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Talking Points on CPI and Boskin Commission

I believe in having a cost-of-living adjustment and indexing our tax brackets to take account of inflation. The process of determining that should never be politicized, but should be based on the best scientific and objective technical judgment.

There have been, however, serious questions raised by experts -- including at the Bureau of Labor Statistics -- as to what is the most accurate measures of the cost-of-living.

I believe that all of us should be open to reviewing the best evidence and expertise as to what the most accurate cost-of- living measure should be, and that our goal should be to reach a broad agreement based on the best scientific and technical judgment possible.

Q: Are you willing to appoint a commission to look at this measure? What are you going to do?

A: There are new reports expected out by the Boskin Commission and a new experimental index by the Bureau of Labor Statistics early next year. The first step should be for everyone to carefully study these measures and keep an open mind. I am going to ask my economic team to review this new data.

Q: In the past the Administration appeared to state that CPI issues were technical and should be left to the BLS. Is the Administration now abandoning this position and saying they would look beyond the BLS to the views of outside economist for a possible legislative fix to the CPI?

A: The Administration believes that the cost-of-living adjustment should be based on the most accurate, technical and scientific judgment that can be broadly agreed to by the top experts across the nation. Much of this top expertise is housed at the BLS, but just as the BLS themselves do, other decision-makers in Washington should also be willing to weigh all of the top expert opinion and evidence from across the nation.

Q: Would the Administration consider a new index -- different from the CPI -- to base government benefit adjustments and tax bracket indexing to?

A: That's a premature questions at this point. As we have said, the important thing is to ensure that we have the most accurate and credible cost-of-living measure possible that protects people's standard of living and is based on the best scientific and technical judgment that can be broadly agreed to by the nation's top experts at BLS and elsewhere.

MORE DETAILED TALKING POINTS

(1) The Consumer Price Index (CPI) is more than just an objective yardstick of changes in consumer prices. It is used by millions of Americans to ensure that their Social Security and other benefits are protected from inflation and to adjust tax brackets to keep our tax system fair. Therefore it is imperative that the index reflects changes in the cost of living as accurately as possible.

(2) The Boskin report raises legitimate and important issues about how changes in the cost of living are measured. Most economists -- including those at the Bureau of Labor Statistics (BLS) -- agree that the existing CPI produced by the BLS is an imperfect measure of changes in the cost of living. The current CPI measures the cost of a fixed market basket of goods. For this reason, it does not reflect the extent to which people substitute less expensive items for more expensive items as relative prices change. Changes in quality are also difficult to capture fully in the index.

(3) The issues raised by the Boskin Commission report must be considered in this way. The BLS, the rest of the Administration, and the public will carefully review the new report and its recommendations. The BLS already has an ongoing effort to improve the CPI and indeed has already made several improvements over the last four years. This effort has identified many of the problems discussed by the Boskin group and has come up with a number of solutions.

(4) The process of making changes in the measurement of the cost of living cannot be politicized; it should be based on broad agreement among scientific and technical experts.

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Frank Ramos → ?

CPI – we won't direct BLS to change CPI – but

might legislate | Cost of Living Index – May direct BLS to reconstruct.

Hill Panel Says Inflation Overstated

Economists' Report Could Spark a Battle Over Benefits, Taxes

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By John M. Berry and Eric Pianin
Washington Post Staff Writers

A panel of economists appointed by Congress issued a much-anticipated report yesterday on the accuracy of the consumer price index, setting the terms for a potentially explosive political battle that could affect most of the households in the United States.

The five economists appointed by the Senate Finance Committee concluded, as expected, that the government has been overestimating inflation for years, currently by about 1.1 percentage points per year. Fixing that arcane statistical mistake, as urged by the group, would raise tax payments, slow the rise in federal benefits and ripple in many other ways through the economic lives of millions of Americans in coming years.

But not all experts agree on the details of the alleged mistake, or on the desirability of fixing it as the panel proposed, or on changing the index so as to reduce the annual cost-of-living adjustments to Social Security benefits, tax schedules and more.

Early reactions from Capitol Hill and the White House suggest that politicians will be sorely tempted to take the panel's advice. The CPI, if not corrected, would unnecessarily add $1 trillion to the national debt over the next dozen years, the report said.

