How inflation affects Social Security, Medicare and taxes

Higher benefits resulting from a cost-of-living adjustment could be offset by bigger Medicare premiums and larger tax bills.

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This fall, the Social Security Administration is likely to announce that benefits will increase by about 6% beginning in January, which would make it the largest cost-of-living adjustment in almost 40 years. But what Social Security giveth, Medicare and the tax man can take away.

Each year, Social Security benefits are adjusted to keep pace with inflation if the average consumer price index for the third quarter of the current year exceeds the third quarter of the previous year. The recent rise in inflation indicates that Social Security benefits could rise by about 6% next year, which would be the largest increase since 1983.

Based on the July CPI, which rose 5.4% over the previous 12 months, the Senior Citizens League projects that Social Security benefits could increase by 6.2% in 2022. The final COLA determination will be made in October once CPI data is available for August and September.

A spurt in inflation also affects two other factors that determine the net amount that retirees receive from Social Security. The first is the premium for Medicare Part B, which covers doctors' fees and outpatient services, and which is deducted automatically from Social Security benefits. Part D premiums, which cover prescription drugs, are also tied to income but are often paid directly to insurers. To the extent that Part B premiums rise faster than the COLA, the net Social Security benefit will not keep pace with inflation.

The second issue pertains to taxation of Social Security benefits. Because taxes are levied on Social Security benefits for households with incomes above certain thresholds ($25,000 for single taxpayers and $32,000 for joint returns) and the thresholds are not adjusted for inflation, rising benefit levels subject more benefits to taxation each year, thereby reducing the net benefit.

A new brief from the Center for Retirement Research at Boston College explores the impact of inflation on retirees and concludes that given the dual impact of higher Medicare premiums and taxation of benefits, “Social Security does not fully insulate older households from inflation’s erosive impact.”

“In most years, rising Medicare premiums mean that a larger and larger chunk of the Social Security benefit goes to health insurance, so the net benefit available for non-health expenditures does not keep pace with inflation,” the CRR report said.

However, a “hold harmless” provision protects most retirees from an actual decline in net Social Security benefits by limiting the dollar increase in an individual’s Part B Medicare premium to the dollar increase in their Social Security benefits. This provision protects about 70% of Medicare beneficiaries.

The 30% who are not eligible for the hold-harmless protection include newly enrolled Medicare beneficiaries, Medicare enrollees who don’t receive a Social Security benefit, high-income enrollees who are subject to Medicare premium surcharges and low-income beneficiaries dually enrolled in Medicare and Medicaid whose full premiums are paid by state Medicaid programs.

The effect of rising Medicare premiums is even more profound for high-income retirees whose Medicare premiums are tied to their income.

For single individuals with incomes of $88,000 or less and married couples with incomes of $176,000 or less, the monthly Part B premium in 2021 is $148.50. The premium rises for taxpayers above these thresholds, reaching a maximum of $504.90 per month per person for those in the highest income brackets. Between 2000 and 2020, the average annual adjustment for the Part B premium has been 5.9%, compared to an average annual Social Security COLA of 2.2%, according to the CRR issue brief.

The other way that inflation affects Social Security benefits is the extent to which they are taxed under the federal personal income tax.

Under current law, individuals with less than $25,000 and married couples filing jointly with less than $32,000 of “combined income” do not have to pay taxes on their benefits. Combined income is adjusted gross income as reported on tax forms plus nontaxable interest income plus one-half of Social Security benefits. Above those thresholds, recipients must pay taxes on up to 85% of their benefits.

Because the thresholds are not indexed to inflation, more and more beneficiaries are being taxed on their Social Security benefits over time. Although Social Security provides benefits on an individual basis, the income tax is levied on a household basis.

When taxation of benefit was first introduced in 1983, only 8% of eligible families paid taxes on their benefits, the CRR report said. Today, the estimate is that 56% of beneficiaries pay taxes on their benefits. If inflation is moderate, that percentage is projected to increase to 58% by 2030. If inflation rises faster, Social Security benefits will be even higher in nominal dollars and more families will pay taxed on more benefits — further reducing the net Social Security benefits.