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The Cost-of-Living Adjustment and What It Means For You

By Elaine Floyd, CFP®

Each year, the Social Security Administration (SSA) announces the cost-of-living adjustment for the next year. Whether you are retired or not, you should be aware of what the changes mean.

In October the Social Security Administration announced that the cost-of-living adjustment (COLA) for 2025 is 2.5%. The increase shows up in beneficiaries' January checks.

Also in the fall, the Centers for Medicare and Medicaid Services (CMS) announced Medicare premiums for 2025. The Part B base premium will be $185, up from $174.70 in 2024. The income-related monthly adjustment amount (IRMAA) for Part B and Part D will be going up by a few dollars for all the tiers. Inflation adjustments raised the income tiers. The IRMAA now starts at $106,000 for single individuals (up from $103,000) and $212,000 for married couples (up from $206,000).

The Social Security COLA translates to an extra $25 on a $1,000 benefit. The higher the benefit amount, the higher the effective COLA is. For example, a person with a $3,000 benefit would see an increase of $75 per month. A high earner who had maximized their benefit by claiming at 70 could be receiving as much as $4,500 per month before the COLA was announced. The 2.5% COLA would boost their benefit by $112.50. Remember, the later you claim (to age 70), the higher your benefit will be and the more dollars the COLA will give you.

MAXIMUM BENEFIT

The national average wage index rose 4.4%. This brings the maximum wages taxable for Social Security up to $176,100, from $168,600 in 2024. Wages above that amount are not subject to Social Security taxes. (They are, however, still subject to Medicare taxes.)

On a more technical note, the increase in the national average wage index affects the indexing factors and "bend points" that will be used to determine the primary insurance amount (PIA) for individuals born in 1963 who will be turning 62 in 2025. Bend points will increase to $1,226 and $7,391 from $1,174 and $7,078 respectively.

The PIA for a person born in 1963 who had maximum earnings since age 22 is $4,020.90. This is the amount a person turning age 62 in 2025 will receive if they apply at their full retirement age (FRA) of 67. But starting in 2026, COLAs will be added to this amount, so by the time they get to FRA, the amount will be higher. If they apply at 62, they receive a reduced benefit of only 70% of the PIA.

The SSA fact sheet says that the maximum benefit for a worker retiring at full retirement age will be $4,018. This is a bit misleading, because they are applying 2025 bend points to someone who is FRA—as if their PIA is calculated at FRA and not age 62. In truth, a person who turns FRA in 2025 had their PIA calculated when they turned 62 in 2020. Using the bend points for that age cohort ($960 and $5,785), the maximum PIA worked out to be $3,142. Adding five years of COLAs (1.3%, 5.9%, 8.7%, 3.2% and 2.5%) would bring the benefit up to $3,876.50. As far as the maximum benefit is concerned, this explanation is the more accurate one. Ignore the one on the fact sheet.

EARNINGS TEST

The "earnings test" is a calculation for withholding benefits when a Social Security recipient is under FRA and still working (earning income). The thresholds for 2025 are $23,400 ($1,950 per month) and $62,160 ($5,180 per month), up from $22,320 ($1,860 per month) and $59,520 ($4,960 per month) in 2024.

If a person under FRA applies for benefits, they will be asked how much they expect to earn during the rest of the year. If they are fully retired and expect to have no further earnings, none of their benefits will be withheld, regardless of how much they earned prior to application. If they do expect to have earnings, they will be under the monthly earnings test for the remainder of the calendar year. If they earn more than the monthly threshold in any month, their benefit for that month will be withheld. Then starting with January of the following year they will be under the annual earnings test. Again, they will be asked how much they expect to earn during the year. SSA will subtract the first threshold, divide by 2, and withhold as many checks as it takes to work off that amount. They will keep doing this every year until the year the person turns FRA. In that year, in the months leading up to the FRA month, the second threshold will be applied: SSA will subtract that threshold, divide by 3, and withhold as many checks as it takes to work off that amount. The month the person turns FRA, there will be no further withholding.

When the person turns FRA, the benefit will be adjusted to remove the actuarial reduction for those months in which a check was withheld. For example, if the PIA is $2,000 and someone with a full retirement age of 67 files at age 62, the benefit will be $1,400 ($2,000 × .70). This represents an actuarial reduction of $600 over 60 months, or $10 per month. For each month the check was withheld, $10 will be added to the benefit. So, for example, if a person had a total of 26 checks withheld, their new benefit would be $1,400 plus $260 (26 × $10), or $1,660. With respect to those withheld benefits, it's as if they had applied at FRA instead of age 62. Once they turn FRA, they can voluntarily suspend the benefit to build 8% annual delayed credits to age 70.

The earnings test can be a hassle for everyone, and in general we encourage people who are still working to wait until they stop working or turn FRA to apply for benefits. The only exception would be a widow who would be switching to a different benefit (retirement to survivor or vice versa) and would therefore not be receiving the adjusted benefit long enough to reap the full FRA-year adjustment. Of course, every situation is unique, and you should talk to a financial professional to determine your best time to claim Social Security.

STATEMENT ESTIMATES

Social Security statement estimates probably won't change that much because estimates are stated in today's dollars anyway. But it's worth noting that for workers under age 62, who have not had their PIA calculated yet, behind the scenes are the machinations of some nice benefits by the time they get to claiming age. Over the next ten years, the trustees estimate that the average wage index will rise by more than 4% a year. If the estimates bear this out, it means that the indexing factors and bend points that will ultimately determine their PIA will be rising by over 4% a year.

And, as always, if you plan to stop working at an age other than one of the Social Security claiming ages shown on the statement, your benefit will turn out to be different from the amount shown. Generally, those who work past claiming age are disappointed that their benefit won't increase by as much as they'd hoped (especially if they already have 35 years of high earnings), while those who stop working early are disappointed that their benefit will turn out to be considerably lower than the amount shown on the statement. But the 4% annual increase in the indexing factors and bend points may turn out to somewhat mitigate the years of zero earnings prior to claiming.

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