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Revising the Consumer Price Index: The Changing-the-Yardstick Approach to Deficit Reduction

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Federal Reserve Board Chairman Alan Greenspan, arguing that there is a bias in the consumer price index (CPI), has proposed changing this basic measure of the cost of living as a way to reduce the federal deficit. By adjusting the CPI downward, government payments that are indexed to it, most importantly Social Security, will be reduced. In addition, since the point at which a taxpayer shifts into a higher tax bracket is tied to the index, most people will pay higher taxes with a lower CPI. Greenspan's proposal would thus allow the federal government to cut hundreds of billions of dollars in benefits and raise hundreds of billions in taxes, without requiring a vote. The idea is therefore very popular in Congress.

However, there is little evidence to support Greenspan's claim that the CPI overstates the increase in the cost of living. In fact, the evidence indicates that the CPI significantly **understates** the increase in living costs for the elderly, the group that would be hit most directly by a reduction in Social Security benefits. Furthermore, if Greenspan and Congress truly believe that the main measure of the cost of living significantly overstates inflation, then the policies they are pursuing with regard to interest rates and deficit reduction have little or no foundation.

There is no clear evidence that the CPI overstates inflation.

Although Greenspan has claimed in congressional testimony that the CPI overstates inflation by 1.0-1.5% annually, there is virtually no evidence to support this charge. The chairman was apparently relying on an unpublished Federal Reserve Board working paper that was not intended as an assessment of the accuracy of the CPI. It is not the sort of work that would usually provide the basis for economic policy.

A more serious assessment by the Congressional Budget Office (CBO) found some evidence that the CPI overstates inflation, but the estimate was much smaller than the 1.0- 1.5% mentioned by Greenspan. The Bureau of Labor Statistics (BLS) eliminated the most serious source of high-side bias noted in the CBO study through a change in procedures introduced in January 1995. The remaining sources of high-side bias probably lead the CPI to overstate inflation by less than 0.3% annually.

At the same time, the CPI probably understates inflation in a number of ways. For example, price increases associated with quality improvements, such as mandatory safety equipment in automobiles, are not counted as an increase in the cost of living, even though the consumer has no choice but to pay the higher price. The use of outdated population weights from 1980 Census data means that higher-than-average price increases in rapidly growing areas are undercounted, while lower rates of price increases in areas with little or negative population growth are overcounted. Also, the high cost to consumers, in terms of time and effort, resulting from the deterioration in the quality of services such as health insurance is not factored into the CPI. Given these possible low-side biases, and considering the procedural change put in place in January by the BLS, the bias toward understatement might be at least as large as the remaining factors that bias the CPI toward overstatement.

The cost of living for the elderly rises more rapidly than the CPI.

The consumption patterns of the elderly are significantly different from those of the rest of the population. A much larger share of spending by the elderly goes to housing and health care, and the price of these items has been rising more rapidly than the overall CPI. BLS found that an index based on the consumption patterns of people over age 62 rose on average 0.3% a year faster than the overall CPI. Thus, the current cost-of-living adjustments for Social Security are already inadequate to maintain living standards, and reducing the adjustments below the current CPI will cause the elderly to fall even further behind.

If Greenspan is right, then his monetary policy is courting disaster.

If inflation is indeed 1.0-1.5% lower than is indicated by the CPI, then the monetary policy pursued by the Federal Reserve Board has been extraordinarily contractionary. The most important factor in monetary policy is the *real* interest rate (the nominal interest rate minus the inflation rate). If Greenspan is right about the CPI, then the real interest rate is 1.0- 1.5% higher than is generally thought, and higher than he has led Congress to believe in his public testimony. This would mean that the real federal funds rate (the key rate under Greenspan's control) is approximately 4%, a level almost certain to bring on a recession.

If Greenspan is right, then there is little reason for concern over the size of the current deficit.

If the CPI significantly overstates inflation, then Congress' current concern over budget deficits is misplaced. The economic rationale for reducing the budget deficit is that lower deficits increase national saving, which leads to higher levels of investment, more rapid productivity growth, and, ultimately, more

rapid real wage growth and higher living standards. Many of the links in this argument are questionable, but the point is that the ultimate purpose of lowering budget deficits is to bring about more rapid real wage growth.

If the CPI has overstated inflation by as much as alleged, then average wages must be growing at a reasonable pace. However, the problem of deteriorating living standards created by greater wage inequality still remains. *Therefore, the issue of wage inequality should take on greater importance, while the issue of overall economic growth is less important than previously thought.* To redress this inequality, Congress should be seeking to expand and improve programs such as education and training, precisely the sorts of initiatives it is currently cutting.

References

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