

How Cost-of-Living Adjustments Affect Social Security Benefits

Tracy Lasecke, CFP®
Chief Executive Officer
Lasecke Weil Wealth Advisory Group, LLC

51 E. Campbell Avenue
Suite 146
Campbell, CA 95008

408-806-0528

tracy@laseckeweil.com
www.laseckeweil.com



Social Security is an important part of your financial planning. We are here to help you make good financial decisions.

By Elaine Floyd, CFP®

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.

Social Security recipients are celebrating the 3.6% cost-of-living adjustment effective January 2012. After suffering through two years of 0% COLAs that were needed to work off a hefty 5.8% COLA in 2009, Social Security recipients are relieved to see a few more bucks coming in, although part of the increase will be offset by a rise in Medicare premiums.

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 the 3.6% COLA?

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 (4.2% in 2011) 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 June of 1949, which means he turned 62 in 2011. He has earned the maximum taxable Social Security wage base since 1971. In 1971 the maximum taxable wage base was \$7,800. But when Bob's earnings are indexed, the \$7,800 is multiplied by 6.4142399 to make it count as \$48,875 on his record. The \$9,000 he earned in 1972 is multiplied by 5.8417435 and counts for \$51,361, and so on. Each successive year's earnings are

multiplied by a gradually decreasing index until it reaches 1 at age 60. The \$106,800 he earned in 2009 and 2010 count at their nominal value.

After each year's earnings are indexed, the highest 35 years are identified. As it turns out, those early years, from 1971 through 1975 won't be counted because his highest 35 years of earnings were 1976-2010. Adding up all the indexed earnings from 1976 through 2010, Bob had lifetime Social Security earnings of \$3,330,098. Dividing this by 420, which is the number of months in 35 years, Bob has average indexed monthly earnings (AIME) of \$7,928.

To calculate his Social Security primary insurance amount (PIA), the \$7,928 is divided into three "bend points." Each bend point is multiplied by a different percentage:

$$\begin{aligned} \text{Bob's PIA} &= \\ &0.90 \times \$749 + \\ &0.32 \times \$3,768 + \\ &0.15 \times \$3,411 = \$2,391 \end{aligned}$$

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 now, his PIA would be reduced to 75%, giving him a monthly benefit of \$1,793 ($\$2,391 \times .75$). Then in January 2012, his benefit would be increased by the 3.6% COLA to give him a new benefit of \$1,858, a \$65 increase.

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. Next year, Bob's PIA will go up to \$2,477 ($\$2,391 \times 1.036$). And if there's another COLA in 2013, 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 of \$106,800 in 2011, his 1976 indexed earnings of \$67,510 will drop off and be replaced by the \$106,800. 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 1950, 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 **over your lifetime** 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 applies in 2011 at 62, in 2012 at 63, and so on. The COLA-adjusted PIA shown in the third column assumes a starting PIA of \$2,391 as noted above, increased by 3.6% in 2012 and 2.8% in each succeeding year.

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
2011	62	\$2,391	75.0	\$1,793
2012	63	\$2,477	80.0	\$1,981
2013	64	\$2,546	86.7	\$2,207
2014	65	\$2,618	93.3	\$2,442
2015	66	\$2,691	100	\$2,691
2016	67	\$2,766	108	\$2,987
2017	68	\$2,844	116	\$3,299
2018	69	\$2,923	124	\$3,625
2019	70	\$3,005	132	\$3,966

(Assumes 3.6% COLA in 2012 and 2.8% thereafter)

As you can see, there's a huge disparity between the \$1,793 he'll receive in 2011 if he starts at 62, and the \$3,966 he'll receive in 2019 if he starts at 70. So let's even things out a bit by looking at what his benefit will be in 2019, when he is 70, depending on when he started benefits.

Benefit at age 70 based on claiming age

Year	Age	Age benefit started	COLA-adjusted benefit
2019	70	62	\$2,254
2019	70	63	\$2,403
2019	70	64	\$2,605
2019	70	65	\$2,804
2019	70	66	\$3,005
2019	70	67	\$3,245
2019	70	68	\$3,486
2019	70	69	\$3,727
2019	70	70	\$3,966

(Assumes 3.6% COLA in 2012 and 2.8% thereafter)

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 2.8%

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 2.8%	Annual raise at age 71 if COLA is 2.8%
62	\$2,254	\$63	\$756
63	\$2,403	\$67	\$804
64	\$2,605	\$73	\$876
65	\$2,804	\$78	\$936
66	\$3,005	\$84	\$1,008
67	\$3,245	\$91	\$1,092
68	\$3,486	\$98	\$1,176
69	\$3,727	\$104	\$1,248
70	\$3,966	\$111	\$1,332

Note how much bigger the raises are on the higher benefit amounts. We can assume that all Social Security recipients are celebrating the 3.6% COLA increase for 2012. But some recipients are probably celebrating more than others. These would be the ones who received higher raises because the 3.6% increase was 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.

Elaine Floyd, CFP®, is the Director of Retirement and Life Planning, Horsemouth, LLC., where she focuses on helping people understand the practical and technical aspects of retirement income planning. Horsemouth is an independent organization providing unique, unbiased insight into the most critical issues facing financial advisors and their clients. Horsemouth was founded in 1996 and is located in New York City.
