Statement of
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Wednesday, April 26, 1989.

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to discuss the price index used to calculate cost-of-living adjustments (COLAs) for Social Security. My remarks will focus on the economic arguments for and against using the CPI-U (the Consumer Price Index for all urban consumers) instead of the CPI-W (the index for urban wage earners and clerical workers), as well as the potential budgetary consequences of such a change.

BACKGROUND ON THE CPI-U AND CPI-W

Cost-of-living adjustments in the Social Security system are currently linked to growth in the CPI-W. The CPI-W is a measure of what it would cost now to buy a fixed basket of goods and services. The basket reflects the estimated spending patterns of wage earners and clerical workers in urban areas according to a survey conducted between 1982 and 1984.

Many economists have advocated using instead the CPI-U because it is a much broader and more commonly used index of inflation. Like the CPI-W, the CPI-U is based on estimated spending patterns during the 1982-1984 period, but its sample population comprises all urban consumers rather than just wage earners and clerical workers. Urban consumers account for

80 percent of the nation's population, while wage earners and clerical workers in urban areas account for only 32 percent.

Differences Between the CPI-U and the CPI-W

Patterns of expenditure reflected in the CPI-U differ from those in the CPI-W in three main areas: food, housing, and transportation. All urban consumers--the group whose consumption patterns underlie the CPI-U--spend a smaller proportion of their total budget on food and transportation, and more on owner-occupied housing, than do urban wage earners and clerical workers. The "all urban" group also spends more on medical care, though the difference is less pronounced.

The CPI-U has grown slightly faster than the CPI-W since the former measure was introduced in 1978. The CPI-U has increased 95.7 percent over this period, while the CPI-W has risen 92.4 percent--a difference that averages less than 0.2 percent per year. Differences in the treatment of homeownership costs, changes in energy prices, and a relatively fast increase in medical care costs account for most of this small difference.

Making inferences from past behavior of the two CPIs is complicated, however, by the fact that the treatment of homeownership costs was changed in both indexes during the early 1980s. But focusing on data since 1984, when homeownership costs were treated more consistently, does not change the story of slightly faster growth in the CPI-U: it has risen 16.1 percent since December 1984, while the CPI-W has increased 15.2 percent--again representing a difference of about 0.2 percent a year. A similar conclusion results from estimating how the indexes would have grown since 1978 if the current treatment of homeownership had been applied to both indexes throughout that period. CBO estimates on this basis that the CPI-W would have risen 94.1 percent, almost the same as the CPI-U's 95.7 percent increase.

Although the changes in the two indexes have sometimes showed significant differences from year to year, these differences have on balance averaged out. In 1986, for example, the CPI-W rose much more slowly than the CPI-U because gasoline prices fell sharply. The two indexes moved closer in the following year, however, when gasoline prices changed by less.

Significance of Differences Between the CPI-U and the CPI-W

While the CPI-U has increased slightly faster in the recent past than the CPI-W, this difference does not necessarily mean that the cost of living has increased by more for the "all urban" population reflected in the CPI-U compared with the price increases recorded in the CPI-W. Two reasons account for this: errors may occur in the measurement of prices in both indexes, and the true cost of living may not grow by the same amount as an error-free price index does.

The possibility of errors in the measurement of price changes means that even when the CPI-U and the CPI-W increase by different amounts, they may not reveal anything significantly different about how prices are changing. Errors in the indexes arise both from sampling error and from other sources. The Bureau of Labor Statistics (BLS) obviously cannot collect all the prices of all the goods and services for sale in every store in the land, so it uses a sample designed to be as representative as possible. Because the sample is not perfectly representative, however, some error is introduced. Other sources of error, which the BLS believes are substantially more important, arise from problems such as changes in product quality, the introduction of new products, and the technical problems of survey design.

