STATEMENT OF

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Subcommittee on Congressional
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Mr. Chairman, reductions in cost-of-living adjustments (COLAs) for federal entitlement programs have figured prominently in discussions of efforts to reduce projected federal budget deficits. The reason is clear: the budget costs associated with COLA adjustments are huge. COLA adjustments for fiscal years 1982 through 1985, for example, will cost about $112 billion.

Besides the implications of COLA changes aimed at immediate relief of our budget problems, a lot of attention has been devoted to longer-run reforms of federal COLA procedures. My testimony today will focus attention on two prominent reform proposals:

- o the replacement of the current measure of homeownership costs in the Consumer Price Index (CPI) with a measure that more accurately reflects the price of housing services; and
- o the construction of a special consumer price index for the elderly as the basis for making COLA adjustments for federal entitlement programs.

My statement will make three major points:

First, the current CPI is a flawed measure of the cost of living largely because the homeownership component is a poor measure of the price of housing services. Replacing the current measure of homeownership costs with a rental equivalence measure would provide us with a better measure of the price of housing services. The decision to replace the current homeownership component in the CPI with a rental equivalence index should provide us with a superior measure of the cost of living.

Second, replacement of the current CPI with a revised rental equivalence CPI as the COLA index for federal entitlement programs, although justifiable on conceptual grounds, would not necessarily result in any net budget savings. The rate of inflation measured by the revised index could be higher or lower than the rate measured by the current CPI depending on prospective changes in house prices, house rents, and mortgage interest rates. Indeed, there is considerable likelihood that the revised CPI could exhibit more inflation than the current CPI for the next year or so at least. Accordingly, proposals aimed at pushing forward from 1985 to 1983 the date at which federal entitlement programs are scheduled to be indexed to the revised CPI could result in budget losses, not budget savings.

Third, there is little hard evidence to support the view that the CPI misrepresents the cost of living for the elderly. The data, imperfect though they are, suggest that differences between the economy-wide CPI and a special index for the elderly would have been small for the 1970s. Alternative treatments of the cost of homeownership would not have affected this result materially.

The CPI as a Cost-of-Living Measure

Criticism of the current CPI centers on its treatment of homeownership costs. Ideally, a cost-of-living measure should include only the actual costs people incur in meeting their shelter needs. One approximate measure of the shelter cost of a home is its rental value: when people pay rent for a home, they have "nothing to show for it" at the end; each month's rent simply pays for the services consumed currently. The current CPI measures more than the shelter cost of the home to the homeowner. Included in the current CPI market basket is the purchase price of the home, an estimate of its financing costs, taxes and insurance, and the cost of house maintenance. In return for these costs, homeowners get more than just places to live. They get an investment with special advantages as a tax shelter and as a hedge against inflation; they frequently have "something to show" for the money they have spent. To include the investment value of homeownership in a cost-of-living measure is a distortion. We do not include the costs of stocks and bonds that people buy in the CPI measure of their cost of living; neither should we include the investment value of homeownership.

In an effort to obtain a truer measure of the cost of shelter services, the Bureau of Labor Statistics (BLS) has announced that it intends to replace the current treatment of homeownership costs in the CPI with a rental equivalency measure--in effect, BLS will replace the current homeownership component with a rent index based on a sample of dwellings that is, as nearly as possible, representative of the types of homes occupied by owners. The revised treatment is to be implemented for the CPI-U in 1983; the CPI-W, the index currently used for Social Security COLAs, is scheduled for revision beginning in 1985.

Although the revised treatment of homeownership costs presents difficult measurement problems, the conceptual attractiveness of the rental equivalency approach is widely acknowledged. The inclusion of only the shelter services of a home reduces the total relative importance of homeownership costs from about 31 percent in the current CPI to about 21 percent in the revised CPI. This 10 percentage-point reduction in weight is a measure of the investment value of homeownership that is inappropriately referred to as a component of the cost of living in the current CPI. The reduced weight means that the revised index will be considerably less sensitive to housing market developments than the current CPI.

