Drafting Changes in Programs Based on the CPI

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A commission of economists appointed by the Senate Finance Committee, and chaired by former chair of the Council of Economic Advisors Michael Boskin, recently suggested that the consumer price index (CPI) overstates cost-of-living increases by about 1.1 percentage points annually. (For prior coverage, see Tax Notes, Dec. 9, 1996, p. 1135.) Congress's interest is far more than academic; if inflation adjustments to programs were to be reduced in size, many types of government benefits would grow more slowly, while income tax collections would be increased.

Because of its interest in conflict, the press likes to concentrate much of its CPI coverage on the short-run impact of potential changes on social security beneficiaries and secondarily on taxpayers. These stories, however, miss out on some of the most interesting and difficult issues surrounding the drafting of legislative changes. Here are three items.

Issue 1: If the CPI is going to be revised by the Bureau of Labor Statistics, there is no easy way to provide adjustments now that can anticipate the impact of those revisions. Suppose, for instance, that the Boskin Commission is correct and that the CPI overstates inflation by 1.1 percentage points today. Suppose also that for social security benefits and for tax brackets Congress changes its cost-of-living adjustment to equal the rate of change in the CPI minus 1.1 percentage points. Suppose the Bureau of Labor Statistics makes later changes to the CPI so that the assumed 1.1 percentage point overstatement becomes only 0.5 percentage point. Then the earlier legislation would have resulted in an extreme over-correction. Moreover, the earlier legislative change would place further pressure on the BLS not to improve its measure.

To make matters worse, a comparison of improvements over time would be almost impossible to conduct. The 1.1 percentage point figure is not only "squishy," it is not done in a way that allows for consistent year-to-year comparisons. How can squishy improvements -- their measurement also subject to future dispute -- be subtracted annually from a squishy baseline that allows for no year-to-year comparisons?

Possible Compromise: If one accepts the commission's arguments about quality increases -- and this is controversial -- it is unlikely that they would ever be captured fully even by the most improved CPI. Other improvements in the CPI, on the other hand, are more likely. Therefore, Congress might start with program adjustments in the first few years at a higher rate but then narrow the gap toward, say, 0.2 percentage or 0.3 percentage points on a more permanent basis. Congress could still argue that it was protecting individuals reasonably against increases in the cost of living.

Issue 2: Over the long term, a CPI adjustment has its largest impact on tax rates. Congressional Budget Office reports are the basic source on the effect of CPI changes on revenues and expenditures. Those reports only focus on a short-run window period such as five years. Tax rate increases, however, compound continuously, whereas social security cuts eventually level out.

Why does this occur? The tax system already allows for what is known as "real" bracket creep. That is, as individuals' real incomes go up, they move into higher tax brackets and their average tax rates increase as more income is subject to higher rates. A slow-down in the CPI would result in even larger amounts of bracket creep. Real bracket creep can continue almost forever -- or until all income is taxed at the highest rate. With social security, however, the CPI cutbacks affect only those who are retired. New generations of beneficiaries get the same level of initial benefits no matter what happens to the CPI. Thus, eventually, the very old -- those with the most years of CPI cut -- die off and are replaced by the young elderly, who start the process all over again. In the tax system, by contrast, newcomers will find themselves already affected by tax brackets that are much less friendly than would have occurred under old law.

The dominance of rate increases is even clearer in the case of a temporary lowering of the CPI. Suppose

Congress were to restrict CPI adjustments to CPI less 0.5 percentage points for 10 years only. Tax rates would be permanently higher for almost all future taxpayers. Social security benefit cuts, however, would eventually affect no one, and retirees entering the social security system after a little more than 10 years would not be affected at all.

Possible Compromise: Some eventual cap on the amount of real bracket creep may be appropriate.

Different indexes also might be considered. For instance, Congress might want to use a different index for the dependent exemption since its erosion tends to raise taxes relatively more on families with dependents. Congress might also seek to let brackets and standard deductions be indexed at slightly different rates so as to reduce the size of marriage penalties in the law. Congress might also want to consider changes to other features and indexes in social security so as to share the burden more equally between future and current retirees.

Issue 3: Social security cuts in cost-of-living adjustments would hit the poorest and oldest of the elderly and near-elderly the worst. Almost every cohort of retirees gets higher levels of benefits than those who have retired before them. Those retiring at 65, for instance, commonly find themselves with benefits 25 percent higher than the benefits of those who are 85 and older. The CPI adjustment doesn't at all affect the wage index, which is used primarily to calculate initial benefits for new retirees. If we reduced benefits by 1.1 percentage points per year after retirement, then those retiring at 65 would start to get benefits that were roughly 67 percent higher than those over age 85. (That is, the ratio would go from about 125-to-100 to 125-to-75.)

Possible Compromise: Again, Congress could consider some other social security changes as well. For instance, it might help some older retirees by requiring that newly eligible couples in social security exchange some of their early benefits for a level payment (larger "right of survivorship") on the death of one spouse. Congress might also consider the extent to which it wanted to concentrate greater attention on the wage index on which initial benefits are paid so as to create greater parity between older and younger retirees.

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