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Committee on Ways and Means
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Introduction

Mr. Chairman, Ranking Member Becerra, and members of the subcommittee, I appreciate the invitation to appear before you today to discuss the merits of switching to the chained Consumer Price Index (C-CPI-U) for provisions in the federal budget that are indexed to inflation.

I am the Executive Director of the Moment of Truth Project, a project of the Committee for a Responsible Federal Budget established to build on and continue the work of the National Commission on Fiscal Responsibility and Reform (also known as the Simpson-Bowles Commission) and which is co-chaired by Fiscal Commission Co-chairs Erskine Bowles and Alan Simpson. I was a staff member on the Fiscal Commission and was involved in development of all policies in the final report, including the proposal to switch to the chained CPI and the broader Social Security reform recommendations. I have been involved in issues related to fiscal policy and Social Security in a number of capacities as a Congressional staff member and in the non-profit sector for over twenty years.

On a personal note, I have significant experience with the Social Security program, which shaped my views both about the tremendous importance of preserving a strong Social Security system and the need to address some of the shortcomings of the program. As a child, I received Social Security survivor's benefits along with my sister after the death of our father. Those benefits were critical in helping my mother make ends meet, provide for my sister and I during some tough financial times our family experienced throughout my childhood, and help pay for my education. More recently, I had the responsibility for managing my parent's finances after my mother was gravely injured in an automobile accident, with my stepfather's Social Security retirement benefit and my mother's Social Security disability benefit providing their only sources of income. Because of their intermittent work histories and other factors, my stepfather's relatively modest Social Security benefit and my mother's very small disability benefit were inadequate to meet expenses in most months.

But neither my experience as a child illustrating the value of the Social Security program nor the shortcomings of the current system I witnessed with my parents as an adult has convinced me that providing cost-of-living adjustments that are greater than inflation is a desirable or justified policy. Rather, it has informed my view about the importance of acting soon to enact policies to make Social Security financially sound for future beneficiaries in a progressive manner that improves benefits and strengthens poverty protections for those who are not sufficiently protected by the current program. I believe that the Social Security reforms included in the Fiscal Commission report, with some tweaks to the benefit formula and minimum benefit provision we have developed based on additional analysis, would achieve both of those goals.

While many of the policy options under consideration in recent budget negotiations require various tradeoffs and tough policy choices to put our debt on a sustainable path, the switch to the chained CPI requires neither. In fact, it offers a rare opportunity to achieve significant savings spread across the entire budget by making a technical improvement to existing policies.

Background

The issue of bias in the Consumer Price Index (CPI) first gained prominence in 1995 after then Federal Reserve Board Chairman Alan Greenspan stated in testimony before the House Budget committee that he believed the existing measure of CPI overstated inflation by 0.5 to 1.5 percent. Chairman Greenspan's remarks called attention to a growing debate among economists and others that had been developing for several years. A report issued by the Congressional Budget Office (CBO) in October 1994 found increased evidence of upward bias in CPI and cited estimates of bias between 0.2 to 1.5 percentage points a year greater, with CBO estimating the bias at somewhere between 0.2 and 0.8 percentage points of GDP based on the empirical evidence at the time.[1]

In response to the increased attention on the issue of bias in the CPI following Chairman Greenspan's comments, the Senate Finance Committee convened a bipartisan blue ribbon commission to study the issue called the "Advisory Commission to Study the Consumer Price Index" and appointed economist Michael Boskin as its chair. The Boskin Commission issued a report identifying several sources of bias in the CPI and suggesting a range for the potential overstatement of between 0.7 percent and 2.0 percent.[2] While some of the specific findings and the overall estimate of bias estimated by the Boskin Commission were subject to criticism, the overall conclusion that shortcomings in the methodology for calculating CPI overstated inflation was supported by subsequent research from staff economists of the Federal Reserve and broadly accepted by most economists.