The Effects of the Revision in Homeownership Costs on the Measurement of Inflation and the Budget

Substitution of a rental equivalency measure for the current treatment of homeownership costs would have made a substantial difference to the behavior of the CPI over the past decade. BLS has produced an experimental index (CPI-U-X1) based on the rental equivalency notion extending back to 1967. To the extent that the cost of homeownership embodied in that experimental index accurately measures the cost of the shelter services of a home, the official CPI overstated the actual rate of inflation by 0.7 percentage points per year on average since 1967 (see Figure 1).

The main determinants of the differences between the CPI and the experimental indexes are documented in Figure 2.

FIGURE 1.

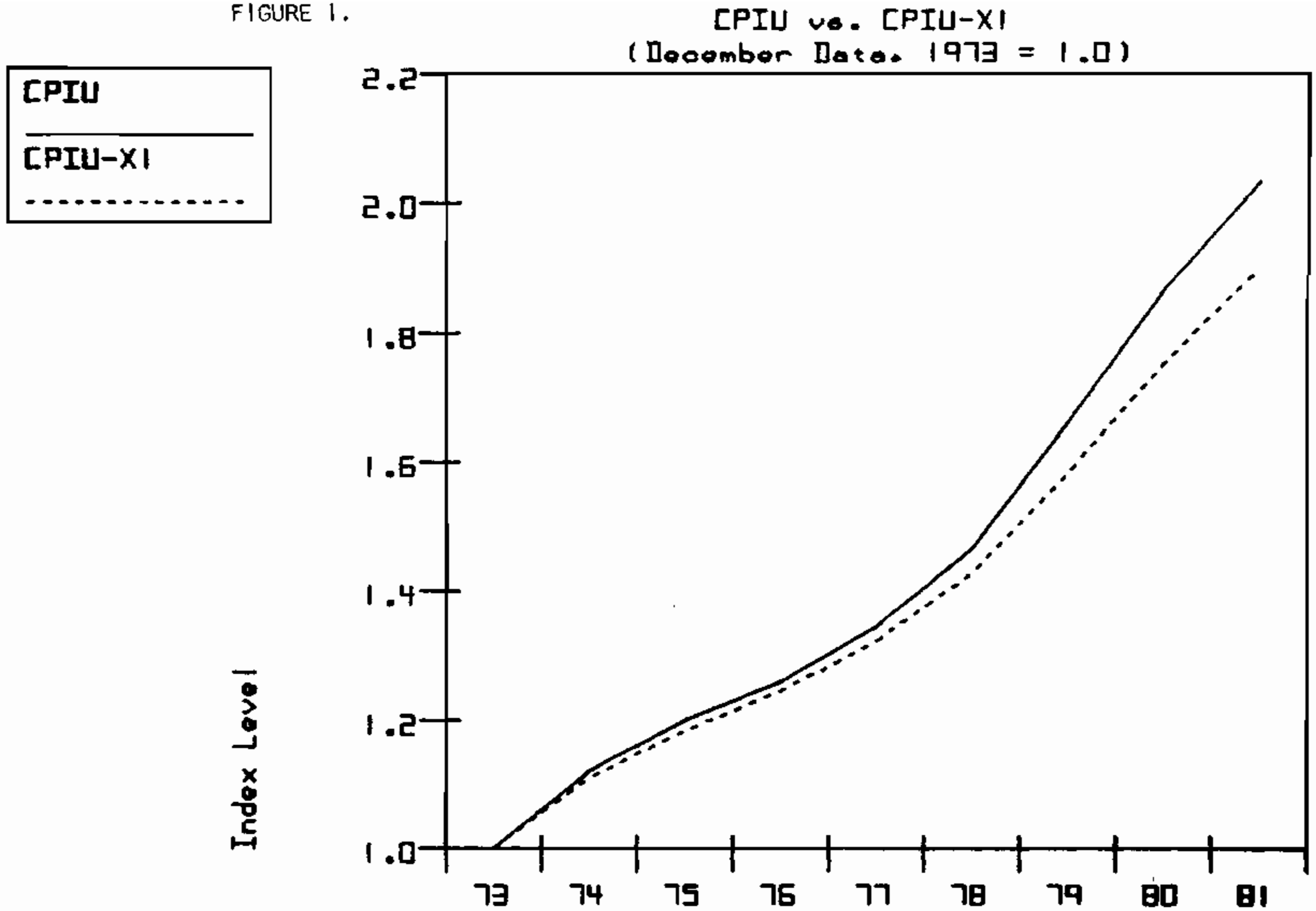
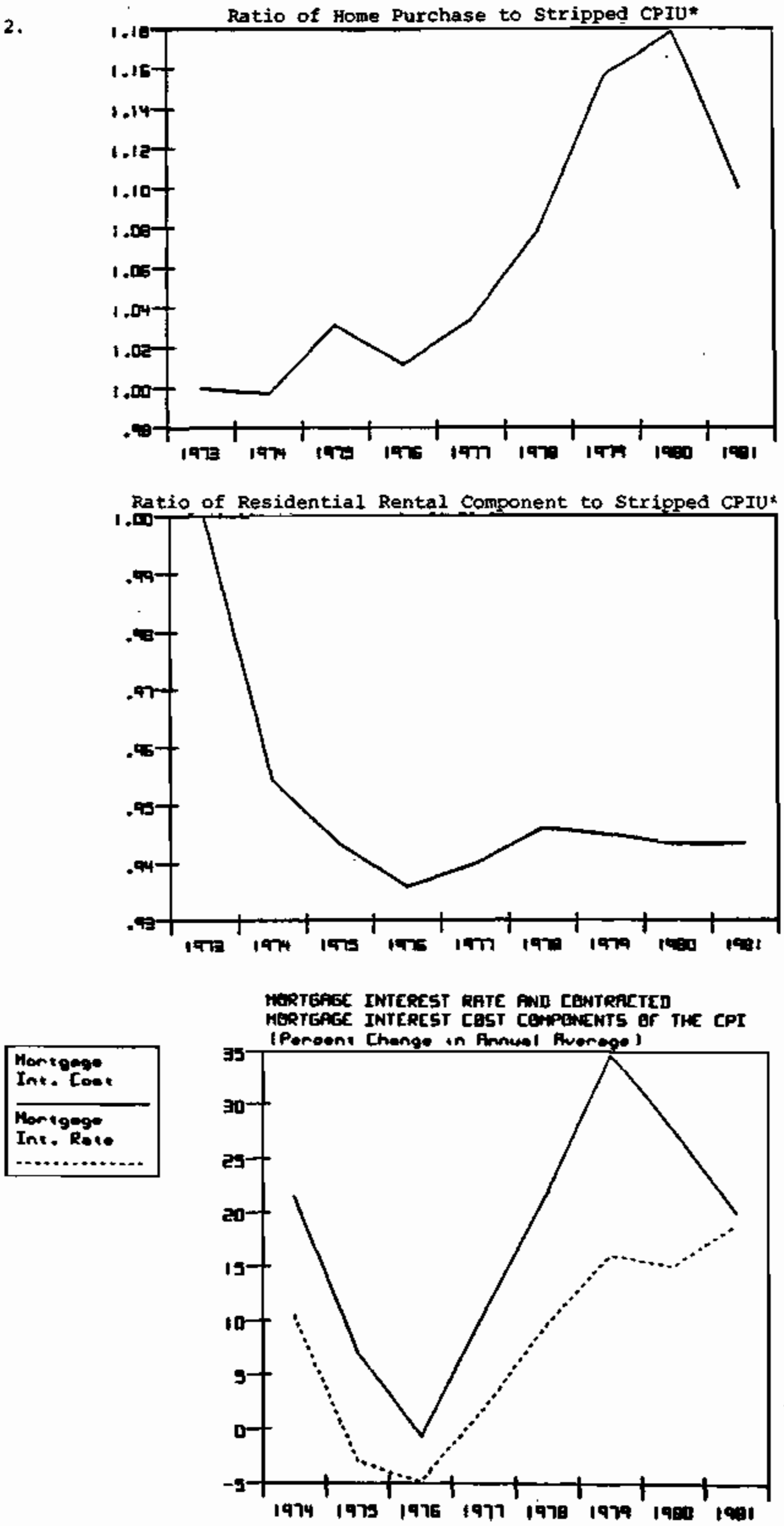

