Quick Study

A Policy Report Summary by the Institute for Policy Innovation

Adjusting the Consumer Price Index

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Each month investors anxiously await news of the latest Consumer Price Index (CPI), a key inflation gauge, produced by the Bureau of Labor Statistics (BLS). If the CPI comes in lower than expected, financial markets usually have a good day. If the CPI comes in higher than expected, prices of bonds and stocks often drop.

Despite the recent budget deal, the CPI will also continue to figure in the struggle to balance the federal budget. In 1996, a commission headed by Michael Boskin (chairman of the Council of Economic Advisers under President Bush) was appointed by the Congress to evaluate the CPI. The Boskin commission estimated that the current CPI overstates increases in the cost-of-living by 1.1 percentage points.

Importance of the CPI for the Federal Budget

The Boskin commission finding has sparked controversy because of the CPI's importance for the federal budget. *Over 30 percent of federal spending receives cost-of-living adjustments based on the CPI.* Perhaps more importantly, 57 percent of mandatory spending is adjusted using the CPI. Seventy-one percent of these adjustments occur in one program—Social Security.

The other key use of the CPI is to index parts of the federal income tax code, specifically the personal exemption, standard deduction, and income bracket amounts. *A reduction in the CPI would lower benefits for millions of entitlement beneficiaries and raise taxes for those who pay federal income taxes.* According to the Congressional Budget Office (CBO), lowering the CPI by one percentage point would raise taxes by $51.2 billion between 1998 and 2002 and by $167.8 billion between 2003 and 2007. Outlays would be lower by $76.8 billion between 1998 and 2002 and by $244.6 billion between 2003 and 2008. As a result, shaving one percentage point off the CPI would reduce the federal deficit by $141.1 billion over the next five years and $652.8 billion over the next ten. [See Table 1 for CBO savings by program.]

Table 1

Change In Federal Spending, Outlays & Deficit
From 1 Percentage Point Reduction in CPI
(By fiscal year, in $billions)

	1998 to 2002	2003 to 2007	1998 to 2007
Revenues	**51.2**	**167.8**	**219.0**
Outlays	**-76.8**	**-244.6**	**-321.4**
Social Security	-54.4	-170.0	-224.4
Railroad Retirement	-0.8	-2.3	-3.1
Supplemental Security Income	-4.1	-15.5	-19.6
Civil Service Retirement	-6.2	-19.5	-25.7
Military Retirement	-4.4	-14.3	-18.7
Veteran's Benefits	-2.7	-8.5	-11.2
Earned Income Credit	-6.1	-24.5	-30.6
Other[1]	-0.3	-0.8	-1.1
Offsets[2]	2.4	10.4	12.8
Debt Service	**-13.1**	**-99.3**	**-112.4**
Deficit	**-141.1**	**-511.7**	**-652.8**

Source: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1998-2007*, Washington, DC, January 1997, p. 41.

Columns may not add due to rounding.

[1] Foreign Service retirement, Public Health Service retirement, Coast Guard retirement and worker's compensation for federal employees.

[2] Food stamps, Medicare and Medicaid.

Effect on Social Security

Before 1972, Social Security did not have annual, automatic cost-of-living adjustments. Instead, Congress periodically adjusted benefits to reflect increases in prices and wages. Party and presidential politics, however, led to dramatic benefit increases in the early 1970s. To depoliticize Social Security, the Congress instituted a benefit for-

mula utilizing the CPI that would automatically adjust benefits for changes in wages and prices.

Effect on Beneficiaries

Reducing the CPI would not affect the basic benefit, or Primary Insurance Amount (PIA), of a retiring worker. It would, however, affect the amount of benefits he or she received over time.

Suppose the unadjusted CPI would increase by 3 percent a year over the next 30 years, and the Social Security COLA also increased by the same amount. Lowering the CPI by one percentage point would also reduce the Social Security COLA. Retired beneficiaries would see their checks decrease by 3.8 percent after 5 years, 8.4 percent after 10 years, 16.9 percent after 20 years and 24.6 percent after 30 years. Reducing the CPI by 0.5 percentage points would lower benefits by roughly half those amounts. In other words, retirees who live the longest are the ones most penalized by CPI reductions.

Effect on Social Security's Long-run Financial Picture

The Congressional Budget Office projects that reducing the CPI by one percentage point would lower Social Security outlays by $224.4 billion over the next ten years. At first glance, the implication is that these savings as a share of spending would continue to grow over time, but that inference would be wrong. The reason is that beneficiaries eventually die and are replaced by younger retirees. New beneficiaries start fresh; that is, their initial benefit depends on the growth in wages, not the CPI.

Savings from reducing the COLA depend on the average age of the beneficiary population. Considering the age distribution of retired workers, we estimate that about half of benefits go to those under age 75 and half to those over age 75. As the result, the most that Social Security could expect to save from reducing the CPI by 1 percentage point is about 11 percent of outlays. A reduction of 0.5 percentage points would produce savings of about 5 to 6 percent of benefits.