Following the release of the Boskin Commission report, the Bureau of Labor Statistics (BLS) made a number of changes in the methodology for calculating CPI to address the sources of bias identified by the Commission and others. In 1999, the BLS adopted a geometric mean to account for improvements to what is known as "lower level substitution bias," when individuals substitute within item categories as relative prices change. BLS has made other changes such as the use of hedonic quality adjustments, which have also resulted in a slight reduction in the growth rate of CPI.

Implementation of the geometric mean has reduced the annual growth rate of the CPI by approximately 0.3 percentage points, with other changes reducing CPI further. The cumulative impact of these changes on the reported CPI is approximately 0.35 percentage points, which is slightly greater than the impact of switching to the chained CPI. Yet these changes implemented by the BLS were automatically applied to the indexation of government programs and the tax code with little notice or controversy.

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[1] Congressional Budget Office, "Is the Growth of the CPI a Biased Measure of Changes in the Cost of Living?" (October 1994). http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/48xx/doc4839/doc48.pdf
[2] The Advisory Commission To Study The Consumer Price Index, "Toward A More Accurate Measure Of The Cost Of Living" (December 4, 1996). http://www.ssa.gov/history/reports/boskinrpt.html

However, the changes made to date by the BLS have not accounted for consumer substitution taking place between categories – known as "upper level substitution bias" – which the chained CPI would address. This kind of substitution bias occurs because the regular measure of CPI assumes consumers will buy the same basket of goods regardless of relative prices, not realizing that consumers can often soften the blow of increased relative prices by consuming more of a relatively cheaper good. For example, if consumers respond to the price increase for Granny Smith apples by buying more Red Delicious apples instead (lower level substitution bias – changes within categories), this is accounted for in the current CPI. Though, the formula does not account for changes between categories (upper level substitution bias) if consumers respond to the higher price of Granny Smith apples by buying less apples altogether and purchasing more oranges instead.

Upper level substitution bias is an artifact of BLS's reliance on a fixed "market basket" of goods, based on old purchasing habits. Instead, this could be fixed by using a market basket based on the newest purchasing habits, except that this would actually cause the opposite problem where substitution biases cause the CPI to understate inflation.

As a result, in 2002 the BLS created a new measure of inflation called the chained CPI (also known as the superlative CPI or the C-CPI-U) to account for consumer substitution between categories. The chained CPI addresses the upper level substitution bias by using a superlative index that updates expenditure weights and formulas in order to address consumer response to substitution between categories. As the CBO explains, the chained CPI "attempts to fully account for the effects of economic substitution on changes in the cost of living… [It] provides an unbiased estimate of changes in the cost of living from one month to the next by using market baskets from both months, thus 'chaining' the two months together."[3]

This measure has been refined and improved since it was initially published. On average, the chained CPI has been 0.25 to 0.3 percentage points lower per year than the standard CPI measures. Though this difference is small on average, it compounds over time. Depending on which index you use, prices have either increased by 34 percent (CPI-U and CPI-W) or 29 percent (chained CPI) between 2000 and 2011.

However, unlike the methodological changes in the calculation of CPI-U and CPI-W that are automatically reflected in the published measures used for indexing programs under current law, using the more accurate chained CPI for indexation instead of the CPI-U or CPI-W requires a statutory change in law.

Fiscal Commission Proposal

When the staff of the Fiscal Commission began assembling deficit reduction options and meeting with organizations and individuals from across the spectrum to solicit suggestions for deficit reduction, switching to the chained CPI was one of the common themes that emerged as an option with strong substantive and political merit.

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[3] Congressional Budget Office, "Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code" (February 24, 2010). http://www.cbo.gov/ftpdocs/112xx/doc11256/CPI_brief.pdf

Switching to the chained CPI was an early area of general consensus as Commission members began to discuss specific policy options. It was suggested as an option to reduce the Social Security shortfall by one of the Democratic Members of the mandatory spending working groups, and had previously been included in bipartisan tax reform legislation introduced by Republican Commission member Senator Judd Gregg. Commission members emphasized the importance of making this change as a technical improvement to more accurately index programs for inflation and believed that, in order to be credible, the change must be applied to all provisions in the budget (both the spending and revenue sides) that are indexed to inflation.