CPIU vs. CPIU-X1
(December Data, 1973 = 1.0)
CPIU
CPIU-X1
Index Level
2.2
2.0
1.8
1.6
1.4
1.2
1.0
73
74
75
76
77
78
79
80
81

FIGURE 2.



*CPIU less food at home, energy, homeownership, and used cars.

- o Over the decade, house prices rose by almost 20 percent more than the prices of other goods and services.
- o Over the course of the 1970s, rents rose by 10 percent less than the average of other prices.
- o Over the same period, mortgage rates rose dramatically, from the neighborhood of 8 percent at the beginning of the decade to rates of about 16 percent at the end.

Higher mortgage rates and higher house prices tended to increase the current CPI but had no direct impact on the experimental index. Lower rents reduced the experimental index by more than they did the current CPI. All these factors led to a growing gap during the 1970s and early 1980s between the two indexes.

The budgetary impact of this apparent overstatement of inflation has been substantial. A difference of one percentage point in the CPI can increase or decrease outlays on indexed federal entitlement programs by about $2 billion. The cumulative discrepancy between the CPI and the experimental index since Social Security indexing was started amounted to about 5.8 percent at the beginning of 1981: this means that Social Security payments are now over $6 billion per year higher than they would have been if the rental equivalency measure had been used for adjusting benefits since 1974. Counting all entitlement programs, the annual excess cost of the overstatement of inflation since 1974 approaches $8-1/2 billion.

Although the trend differences between the CPI and the experimental index have been sustained for an extended period of time, it would not be appropriate to extrapolate those differences into the future. Indeed, many people think that the revised CPI will exhibit more inflation than the current CPI for the next year or two at least. Beyond that time frame, however, it is impossible to determine whether the revised CPI will show more or less inflation than would have been shown by the current CPI.

The relative prospective rates of inflation as measured by the current CPI and the revised CPI will be determined almost exclusively by the prospective rates of increase of three price components--mortgage rates, house prices, and rents. While some of the past trends in these components are likely to continue into the 1980s, with possible interruption during the current recession and subsequent recovery, others are likely to be reversed.

- o Mortgage rates are not expected to continue rising as they did in the 1970s and early 1980s. The only basis for continuing long-run increases in mortgage rates would be an accelerating rate of inflation. However, almost every forecast, including that of CBO, projects lower rates of inflation in the future.

- o The recent softness in house prices could persist for some time into the future aided, in part, by a continued slump in the housing market. However, because the demographic factors underlying housing demand will remain strong through the mid-1980s at least, house prices are likely to continue to increase faster than other prices during the decade of the 1980s.

- o It is very uncertain at this time whether future rents will rise or fall relative to the prices of other goods and services. In any event, there is no reason to anticipate further persistent declines in rents relative to house prices.

Other things remaining equal, if mortgage rates fall this will lower the growth of the current CPI relative to the revised index; if house prices rise faster than those of other goods, the current CPI will tend to grow faster than the revised index; and given the greater weight of the rent index in the revised CPI, an increased pace of rental prices would raise the growth of the revised index relative to the current CPI.

A great many factors will affect future movements in mortgage rates, house prices, and rents; these are analyzed in the Appendix. Taking them together, there is considerable likelihood that declining mortgage rates would pull the growth of the current CPI below that of the revised index in the next year or two. Beyond that period, CBO's best guess is that inflation rates calculated using the current measure of homeownership and the rental equivalence measure will not differ from one another substantially.