At the same time, administration officials and members of Congress indicated shared, deep anxieties about the political risks likely to accompany any attempt to change cost-of-living adjustments that Americans take for granted.

Senate Finance Committee Chairman William V. Roth Jr. (R-Del.) said, "I want to stress that any action we take on this report must be broadly and deeply bipartisan. . . . Clearly this reform will not be successful without President Clinton's leadership."

"I would like to see movement [in

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1997], but that will depend on how fast we can develop the bipartisan consensus to what needs to be done," Roth said during a briefing. "But I want to emphasize that I think action is necessary promptly rather than delay."

White House economist Joseph E. Stiglitz said in a statement that the commission report "raises important issues about how changes in the cost of living are measured." But he also cautioned, "The process for improving [the CPI] should never be politicized. Our goal should be to reach agreement based on the best scientific and technical judgment possible."

Sen. Daniel Patrick Moynihan (N.Y.), a leading Democratic proponent of revising the CPI, bristled at suggestions that the changes would constitute a back-door cut in seniors' benefits and a boost in taxes for many Americans who would be kept in higher tax brackets.

"I want to stress that any action we take on this report must be broadly and deeply bipartisan. ... Clearly this reform will not be successful without President Clinton's leadership."

—William V. Roth Jr., Senate Finance Committee chairman

"We're not trying to cut, we're not trying to raise," Moynihan said. "We're proposing an accurate count."

The CPI is the basis for annual increases in Social Security payments, federal pensions and military benefits, as well as determining the poverty line. The measure is widely used throughout the private economy as a basis for salary raises, rent increases, union agreements, alimony and child support payments and a host of individual and corporate business decisions.

For example, Social Security payments will be increased in January based on a 2.9 percent increase in the CPI over the last fiscal year. That means the average monthly payment will be raised by $21 to $745. If the increase had been shaved by 1.1 percentage points, the payments would increase to $737—a difference of $8.

Some of the panel's recommendations were immediately challenged by officials at the Bureau of Labor Statistics, which is responsible for the CPI, adding to its potential to become a political hot potato.

The commission chairman, economist Michael Boskin of the Hoover Institute at Stanford University, and Republican and Democratic leaders all stressed the extreme political delicacy of tampering with the CPI. The Republicans remember that they lost control of the Senate in 1986 after attempting to trim the Social Security cost-of-living adjustment the year before.

On the other hand, reducing the annual inflation adjustments for benefits and tax schedules could cut projected deficit spending over the next decade by as much as a third, according to the study. That would make meeting the goal of President Clinton and congressional Republicans of balancing the federal budget by 2002 a much easier task.

But the commission said that much of the overstatement of the cost of living could not be eliminated simply by changing the CPI. It would take political action because some of the presumed flaws in the index cannot be eliminated given the state of knowledge about statistics.

"Congress and the president must decide whether they wish to continue the widespread substantial overindexing of various federal spending programs and features of the tax code. If the purpose of indexing is accurately and fully to insulate the groups receiving transfer payments and paying taxes [from inflation], no more and no less, they should pass legislation adjusting indexing provisions accordingly," the commission said.

That could be accomplished by subtraction of "an amount partly or wholly reflecting the overindexing" from the adjustments based on the current CPI, it said.

The commission, which also included Robert J. Gordon of Northwestern University, Zvi Griliches

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The Washington Post

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and Dale Jorgenson, both of Harvard University, and Ellen R. Dulberger of International Business Machines Corp., concluded that the CPI overstates inflation for several reasons:

- Quality adjustments: BLS has underestimated the amount of improvement in the quality of goods and services being purchased. If the price of an item goes up but it will last longer, provide better service or need fewer repairs than a previous version, some or all of the increased cost should not be counted as inflation. BLS makes some adjustments for quality but not nearly as many as should be made, particularly for items such as health care, new cars and electronic equipment, resulting in a 0.6 percentage point annual overstatement in inflation, the commission said.
- Substitution effects: When the price of one type of good or service goes up more than that of another, consumers may buy more of the latter and be just as well off. Boskin gave as examples chicken as a substitute for beef, or one type of apple for another. The CPI, which is based on a fixed market basket of goods and services, does not consider such substitutions and therefore overstates the rise in the cost of living by 0.4 percentage points, the report said.
- Outlet effects: When consumers switch from a regular store to a discount store, the CPI calculation assumes that the difference in price charged by the stores is equal to the value of the extra service given customers in regular stores. The commission argued that this is not true and this accounts for the final 0.1 percentage point in overstatement.