These savings would not solve the long-run Social Security problem, as some mistakenly believe. Reducing the CPI by 0.5 percentage points would postpone the date when tax revenues fall short of benefits by three years, from 2012 to 2015. Reducing the CPI by one percentage point would postpone that date to 2018. [See Figure 1.]

Effect on Income Taxes

One of the most important tax policy reforms was the inflation-indexing contained in the Economic Recovery Tax Act of 1981. Since 1985, the income bracket amounts along with personal exemptions and standard deductions of the individual income tax have been indexed to the CPI, limiting "bracket creep" and the government's reward from inflating the economy.

A slower increase in the CPI would raise taxes because the income brackets, personal exemptions, and standard deductions also would increase more slowly. This would increase the amount of income that is subject to tax and push taxpayers into higher brackets sooner than otherwise, subjecting more of their income to tax at higher marginal rates.

Increasing taxes by reducing the CPI would hurt both the economy and taxpayer wallets. To estimate these negative effects, we used our general equilibrium, neo-classical model of the U.S. economy to assess what would happen if the CPI were lower by 0.5 and 1 percentage points.

Economic Effects

A lower CPI would slightly increase the marginal tax rates on income earned from work (wages and salaries) and saving and investing (dividends, interest, capital gains, net business income). Another more important effect on marginal tax rates would occur through the reduction in Social Security benefits. As described earlier, payroll taxes and benefits are linked through the amount of wages earned. Lowering future benefits would be the same as increasing the tax on labor, or alternatively, reducing the value of labor compensation. Over a worker's ex-

Figure 1

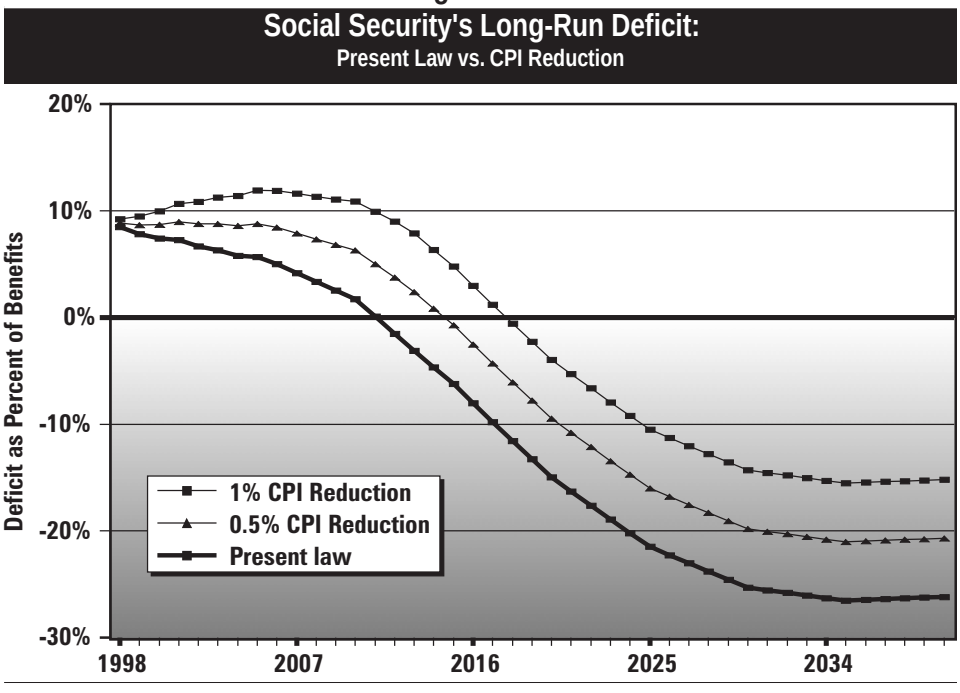


Table 2

Effects on Federal Revenues and Deficits of Reduced CPI (Amounts in $billions)		
	1998-2002	2003-2010
Reduce CPI Indexing by 1 Percentage Point		
Static Federal Revenue	50.8	376.3
Dynamic Federal Revenue	27.6	258.8
% Static Revenue Gain Offset through Lower Growth	45.6%	31.2%
Effect on Federal Deficit[1]	-111.3	N/A
Reduce CPI Indexing by 0.5 Percentage Point		
Static Federal Revenue	25.0	183.6
Dynamic Federal Revenue	11.6	128.0
% Static Revenue Gain Offset through Lower Growth	53.8%	30.3%
Effect on Federal Deficit[1]	-53.4	N/A

Estimates from the Fiscal Associates Model.

[1] Includes effect of lower debt interest.

pected lifetime, lowering Social Security benefits through a one percentage point reduction in the CPI is the same as a one percent increase in total labor taxes.

Reducing the CPI by 1 percentage point would lead to less GDP, less capital formation and fewer jobs. Between 1998 and 2002:

- Higher marginal tax rates on labor would lead to 469,000 fewer jobs.
- Higher marginal tax rates on capital along with lower employment would reduce the stock of capital by $65 billion compared to the baseline.
- Less labor and capital would lower GDP by $91.5 billion over the period. By the year 2002, annual GDP would be lower by $43 billion.