In the fall of 2010, the Fiscal Commission issued its final report, "The Moment of Truth," which was supported by eleven of the eighteen Commission members and included over sixty specific recommendations, including a recommendation to adopt the chained CPI as a more accurate measure for all CPI-linked provisions in the budget.[4]

While every member of the Commission who supported the final report had to accept one or more items they opposed in the context of the entire plan, the chained CPI was one of the few major provisions in the plan that was supported by all of those who endorsed the final plan and even a few who opposed it. For instance, Andy Stern, who opposed the Commission's plan, included the chained CPI in the alternative proposal he put forward.[5]

Since the report was issued, additional suggestions have been put forward for benefit enhancements and low income protections beyond the twenty year bump up in the original Commission recommendation. These include indexing the Supplemental Security Income (SSI) disregard and asset limits that deserve serious consideration. However, the rationale for using the most accurate measure of inflation to index provisions in the federal budget remains as strong today as it did when the Commission report was issued.

Broad Support for Chained CPI

Switching to the chained CPI enjoys broad support from experts across the political and ideological spectrum who agree that it is the best available measure for overall changes in the cost of living. Support ranges from Austan Goolsbee, who served as Chair of the Council of Economic Advisors under President Obama, to Michael Boskin, who held the same position under the President George H.W. Bush; experts at the Heritage Foundation, the Center of American Progress, the Center on Budget and Policy Priorities, American Enterprise Institute, Progressive Policy Institute; the National Research Council's Committee on National Statistics; and the editorial boards of the Washington Post and USA Today.

Every serious bipartisan budget plan – from the Fiscal Commission, the Bipartisan Policy Center's Debt Reduction Task Force ("Domenici-Rivlin"), the bipartisan Senate "Gang of Six" and numerous other Congressional leaders in both parties to the Obama-Boehner negotiations – has

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[4] National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (December 1, 2010). http://www.momentoftruthproject.org/sites/default/files/TheMomentofTruth12_1_2010.pdf

[5] Andy Stern, "21st Century Plan for America's Leadership," (December 2010). http://crfb.org/blogs/stern-releases-plan-lower-budget-deficitand-investment-deficit

included savings from switching to the chained CPI to more accurately index provisions in the budget.

Budgetary effects

In addition to improving technical accuracy, switching to the chained CPI would substantially help to reduce future deficits. While most of the discussion regarding the proposals to switch to the chained CPI have focused on the impact it would have on Social Security lead to the impression that it singles out Social Security for savings, the impact of the policy would actually be spread much more broadly and applied to all provisions in the budget currently indexed to changes in the cost of living based on CPI. In fact, Social Security would only make up one third of the savings from switching to the chained CPI over the next decade. Another third of the savings would come from new revenue and the remaining third from other spending programs and interest savings.