Even if one could remove all error from the CPI-U and the CPI-W, neither index would necessarily give a true picture of changes in the cost of living. These indexes measure nothing more than price changes; they do not reflect changes in buying patterns, which can offset the cost to consumers from increases in prices. In fact, when faced with an unusually high price for any one item, most consumers will try to purchase less of it. If gasoline costs $2 per gallon, people first drive less, and then, when they next buy a car, pay more attention to its fuel efficiency. When beef prices rise, people switch temporarily or permanently to chicken. Recent studies suggest that, overall, changes in purchasing patterns hold down cost-of-living increases by about 0.1 percent to 0.2 percent a year relative to the increases recorded by consumer price indexes. This is an average figure, and does not reflect the fact that consumers differ in their ability to substitute cheap items for expensive ones.

BUDGETARY IMPLICATIONS OF SWITCHING TO THE CPI-U

Switching to the CPI-U as a Social Security index may well affect budget outlays, but analysts could not predict with confidence whether it would increase or reduce outlays unless the change were made quite soon. Social Security benefits would have been higher if the CPI-U had been used as an index since 1978, because the CPI-U has grown slightly faster than the CPI-W during that period. This increase does not mean, however, that switching to the CPI-U will necessarily cost more in the future. The prices of the specific categories of commodities and services whose recent changes accounted for the CPI-U's more rapid growth may not behave in the future as they have in the past. Such specific prices, like the price of energy, are notoriously hard to predict, and, as a result, CBO and other forecasters seldom project differences in the growth rates of the CPI-U and CPI-W. Accordingly, if

CBO were asked to estimate the cost of switching to the CPI-U beginning in fiscal year 1991 or later, it would project a budgetary impact of zero.

If, however, a proposal were made to switch to the CPI-U effective in fiscal year 1990, then CBO might project a budgetary impact, since the projection would be based in part on price changes that have already taken place. Currently, Social Security COLAs take effect in January and are based on price changes that occurred over a reference period covering the year ending in the third quarter of the previous calendar year. CBO could project a budgetary impact, however, if a change in the COLA were proposed to take effect soon enough so that the likely price change over the reference period would be either already known or heavily affected by price developments that are already known. At present, for example, gasoline prices are rising much faster than other prices, which suggests that by the time CBO updates its forecast of prices and other economic variables this summer, the CPI-U may have grown less than the CPI-W. If we project no further differences between the growth rates of the CPI-U and CPI-W for the remaining months of the reference period, the projected Social Security COLA for next January would be somewhat lower if it were based on the CPI-U rather than on the CPI-W.

Shifting to the CPI-U as an index for Social Security benefits has both advantages and disadvantages. One advantage is that the change in the CPI-U is the measure of inflation now most frequently quoted in the press and by economists. Use of a different measure for calculating COLAs risks confusing the discussion of budget projections and economic forecasts.

A second advantage of a shift to the CPI-U is that it may better serve two objectives that policymakers may have in indexing Social Security benefits for inflation. First, if the objective of indexing is to protect Social Security beneficiaries from declines in their standard of living caused by inflation, the CPI-U may be a better choice because it appears to reflect more accurately the prices faced by beneficiaries. Second, if the purpose of indexing is to compensate Social Security beneficiaries for the inflation faced by the general population, then the CPI-U is still a better index than the CPI-W--again because it is a more general price measure.

The disadvantages of switching to the CPI-U primarily have to do with how some Social Security beneficiaries may perceive such a change. Some beneficiaries may be bothered by a shift to a different index. Indeed, in these times of budgetary pressures, they may interpret any change in Social Security as a cost-saving measure, notwithstanding the government's assurances to the contrary.

CONCLUSION

The CPI-U has increased faster than the CPI-W by about 0.2 percent a year in the recent past. This difference is not large enough to permit us to say with confidence that the cost of living has increased faster for members of the "all urban" population, whose spending patterns are reflected in the CPI-U than for the population of wage earners and clerical workers in urban areas, whose spending underlies the CPI-W. We can say, however, that Social Security benefits would be higher had they been indexed to the CPI-U instead of the CPI-W in the past. Still, there is no basis for believing that a switch to the CPI-U would increase benefit levels in the future unless the change were made very soon. A decision to make such a change should bear in mind that the beneficiaries may misinterpret the change as a money-saving measure, but that the CPI-U, being a broader index, has certain technical advantages over the CPI-W.