TESTIMONY OF

Joseph J. Minarik
Deputy Assistant Director
Tax Analysis Division
Congressional Budget Office

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My name is Joseph J. Minarik, and I am Deputy Assistant Director of the Tax Analysis Division of the Congressional Budget Office (CBO). I appreciate the opportunity to testify before this subcommittee today on the revision of the Consumer Price Index (CPI) and special group price indexes. Because Alice M. Rivlin, director of the CBO, has already entered her detailed testimony into the record, I will only briefly summarize that testimony in a prepared statement at this time.

The Revision of the Consumer Price Index

The preponderance of expert opinion has for some time held that the Consumer Price Index as currently formulated is a poor measure of the rate of inflation. The failing of the CPI is its treatment of owner-occupied housing. The present formulation exaggerates the importance of home prices and particularly of mortgage interest rates in the price structure of the economy. To make this statement is not to criticize the Bureau of Labor Statistics (BLS), which instituted the current treatment of owner-occupied housing in 1953 when today's rapid inflation and high interest rates could not have been foreseen.

The Bureau of Labor Statistics' future rental equivalence treatment of owner-occupied housing for the CPI should be welcomed. The rental equivalence approach makes the vital distinction between the shelter and the investment costs of homeownership. Thus, the weight assigned to homeownership and the price computed for it in the CPI will correspond only to what the homeowner pays for the shelter of the home, not for any additional spending intended as an investment toward a future return.

In recent years, the CPI has increased more rapidly because of the flaw in its treatment of homeownership. It would be a mistake, however, to say that the CPI inherently exaggerated inflation, and that the revised CPI will show less inflation than the current version would. In fact, what the current CPI exaggerates is movements in home prices and mortgage interest rates. These movements could be up or down, fast or slow. Therefore, the effect of revising the CPI depends on economic developments that are extremely difficult to forecast.

To play out a few scenarios: If interest rates and house prices remain at their current levels, those components of the current CPI would show no change (that is, zero inflation). The revised CPI, which would omit those components and put more weight on other goods (whose prices would presumably increase at some nonzero rate), would show more inflation, not less.

Suppose alternatively that mortgage interest rates fell from current levels. Then the current CPI would place a heavy weight on a negative component, and again would show less inflation than the revised CPI.

Finally, imagine a financial crisis in which interest rates rose sharply from their current levels--the kind of deterioration that has been inconceivable for the past 15 years. Under those conditions, in contrast to the two scenarios above, the revised CPI would show less inflation.

The CBO's current economic forecast implies a general slow decline of interest rates over the foreseeable future, as most other forecasts do. This would suggest that the federal government's indexed outlays could be

held down by postponing the changeover to the revised CPI. However, our ability to forecast future interest rates is admittedly weak. Unforeseen developments could easily reverse any projection. It might be wiser to change to the more conceptually sound index, comforting ourselves with the knowledge that, by Murphy's law, whichever index we choose in order to minimize federal outlays will inevitably turn out to be the wrong one.

Behind this facetious argument lies a grain of serious analysis. The worst possible contingency for the indexed federal programs would be a shock to the economy causing higher interest rates and unemployment while the current CPI is in use. In that event, indexed outlays would increase sharply because of the CPI's flawed treatment of homeownership, and federal income and payroll tax revenues would be reduced at the same time. On the other hand, if we implement the revised CPI, we at least minimize the bulge in indexed outlays in this worst case scenario. Of course, implementing the new index will not give us the greatest outlay savings if interest rates should fall sharply, but most of us would gladly accept such bad luck.

Special Group Price Indexes

Another topic of recent interest is the desirability of the creation of special group price indexes. Our knowledge in this area is extremely limited, and so we should move with caution.

Construction of a new price index for some special subgroup of the population--in particular, the elderly--would be extremely costly and time consuming. We should therefore proceed if, and only if, there is solid

evidence that the new index would depart significantly from the current CPI, and if we are to put the new index to use in some federal government program. It is not at all clear that either of those two conditions is met.

First, the evidence on the rate of inflation in the market basket of the elderly, relative to that of the general population, is extremely sketchy. The work that has been done in this area suggests that the divergence between the inflation rate faced by the elderly and that of the population at large, if there is any divergence at all, is very small.

Second, there is a real question as to whether such a price index for the elderly should be used. Some analysts believe that a price index for the elderly would show that that subpopulation faces more rapid inflation, and thus would justify greater indexation of Social Security benefits. Unfortunately, while more rapid inflation in an elderly price index might lend intellectual support to greater indexation, it would not pay for it, and the Social Security system is in rough financial waters as it is. Other analysts believe that an elderly index would increase more slowly than the CPI, and thus justify a cutback in indexation. This group might think again about the inevitable controversy involved in indexing Social Security at a rate less than the general rate of inflation, by which many other programs are indexed. And both groups might consider how we would treat the almost one-third of Social Security beneficiaries who are not elderly, and the chaos that would arise if we tried to index different beneficiaries by different indexes.

An alternative proposal would be to create an elderly price index on an experimental basis, using the current CPI with slightly altered weights as a basis, merely to observe its behavior relative to the index for all urban consumers. This proposal seems harmless enough, but it has dangers of its own. Such an experimental index would differ significantly from an actual price index for the elderly, begging many important statistical questions. The current CPI is not designed to represent the geographical location of the elderly, or the stores at which they choose to shop; rather, it reflects those patterns for the entire urban population, which may be different from those of the elderly. (Another question is what goods and services the elderly consume; we have some information on this question from the data on the elderly who were sampled in the construction of the current CPI.) As a result, extreme controversy would be sure to follow the release of an experimental elderly price index based on the CPI. If it differed from the general index, one group of analysts would praise it and demand that it be made official, while others would attack it for its conceptual flaws. On the other hand, if the experimental elderly price index did not differ from the CPI, then <u>both</u> groups would argue that the experimental index was flawed. And in the final analysis, we would have learned nothing.

If we wish to learn more about the effects of inflation on the elderly, we should consider the merits of some basic research: Where do the elderly shop? How do prices change at those outlets, as opposed to the outlets frequented by the population at large? How have public and private

insurance affected the medical care costs of the elderly? Answers to these questions will be needed to assess the importance of, and to construct, a price index for the elderly.