As both Boskin and Moynihan stressed at yesterday's briefing, BLS has acknowledged for half a century that the CPI is not a true cost-of-living measure. The CPI measures changes in a fixed "market basket" of goods and services chosen on the basis of surveys of consumer purchases, including food, housing, apparel, transportation, medical care, entertainment and other items. The current market basket is based on purchases in the 1982-84 period, and is scheduled to be updated in early 1998.

However, BLS Commissioner Katharine G. Abraham questioned the commission's detailed proposals for dealing with the substitution problems. The commission said BLS should use a new mathematical technique called a "geometric mean" that assumes consumers readily substitute one product for another.

"We do not believe that adequate evidence for reaching [the commission's] conclusion now exists. This is, however, something that BLS is actively investigating," Abraham said in a statement.

The key issue is the extent to which consumers actually switch their purchases when the relative prices of items change. Currently, the consumer expenditure surveys conducted quarterly by BLS ask about spending on, say, fruit but not about preferences for oranges versus tangerines, much less for one kind of apple compared with another, to use Boskin's example. Thus, there are no actual data on which to resolve this issue, BLS officials said.

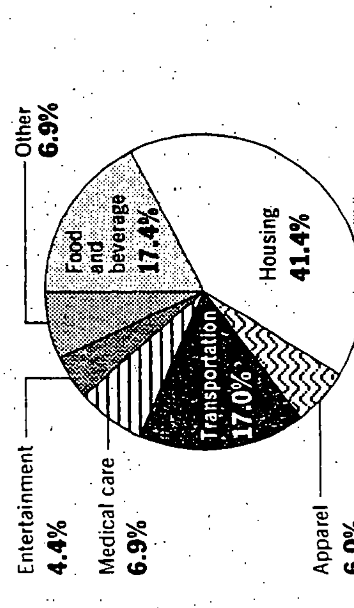
At a press briefing Tuesday, Abraham gave one example of a portion of the the CPI—laundry equipment—in which assuming that consumers would substitute one item for another would not make much sense. "If the price of dryers went down, I don't think people would buy more washing machines," she said.

Such reservations about the commission's proposals are sure to undermine the hopes some members of Congress had that its report would provide a surefire way of avoiding other politically difficult steps needed to balance the budget.

Although the White House and Congress appear within striking distance of an agreement, Senate Budget Committee Chairman Pete V. Domenici (R-N.M.) cautioned other Senate GOP leaders during a private briefing yesterday that the remaining differences are substantial.

WHAT IS THE CPI?

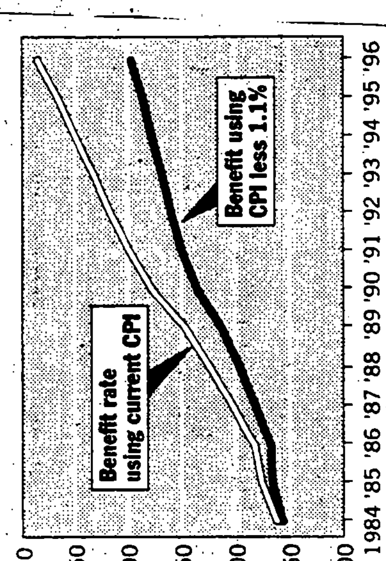
THE CONSUMER PRICE INDEX *measures the change in the cost of buying a fixed basket of goods and services. On a regular basis, 95,000 items from 22,000 stores are surveyed, as well as 35,000 rental units, to compute the CPI. Here is how the components are weighted.*



MANY PAYMENTS, *costs and sums are linked to the change in the CPI. They include:*

- Social Security retiree payments
- Veterans pensions
- Social Security disability payments
- Federal employees' retirement plans
- Increases in some labor contracts
- Rent increases in rent-controlled buildings
- Standard deductions for income tax
- Federal budget deficit
- Food stamp benefits

HERE IS A LOOK *at how the Social Security cost of living adjustments for retirees receiving benefits as of Dec. 31, 1984, would have been different if the CPI had been 1.1 percentage points less each year.*



SOURCES: Bloomberg Business News, Social Security Administration

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