

**One Bureau of Labor Statistics index guides annual COLAs for Social Security beneficiaries.
How does it work?**

“Well they measure inflation with an index called the consumer price index for wage-earners, and it’s basically based on the budget of average wage-earners around the country, and they find out what they spend their money on, and then they look at the prices of the things that they spend money on, and they compute the costs of buying a basket of goods and services with a few adjustments to it.”

Why wasn’t there a COLA in 2010, and why won’t there be one for 2011?

“It’s the first time they didn’t since indexing of the benefits began in 1972. Basically, they didn’t get any inflation adjustment because there hasn’t been any inflation since 2008, the last time they did get an adjustment.”

Why do a lot of economists argue that CPI overstates increases to the cost of living?

“First of all, if we really wanted to measure the cost of living, we’d try and compute how much happiness a dollar buys, and if it was more expensive to buy a unit of happiness, we’d presumably increase the benefit. But of course you can’t measure such a thing, so we used accrued approximation, which is the consumer price index. And that is based on typical purchases of American wage-earners, and they look at the prices of things that are purchased. Now the Bureau of Labor Statistics has gone to a great amount of trouble in recent years to try and make it more like a true cost-of-living index. Before 1999, you looked at the basket of goods that people bought and you assumed that they bought exactly the same amount regardless of price. So if the price of rye bread went up, you just bought the same amount. Well, people don’t behave that way, and it is more likely that they’ll reduce their purchases of rye bread and increase, say, whole wheat bread purchases. And now the CPI takes account of that, so that’s a big improvement. However, it doesn’t reflect the fact that if the price of bread goes up, maybe you’ll eat out more at restaurants or something like that. That sort of substitution is not in the CPI right now, and it would make it closer to a cost-of-living change if you could, if it did take account of the fact that people substitute across categories when prices change. The other big problem with the consumer price index is that it doesn’t handle—it doesn’t handle new products very well. I mean, your dollar is obviously worth more now that you can buy an iPhone, or an iPad, something that didn’t exist a very few years ago. But it is very difficult to adjust for that in the consumer price index.”

What other indices could be used to gauge the need for and size of COLAs?

“There is an experimental index that the BLS uses which does take account of the fact that people might, say, buy more food in restaurants if the price of buying groceries went up. And that could be used; it goes up less than the regular CPI. Now, the problem is, it takes a very long time to collect the data for that, so you would have to base your adjustment on preliminary data and then correct in subsequent years. Another possible index is the special CPI that has been created for the elderly. It reflects the fact that the elderly spend a lot more on health care than other people and the price of health care has been going up a great deal more than the price of other goods and services. But it hasn’t moved that differently from the regular CPI because even though the elderly buy more health care, it only accounts for 11 percent of the budget. The big overwhelming item in everybody’s budget is housing, and the price of that changes about the same for everybody, and that tends to drag the indices together. So the special index for the elderly since 1997 has only gone up about one-tenth of 1 percent a year more than the CPI-W that is used to correct for inflation now.”