Losses from reducing the CPI by 0.5 percentage points would be roughly half these amounts.

Federal Budget Effects

The main pressure to lower the CPI is to help reduce the federal deficit. While that would occur, the CBO-projected reduction of $141 billion in the federal deficit by 2002 would likely be closer to $111 billion. Budget effects for reducing the CPI by 0.5 percentage points would be about half these amounts. [See Table 1 for CBO estimates and Table 2 for model estimates of revenue and deficit effects.]

Taxpayer Effects

Taxpayers at all income levels would pay more in federal income taxes. Compared with current tax law, federal income taxes for single returns would go up by 2.5 percent while those for joint returns would go up by 1.8 percent. *Taxpayers earning less than $50,000 would experience the largest percentage increases in their tax bills.*

But these numbers ignore economic feedback effects. Many taxpayers could be even worse off if their incomes were affected by the lower growth resulting from higher taxes. For example, on average, single taxpayers earning between $30,000 and $40,000 would experience a bigger drop in aftertax incomes ($279) than simply the increase in their tax bill ($158) if the CPI were reduced by 1 percentage point. Most taxpayers would see their aftertax incomes delince by 0.8 percent.

Do More Savings Come from Lower Spending or Higher Taxes?

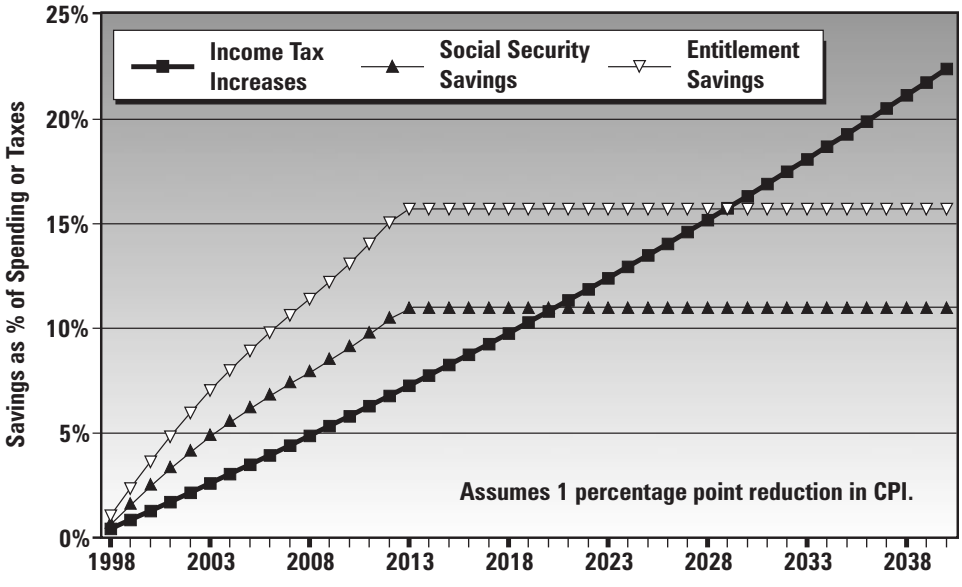
Will reductions in the CPI produce more savings from lower spending or higher taxes? At least initially, the answer is lower spending. Based on CBO estimates, for every dollar in higher taxes spending would be reduced by $2.50 between 1998 and 2002.

However, savings from entitlement programs would eventually level off. As discussed above, since initial Social Security benefits depend on wage, not CPI increases, savings would be limited to a fixed share of benefits (11 percent in the case of a one percentage point CPI reduction).

Taxes are a different matter, however. Compounding of lower CPI adjustments to the personal exemption, stan-

Figure 2

Entitlement Savings Eventually Level Off but Tax Increases Keep Going



Want More Info?

This study is a summary of IPI Policy Report # 144, Adjusting the Consumer Price Index

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dard deduction, and income brackets would continue forever or until Congress legislated new amounts. As a result, savings from higher taxes would eventually surpass those from entitlements. The percent increase in income taxes would exceed the percent reduction in Social Security by 2020 and in all entitlements by 2030. In dollar amounts, higher taxes would exceed Social Security savings by 2005 and total entitlement savings by 2019. [See Figure 2 for long-run spending and tax implications.]

Conclusions

The CPI is a key measure of inflation used by both the public and private sectors. Any changes should be carefully considered and implemented using accepted statistical methods.

The Boskin commission has identified some mathematical problems which BLS should correct as soon as possible, possibly reducing the CPI by an average of 0.4 percentage points a year. [Note: for an in-depth evaluation of these mathematical problems, see the full length report from which this Quick Study is drawn.] In addition, Congress should see that BLS has adequate funding for more accurate sampling and further research of product quality adjustment, new products, and new outlets of products such as discount stores.

Because it is used as an inflation adjustment in entitlement programs and the tax code, the CPI will remain a politically-charged issue. Even a 0.4 percentage point reduction that appears to have technical merit could save the federal government roughly $200 billion over the next decade through lower spending and higher tax collections. What must be avoided, however, is the substitution of arbitrary for scientific judgment on how federal programs should be adjusted for inflation.