Is There Need for a Special Consumer Price Index for the Elderly?

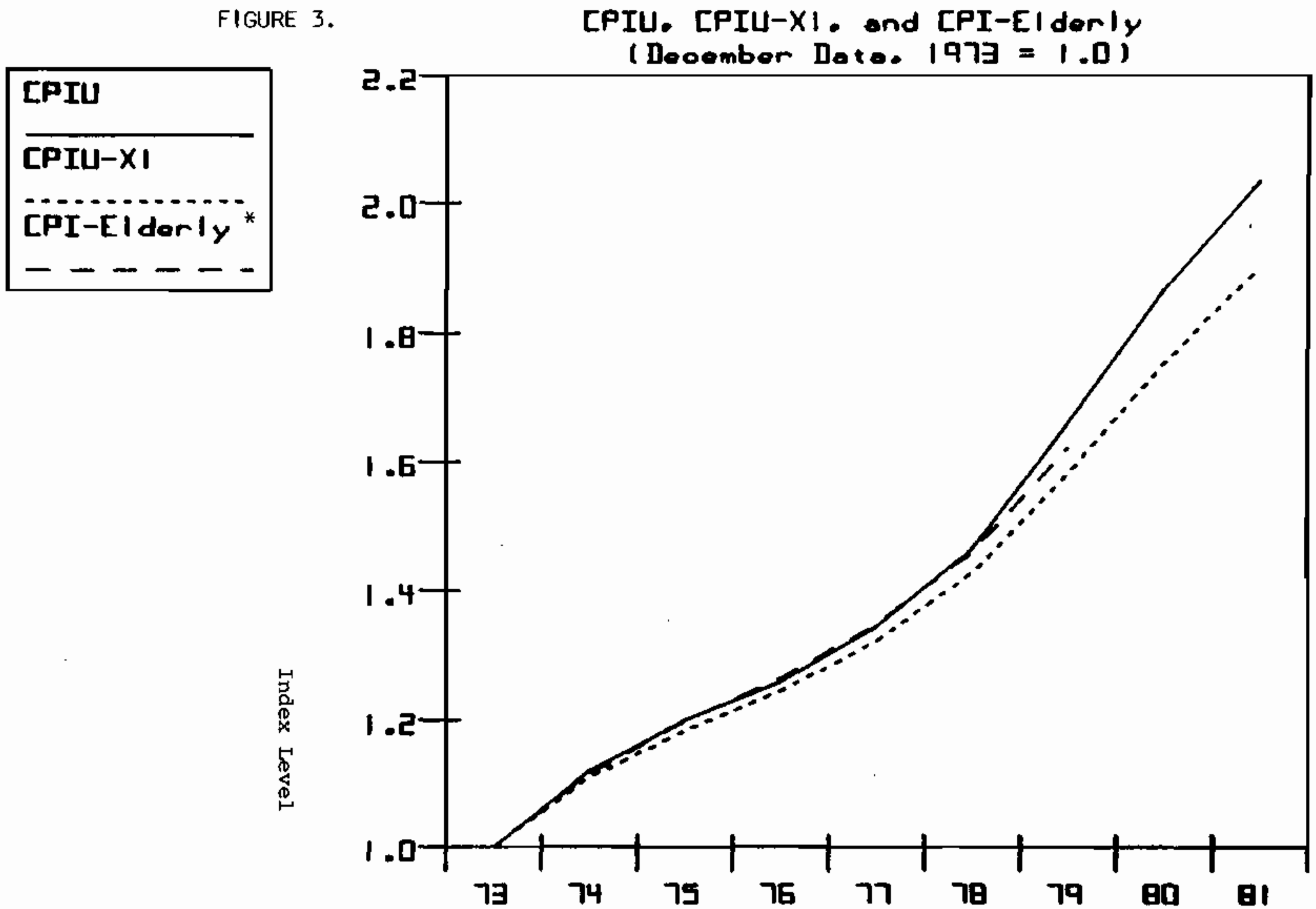
A lot of interest has centered around the idea of a special consumer price index for the elderly to be used as the basis for determining the size of COLA adjustments for federal entitlement programs. Two important issues have been raised by this discussion:

- o The first is conceptual: would it be appropriate to use a special consumer price index for the elderly as the basis for making COLA adjustments for federal entitlement programs?
- o The second is factual: to what extent does the economywide CPI misrepresent the degree of inflation experienced by the elderly?