According to the CBO, switching to the chained CPI would reduce deficits by $340 billion over the next decade if implemented for 2014, relative to current law which projects continued overpayments and under collection. Adopting the chained CPI for Social Security cost-of-living adjustments (COLAs) alone would save $127 billion through 2023, over the same period. Using it for COLAs in other federal retirement programs would save another $38 billion, and there would be an additional $51 billion in deficit reduction from other areas of the budget. On the tax side, moving to the chained CPI would cause tax bracket thresholds and other parameters to grow more slowly and raise an extra $124 billion over the ten-year period relative to current law.
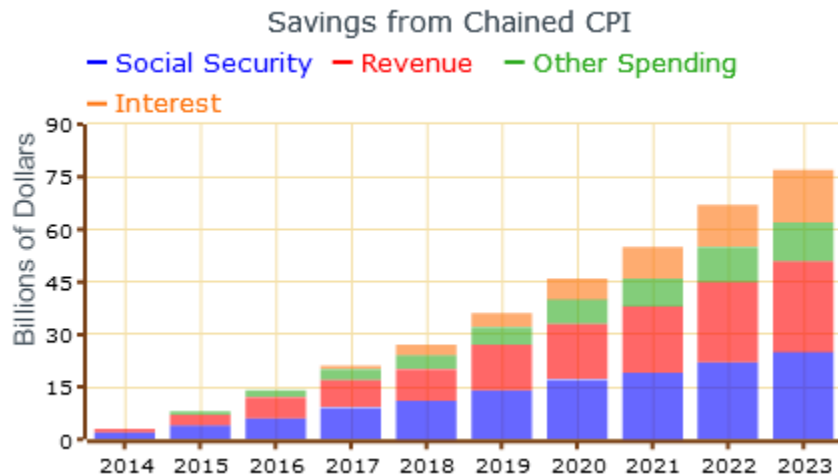
Source: Committee for a Responsible Federal Budget

Using a superlative measure of inflation has the added benefit of providing a more accurate understanding of changes in real variables in the economy. As the Boskin Commission report stated, "Even if no federal program on either the outlay or revenue side of the budget were indexed, it would still be desirable to improve the quality of measures of the cost of living from the standpoint of providing citizens a better and more accurate estimate of what was actually going on

in the economy."[6] However, the magnitude of our fiscal challenges and the substantial fiscal impact of achieving this correction make this change particularly timely.

In addition to the $340 billion in deficit reduction, implementing the chained CPI would contribute to reducing the long-term funding shortfall in Social Security. Switching to the chained CPI for COLAs would close more than one fifth of Social Security's 75-year shortfall. This would be a significant down payment toward bringing that program into long-term balance, preventing the across-the-board cut in all benefits projected by the Social Security Trustees under current law and ensuring its existence for our grandchildren.

While this policy would provide much needed deficit reduction, it should not be considered a change in tax or spending policy. Cost of living adjustments for retirement benefits and indexation of other government programs and provisions in the tax code are intended to ensure these provisions keep pace with inflation. Rather than serving to raise taxes and cut benefits, switching to the chained CPI would simply be fulfilling the policy of properly adjusting provisions in the budget to reflect for cost of living changes.

Impact on Benefits

Importantly, under chained CPI, nominal benefits for Social Security and other retirement programs will continue to grow year after year. No one will see the dollar value of their benefits go down – instead they will continue to go up at a modestly slower pace. The Committee for a Responsible Federal Budget estimates that an individual's Social Security benefits will rise by approximately 60 percent over 20 years under chained CPI, compared to just under 68 percent under the current CPI-W measure.

Most of the criticism of switching to the chained CPI focuses on the reduction in benefit levels relative to "scheduled benefits." Under this measure, the chained CPI reduces benefits 20 years from now by between five to six percent. But the scheduled benefits analysis ignores the projected exhaustion of the Social Security trust fund by 2033. At that point, revenues will only be able to cover 75 percent of promised benefits by assuming that general revenue funds are shifted to cover the funding shortfall and to ensure that Social Security pays full benefits despite the legal requirement that outlays for benefits be limited to dedicated revenues and the longstanding social insurance principle behind the Social Security system.

By contrast, "payable benefits" take into account trust fund insolvency and the automatic benefit reduction that would be required under current law. Considering that the trust fund is projected to be exhausted in 2033, at which point beneficiaries would receive a nearly one-quarter benefit cut, benefits under the chained CPI would be about 25 percent higher than under the payable benefit scenario in 2033.

