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FINANCIAL EDUCATION

THINK TWICE BEFORE COUNTING ON A COLA

The rising costs of food, gas, electricity, and health care can strain anyone's budget. The situation is even worse if your living expenses increase while your income stays the same, because your purchasing power will steadily decline over time. That's why cost-of-living adjustments, or COLAs, are especially valuable to retirees and others living on fixed incomes.

A COLA is an increase in regular income you receive (such as a Social Security or pension benefit) that is meant to offset rising prices. It's important protection because price inflation has occurred in most years during the last 40 years. However, a COLA may not be payable in years when inflation slows or declines.

HOW COLAs WORK

It's easy to think of a COLA as a "raise," but a COLA is meant to help you maintain your standard of living, not improve it. For example, let's say you receive a $2,000 monthly retirement benefit, and the overall cost of the things you need to purchase increases by 3% during the year. The next year, you receive a 3% COLA, or an extra $60 a month, to help you manage rising prices.

That 3% COLA doesn't sound like much, but without a COLA, inflation can seriously erode your retirement income. Assuming a 3% inflation rate, in just 10 years, the purchasing power of your monthly $2,000 benefit would drop to $1,520; in 25 years, the purchasing power of your benefit would be only $963, less than half of what you started with.

Who receives COLAs?

Social Security is the major source (and in some cases the only source) of inflation-protected retirement income for many Americans. COLAs are also commonly paid to retirees who are covered by state or federal pensions. However, most private pensions do not offer COLAs.

Less commonly, employers may offer COLAs as part of compensation packages. For an additional cost, you might also be able to purchase riders for certain insurance policies (such as disability income and long-term care policies) to ensure that the benefits you receive keep pace with inflation (subject to contractual terms, conditions, and limitations).

WHEN THERE IS NO SOCIAL SECURITY COLA

Social Security COLAs are officially announced each October and reflect the annual increase in the average Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). The average CPI-W for the third calendar quarter of the last year a COLA was payable is compared to the average CPI-W for the third calendar quarter of the current year. Any percentage increase that results is the COLA for that year and will be payable to beneficiaries beginning in January of the following year. However, beneficiaries will not receive a COLA if there is no increase in the average annual CPI-W.

No COLA for Social Security beneficiaries also means no increase in two Social Security limits: the contribution and benefit base (also called the Social Security wage base) and the retirement earnings test exempt amounts.

The contribution and benefit base is the cap on the annual amount of wages and self-employment income subject to Social Security payroll taxes. The retirement earnings test applies only to people under full retirement age (FRA) who receive Social Security benefits and also have earnings from work. If your earnings from work exceed a specific annual limit--the retirement earnings test exempt amount--part of your Social Security benefit will be withheld. (There are actually two different earnings test exempt amounts. One limit applies before the calendar year you reach FRA, and a higher limit applies in the year you reach FRA, up until the month you reach FRA.)

Medicare beneficiaries are also affected. A "hold harmless" provision in the Social Security Act protects most Social Security beneficiaries from increases in their Medicare Part B premium when there is no Social Security COLA. However, about 30% of Medicare beneficiaries are not protected by this provision, including those subject to income-adjusted Part B premiums, those who are enrolled in Medicare but not receiving Social Security benefits, and those who are newly entitled to Medicare.

* If you fall into one of these groups, you may pay a substantially higher Medicare Part B premium when no COLA is payable.

Putting COLAs in perspective

As important as COLAs are, they are still vulnerable to cutbacks. For example, pension plans that are underfunded may view reducing COLAs as a relatively simple way to cut costs, and some plans have attempted to eliminate COLAs altogether.

Consider taking additional measures to account for the effect of long-term inflation. For example, use realistic inflation and investment return assumptions when planning for retirement, maintain a diversified portfolio that reflects your time horizon and tolerance for risk, and consider investments that have historically held their own against inflation.

Will you receive a Social Security COLA in 2016?

The Social Security Administration has announced that, because of low annual inflation, Social Security recipients will not receive a cost-of-living adjustment (COLA) in their benefit checks in 2016. (Source: Social Security Administration press release, October 15, 2015)

***Source:** 2015 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, (P32)

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