Although the case for a special index for the elderly is attractive conceptually, two considerations need to be kept in mind. First, federal entitlement programs provide benefits to more than just the aged. The elderly are admittedly the largest subgroup of recipients, but as of November 1981, almost one-third of all Social Security beneficiaries were under the age of 65; almost one-fourth were under the age of 62. Second, because spending patterns vary so widely among the elderly--reflecting, in part, the marked differences in economic circumstances faced by the aged--it is not clear that a special measure of the cost-of-living change experienced by the elderly would be much better than the current CPI.

This brings us to the second issue--the degree to which the economywide CPI misrepresents the extent of inflation experienced by the elderly. We know that the elderly, on average, spend a greater proportion of their income on food at home and on medical care, though inadequate account has been taken of the complex medical insurance situations facing the aged; we know that the elderly spend a lower proportion of their income on food away from home, on transporation, and on recreation; and we know that they are more likely to own their homes outright. Despite these spending pattern differences, the evidence, imperfect though it is, suggests that differences between the economywide CPI and a special index for the elderly would have been very small for the decade of the 1970s. Consumer price indexes incorporating expenditure weights more appropriate to the elderly population tend to move in a manner very similar to the movement of the economywide CPI (see Figure 3). Importantly, the differences between these two indexes are not particularly sensitive to changes in the treatment of homeownership costs. This meets directly an often repeated criticism that movements in the cost of homeownership as measured in the

FIGURE 3.



*Source: "Indexing of Social Security Benefits", A. DiPietro and B. Smith, U.S. Treasury Study Paper, September 1980. Index uses rental equivalence measure of homeownership.

current CPI are of little relevance to groups such as retirees, since the freqeuncy with which they purchase houses is much less than for urban consumers in general. Thus, although the revised index will more accurately reflect the expenditure patterns of the elderly, the rate of inflation for the elderly is little affected.

To represent even better the expenditure patterns of the elderly and other recipients of entitlement program outlays, a case can be made, on conceptual grounds at least, for replacing the CPI-W, the current COLA index, with the CPI-U. This is because the CPI-W is based on the expenditure patterns of urban wage and clerical workers only, whereas the CPI-U is based on the expenditure patterns of all urban consumers, including retirees.

Conclusion

In conclusion, Mr. Chairman, the present Consumer Price Index is not a satisfactory measure of the cost of living because it does not accurately treat homeownership costs. While this deficiency will be corrected in the new, revised CPI, we cannot be certain whether the change will increase or decrease the cost of indexed federal programs over the long run in comparison to their costs using the present CPI. Finally, although the idea of switching to a special index for the elderly as the basis for COLA adjustments for federal entitlement programs is conceptually attractive, it requires more study before being pursued.

APPENDIX. FACTORS INFLUENCING FUTURE MOVEMENTS OF HOUSE PRICES, RENTS, AND MORTGAGE INTEREST RATES

Future Movements in House Prices

Prediction of house prices requires balancing underlying demographics against variations in financing costs, current house prices, and the expected returns from owning houses. The expected returns are themselves sensitive both to expected house price changes and to changes in tax laws.

- The demographic pressures on house prices that were partly responsible for the rapid escalation of those prices in the 1970s are still present. In the outyears, however, all indications are that the demographic pressures will ease substantially. This points to continued upward pressure on house prices in the near term followed by considerable easing later on.

- The current slump in the housing industry means that the housing stock in the near term will be unusually low. For any given increase in demand for housing in the next few years, house prices are therefore likely to increase more rapidly than otherwise. What the future holds in this regard is very uncertain.