In addition, real benefits for an 85 year old will be higher in the future than they are for a similar retiree today. When the real benefits for an 85-year old in 2013 are compared to a similar

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[6] The Advisory Commission To Study The Consumer Price Index, "Toward A More Accurate Measure Of The Cost Of Living" (December 4, 1996). http://www.ssa.gov/history/reports/boskinrpt.html

beneficiary in 2033 (assuming both retire at age 65 and accounting for the switch to the chained CPI), real benefits for the latter beneficiary would be higher because the growth in initial benefits, which essentially grows with wage inflation, outweighs the slower growth of the chained CPI. Specifically, benefits for the 85-year old in 2033 would be 8 percent higher than the present-day 85-year old.
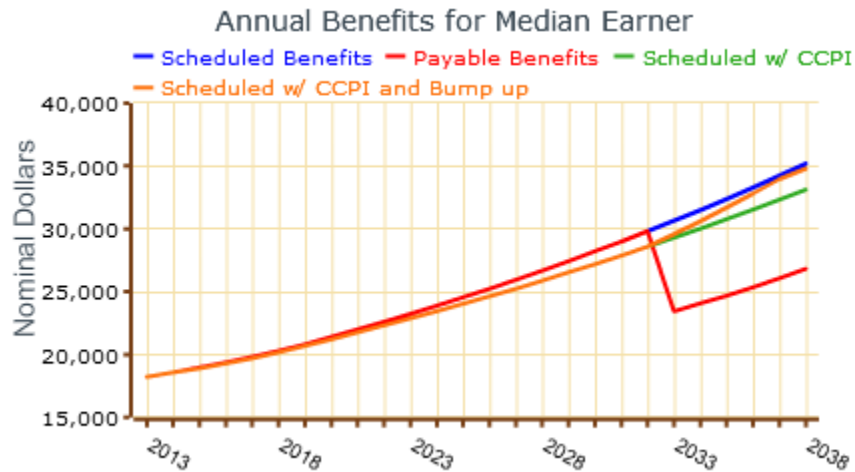
Source: Social Security Administration

Distributional Effects of Chained CPI

One concern that has been raised about proposals to switching to the chained CPI is the distributional impact and the effect on lower-income Social Security beneficiaries. The non-partisan Tax Policy Center and the Social Security Administration have both estimated that using the chained CPI would be roughly distributionally neutral for both the tax code and Social Security.

Because the COLA offers the same percent increase for all beneficiaries, the effect of switching to a more accurate, but modest measure of inflation would therefore be roughly the same for everyone. Of course, in reality there would be some slight differences due to a number of factors, including how long individuals receive benefits from the program. However, these deviations would actually be marginally progressive rather than regressive. According to the Social Security Administration's shared earnings quintile, switching to the chained CPI would reduce average benefits in 2050 by about three percent relative to the current CPI for those in the bottom three quintiles, and four percent for those in the top two quintiles. It should be noted that other methods of modeling income – such as the household benefit quintile, individual income quintile, and the average indexed monthly earnings (AIME) quintile – can slightly skew the distributional impact of the chained CPI.

Still, distributional neutrality does not mean we do not need to be concerned with low-income individuals and the very old. For all its flaws, the current CPI formula offers accidental protection to beneficiaries whose initial benefit levels under the current formula are inadequate and those most at risk of outliving their savings – even though it does so in a very blunt and untargeted way. Instead

of this approach, a better way to protect those groups would be through specific policy changes targeted to those populations.

Ideally, these concerns would be addressed in the context of a comprehensive plan which includes other policies to improve progressivity of the Social Security system and tax code and other provisions to benefit low income and vulnerable populations. For example, in addition to switching to chained CPI, the Fiscal Commission proposal included a tax reform proposal which eliminated or significantly scaled back many tax breaks and preferences that disproportionately benefit higher income taxpayers along with Social Security reforms which raised the taxable maximum and made the benefit formula more progressive. As a result, the net impact of the Fiscal Commission recommendations was highly progressive for both revenues and Social Security benefits. The Domenici-Rivlin plan put forward by the Bipartisan Policy Center Debt Reduction Task Force, which also recommended switching to the chained CPI as part of a comprehensive deficit reduction plan, produced similar results.

