs have averaged 3.7%.

How Is the COLA Financed?

The cost of COLAs (i.e., benefit increases) have traditionally been *at least* partially offset by increases in payroll tax revenues. Payroll taxes are levied on covered earnings up to a maximum amount each year, the *contribution and benefit base* (CBB). The CBB is commonly referred to as the *taxable maximum*. The CBB is a cap on both contributions and benefits. As a contribution base, it establishes the maximum amount of a worker's earnings subject to the payroll tax. As a benefit base, it establishes the maximum amount of earnings used to calculate benefits. The CBB is indexed to the AWI. Thus, the amount of economy-wide earnings subject to the Social Security payroll tax generally increases each year. In 2022, the CBB increased to $147,000 (from $142,800 in 2021). The 2021 Annual Report projected a CBB of $156,000 for 2023 (under the intermediate assumptions). The President's FY2023 budget projects a CBB of $156,300 for 2023.

The formula for determining the CBB is set by law (42 U.S.C. §430[b]). For any year after 1994, the CBB is equal to the base for the year 1994 ($60,600) multiplied by the ratio of the AWI for two years before the year for which the amount is being calculated to the AWI for the year 1992 (i.e., 1994 *minus* 2), with the result rounded to the nearest multiple of $300. If the result is less than the current base, then the base is not reduced. That is, if the AWI decreases, resulting in a drop in the CBB, the CBB from the prior year is used. Also, due to the $300 rounding rule, it is possible for the CBB to remain unchanged in years of little wage growth. In 2009, the AWI decreased by -1.51%, and as a result, the CBB from 2010 to 2011 did not change.

Between 1972 and 1977, and since 1982, the adjustment to the CBB has been effective only when a COLA is payable. If there is no COLA, the CBB remains unchanged regardless of wage growth. For example, no COLA was payable in 2016. As a result, although the AWI increased in 2014 (the AWI from two years prior used to calculate the 2016 CBB), the CBB was unchanged from 2015 to 2016.

Congressional reports accompanying the Social Security Amendments of 1972 explicitly indicated that automatic increases in the CBB were intended to provide financing for increases in benefits resulting from automatic COLAs and from increases in the CBB itself. However, the degree to which the increased benefits would be offset in any given year is unclear. In general, it is thought that higher-COLA years will be balanced by subsequent lower-COLA years.

How Might COLAs Impact Social Security's Financial Status?

The financial health of Social Security is determined by the combination of inflows (i.e., tax revenues and earned interest) and outflows (i.e., benefit payments and program administration). Simply speaking, it is the interactions among revenues, costs, and the asset reserves held in the trust funds. Changes that increase revenues, decrease costs, or increase trust fund reserves have positive effects on the program's financial status. Changes that decrease revenues, increase costs, or decrease trust fund reserves have negative effects on the program's financial status.

The CBB and COLA can interact in three possible combinations, and each combination affects the program's financial status in a different manner. One scenario is a payable (positive) COLA and an increase in the CBB. (This has happened in most years.) A payable COLA would lead to higher benefit payments (costs), while the increase in the CBB would lead to an increase in the total amount of earnings subject to the payroll tax. That is, there would be an *immediate* increase in revenues *and* costs. The degree to which the increase in revenues would offset the increase in costs would depend on the relative magnitude of each increase, among other factors. A second scenario is a payable COLA while the CBB remains unchanged (due to a decrease in the AWI or the CBB rounding rule). A payable COLA would lead to higher benefit payments (costs), while an unchanged CBB would result in roughly the same amount of earnings subject to the payroll tax. Under such a scenario, there would be an *immediate* increase in costs and relatively *no change* in revenues. A third scenario is no COLA (i.e., flat or declining price index) while the CBB remains unchanged. (The CBB cannot increase if there is no COLA.) In this instance, there would be no *immediate* change in revenues or costs.

These scenarios present the *immediate* and *first-order effects* of COLAs on Social Security's financial status. However, the combinations of changes in CBB and COLAs can have varying *long-term effects* and *second-order effects*. For instance, in one year there may be a COLA but no increase in the CBB, so the increase in costs would not be offset by any increase in revenues. However, in subsequent years, there may be relatively small COLAs and relatively larger increases in the CBB. Perhaps, over a multiyear period, the increases in benefit costs would be more than fully offset by revenue increases, leading to improvements in Social Security's financial status. That is, any one year's COLA or CBB imbalance may not have *long-term*, lasting effects on the system's finances.

COLAs and CBB changes can have *secondary effects* as well. Increases in the CBB are generally associated with higher average benefits due to growth in the AWI. Conversely, if the AWI were to decrease, the CBB would remain unchanged, and average benefits would be lower than if wage growth were to increase or remain level. In this instance, the CBB would remain unchanged. Moreover, any of these combinations may induce behavior changes, such as changes in claiming ages, which could also affect Social Security's financial status.

CRS Report 94-803, *Social Security: Cost-of-Living Adjustments*, and CRS In Focus IF10522, *Social Security's Funding Shortfall*, provide more detailed discussions on COLAs and the projected financial shortfall, respectively.

Barry F. Huston, Analyst in Social Policy
Paul S. Davies, Specialist in Income Security

IF12109

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.