- Over the near term, prospective reductions in mortgage rates are likely to stimulate a significant increase in the demand for housing, both because of reduced financing costs generally and because lower mortgage payments increase the size of the pool of qualifed buyers. However, the rapid escalation of house prices over the course of the past decade has increasingly put homeownership out of reach of large numbers of families. How much demand for housing will increase in the short run is, therefore, uncertain. There is even more uncertainty with respect to the long term.

- If the overall inflation rate falls as many forecasters now predict, the incentive to use real estate as an inflation hedge will be reduced, easing the upward pressure on house prices. Lower inflation will also reduce the tax advantages for homeowners, in particular the favorable tax treatment of capital gains derived from house sales. The reduction in the overall inflation rate may ease the upward pressure on house prices.

- Current house prices may contain a premium representing the costs of "creative financing." Lower interest rates could conceivably reduce house prices below what they would otherwise have been.

- If the new variable-rate mortgages prevent unexpected reductions in real mortgage rates whenever the rate of inflation is unexpectedly high, then real mortgage rates could be higher in the 1980s than in the 1970s--though presumably not higher than their recent historical peaks. This would help slow the demand for housing and slow the rate of housing price increases.

Thus, there are plausible reasons to expect either an acceleration or a deceleration of housing prices.

Future Movements in Rents

It is extremely difficult to predict future trends in rents. Rents and house prices are related to one another, but the relationship is a complex one. Some argue that when house prices are expected to increase, landlords may figure more capital gains into their rate-of-return calculations and temporarily hold down rent increases. Others argue that since house prices must ultimately correspond to the capitalized value of the stream of rents, expected house price increases will ultimately raise rents. There are other uncertainties as well:

- The new rent index to be used in the revised CPI will not be identical to the rent index in the current CPI. The revised rent sample for owner-occupied housing may well show faster growth in rents than the current one. The current rent sample contains a disproportionate number of inner-city housing units that have fallen into disrepair over time. This may have been due, in part, to the existence of rent controls, which served to slow the rate of rent increases relative to other prices. Rent controls have no meaning in the context of owner-occupied housing, and owner-occupied housing is generally maintained in much better repair than rental housing units, implying correspondingly higher rental equivalence values.

- The rate of increase in rents may also be affected by general housing market developments. If lower inflation rates, higher real mortgage rates, and reduced tax advantages from owner-occupied housing slow the demand for housing, this would increase the demand for rental units, increasing the rate of rent inflation. On the other hand, provisions of the Economic Recovery Tax Act of 1981 that make it possible to depreciate rental property on a greatly accelerated schedule will increase incentives to invest in rental housing. This increase in the supply of rental housing would tend to hold down rent increases.

- The house price index used in the current CPI is based on the prices of houses backed by FHA mortgage guarantees. The rate of increase in this price index has been less rapid than the rate of increase in housing prices generally, according to census data. The rental equivalency measure for all owner-occupied housing, therefore, could show more inflation not only relative to the current rent index, but relative to the current house price index.

- Rent controls affect the CPI measure of rents to an unknown extent. If rent controls became more prevalent, this would reduce the CPI measure of the rental equivalent value of owner-occupied housing relative to its value in the free market.

Future Movements in Mortgage Rates

Almost all forecasters agree that mortgage rates will decline from their current record high levels over the near term, both because the inflation rate is expected to decline and because some reduction in real mortgage rates is anticipated.

We cannot be confident, however, that mortgage rates will decline significantly after 1983. If mortgage rates fall sharply in 1982, then, other things being equal, the current CPI will fall relative to the CPI-U-X1 in 1982. But unless mortgage rates continue to fall through 1983, the decline in mortgage rates will not affect the old CPI measure in 1983 and beyond, and consequently the CPI revision will not have any important impact on measured inflation rates from 1983 onward. It is not possible at present to make meaningful predictions as to whether mortgage rates will be rising or falling between 1983 and 1985, or from 1985 onward.