Looking specifically at proposals to switch to the chained CPI in isolation, any undesirable effects of the chained CPI on certain vulnerable populations can be addressed through small policy changes targeted to those populations rather than continuing to provide higher than justified inflation adjustments for all individuals regardless of income at a cost $340 billion over ten years. For example, the Fiscal Commission recommended instituting a flat dollar benefit bump-up equal to five percent of the average benefit. Calculating the bump up based on the average benefit rather than as a percentage of an individual's benefit level would target assistance to those who need it the most by providing a greater percentage increase in benefit levels to beneficiaries with benefits below the average level, as illustrated by the chart below.
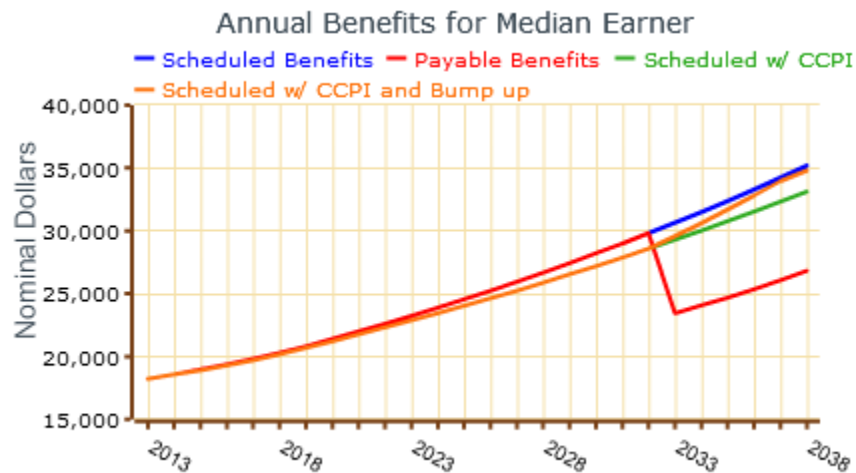
Source: Social Security Administration

Other policies such as enhancing SSI benefits or increasing the refundability of certain credits on the tax side could be included in a package to offset the impact of the change on lower income individuals. Moreover, policymakers could further look at enhancements to food stamps or other low-income programs to offset the impact on means-tested programs.

Overall, there is no reason to maintain an average tax windfall of $450 for those in the top quintile as a result of using an inaccurate measure of inflation in the tax code just to prevent a $25 tax increase for those in the bottom quintile. Likewise, there is little reason to provide higher than warranted increases in benefits for all Social Security beneficiaries just to protect lower-income beneficiaries when those concerns could be addressed by much more targeted policies and at lower overall costs.

Chained CPI and Social Security

One of the primary arguments raised against using the chained CPI to index Social Security benefits is that it is inappropriate because it does not reflect the spending patterns of seniors, particularly the higher than average spending on health care by seniors. As a result there have been suggestions that the experimental CPI for the elderly, or CPI-E, an experimental index developed by BLS, would be a more appropriate measure to calculate Social Security COLAs.

In contrast to the broad consensus among economists that the current CPI measure overstates inflation, there is much less agreement about whether the correct cost of living index for the elderly is, in fact, higher than it is for younger Americans. A recent CBO report stated that "it is unclear whether the cost of living actually grows at a faster rate for the elderly than for younger people."[7]

With respect to the criticism that using the chained CPI to index Social Security does not account for higher spending by seniors devoted to health care, studies have suggested that the BLS may overstate the effect of health costs on inflation. This would offset the impact that higher average spending on health care by seniors would have on inflation. In addition, while total spending on health care for seniors as a group is higher than other age cohorts, most of the higher spending is concentrated in a relatively small portion of seniors.[8] Instead of providing higher cost of living adjustments for all seniors to account for higher health care costs for a small percentage of seniors, the better policy would be to provide catastrophic coverage for seniors with high health care costs through out of pocket limits in the Medicare program as the Fiscal Commission and others recommended.

The CPI-E has several flaws that are likely to overstate inflation. In addition to the limitations of the current measure, the CPI-E fails to account for the totality of the differences, beyond healthcare, between the spending patterns of the elderly and of the general population, such as senior discounts or outlet and mail-order shopping. The higher weight given to health expenditures in CPI-E would also exacerbate the potential overstatement of health inflation in the CPI.

Furthermore, it is not clear that the way CPI measures the costs of homeownership – by imputing the rental value of the home – is a very accurate measure of cost of living given that 80 percent of seniors are homeowners rather than renters (compared to 60 percent of the population under age 65)

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[7] Congressional Budget Office, "Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code" (February 24, 2010). http://www.cbo.gov/ftpdocs/112xx/doc11256/CPI_brief.pdf

[8] Robert J. Gordon, "The Boskin Commission Report: A Retrospective One Decade Later," Northwestern University and National Bureau of Economic Research (2006). http://faculty-web.at.northwestern.edu/economics/gordon/P376_IPM_Final_060313.pdf

and 70 percent of them have fully paid off their mortgage (compared to 17 percent of the population under age 65). In other words, more than half of seniors have no mortgage or rental costs even as the CPI-E – almost half of which is made up by housing – assumes they have growing rental costs.

The BLS itself stresses the limitations of the CPI-E because of shortcomings in the methodology, warning that "any conclusions drawn from the data should be interpreted with caution" and says it is not likely to be appropriate as an index to use for Social Security COLAs.[9] A report by the National Research Council's Committee on National Statistics echoes this by saying, "In the absence of an index that can capture these differences, we see no rationale for basing social security COLAs on the type of indexes constructed in the BLS studies."[10]

It is true that using a more accurate measure of inflation to index Social Security may exacerbate some of the shortcomings of the current Social Security system, which may provide too few resources to very-low income individuals, particularly as they get older and outlive their retirement savings. However, those shortcomings can and should be addressed through targeted policy changes, such as those previously mentioned, designed to help those populations instead of providing higher than justified COLAs to all beneficiaries.

Implementation of Switching to the Chained CPI

One shortcoming of the chained CPI is that it requires data which is not fully available for two years, and so the BLS publishes the chained CPI in initial and interim forms before publishing in final form with a time lag. However, as the BLS has grown more experienced with calculating the chained CPI, the errors associated with its initial estimate have and will continue to decrease. More importantly, the CBO and others have identified ways to ensure COLAs remain accurate over time, by calculating COLAs using a combination of the current initial chained CPI and a correction for past errors.
In this way, any errors from using the chained CPI would be small, and would disappear by the time the final index was released. This differs from the problems associated with the overstatement of the current CPI, which compound rather than correct over time.

Conclusion

Addressing our fiscal challenges will require many tough choices and policies, but adopting the chained CPI represents neither. Eliminating the unjustified increases in spending and reduced revenues from the current inaccurate measure of inflation should be a priority for any comprehensive deficit reduction plan. The chained CPI represents a more accurate and effective way to maintain purchasing power in spending programs and to index various parts of the tax code.

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[9] Kenneth Stewart, "The experimental consumer price index for elderly Americans (CPI-E): 1982–2007," Bureau of Labor Statistics (April 2008). http://www.bls.gov/opub/mlr/2008/04/art2full.pdf

[10] National Research Council, *At What Price?: Conceptualizing and Measuring Cost-of-Living and Price Indexes.* By Panel on Conceptual, Measurement, and Other Statistical Issues in Developing Cost-of-Living Indexes, Committee on National Statistics, National Research Council

Any policy that affects either Social Security and other benefit programs or government revenues will be controversial, but if a technical change with broad support among experts like switching to the chained CPI to more accurately index provisions to inflation cannot win bipartisan support in Congress, then prospects for putting our debt on a sustainable, downward path as a share of the economy are grim.