SOCIAL SECURITY OVERSIGHT: COST-OF-LIVING ADJUSTMENTS

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WEDNESDAY, JUNE 24, 1981

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, D.C.

The committee met, pursuant to recess, at 2:35 p.m., in room 6226, Dirksen Senate Office Building, Hon. John Heinz, chairman, presiding.

Present: Senators Heinz, Percy, Cohen, and Chiles.

Also present: John C. Rother, staff director and chief counsel; E. Bentley Lipscomb, monority staff director; Larry Atkins and Dorothy Watson, professional staff members; Ann Gropp, communications director; Kathleen M. Deignan, minority professional staff member; Robin L. Kropf, chief clerk; Nancy Mickey, clerical assistant; and Eugene R. Cummings, printing assistant.

OPENING STATEMENT BY SENATOR JOHN HEINZ, CHAIRMAN

Senator HEINZ. Today, the Special Committee on Aging holds the third of a series of hearings on the problems of assuring adequate financing and restoring public confidence in the social security system.

The purpose of today's hearing is to examine the issues surrounding the indexing of social security benefits to match cost-of-living increases. There is no question of greater importance to retired Americans than that of how the Congress will reconcile the need to protect social security benefits from erosion with the need to protect the financial stability of the social security system when rapid inflation and low wage growth are combined.

In 1972, Congress amended the Social Security Act to provide for automatic adjustments in benefits for the annual rate of increase in the Consumer Price Index. This automatic indexing was intended to provide for a more timely and predictable increase in benefits that could be accomplished through ad hoc changes. It made social security more secure for the retired person concerned about keeping up with inflation. Many persons also saw indexing of benefits as a way to restrain political forces supporting even larger ad hoc benefit increases.

The results, however, were completely unanticipated. Automatic cost-of-living increases have raised the dollar value of social security benefits by 62 percent over the level of benefits paid in June 1975. As a result, we now hear critics argue that benefits to the elderly have been raised too much. They maintain that the method used to adjust social security benefits has overcompensated the

elderly and has actually increased the relative purchasing power of their benefits since 1975.

At the heart of this controversy is the contention that the Consumer Price Index, because of peculiarities of its construction, has risen more rapidly in recent years than the prices actually paid by the average consumer. However, finding this to be true for the average consumer does not necessarily make it true for the elderly consumer. Evidence, which we hope to review at this hearing today, suggests that older people experience higher-than-average rates of inflation, and therefore may warrant the adjustment in benefits they are currently receiving.

Even if the social security benefit is adequately adjusted for inflation, let us not forget that much of the income retirees and their families depend upon is not. Few private pension plans have automatic cost-of-living increases. Most plans provide ad hoc pension benefit increases which rarely keep pace with inflation. In addition, earnings income for the elderly has dropped significantly over the past decade.

Despite these shortcomings in retirement income programs, there can be no denying that automatic cost-of-living indexing, at least the way it is currently structured, is producing serious problems in the financing of social security benefits. Last year's 14.3 percent increase in benefit payments cost the social security system over $16.8 billion. This increase in payments came at a time with unemployment at 7.1 percent and wage growth at only 9.1 percent. These together were slowing the rate of increase in revenues.

Hearings before this committee last year touched on the problems of indexing social security benefits. These hearings, as many may recall, were exploratory, addressing a variety of options and concerns in this area. Now that the Congress is prepared to significantly cut spending in a wide range of domestic social programs, attention has focused more directly than ever on the automatic increases in social security payments.

This concern has led to several proposals to alter the method for cost-of-living adjustments in order to restrain benefit increases when inflation is high and wage growth low. In May, the Senate approved by a vote of 49 to 42, an amendment to the First Concurrent Budget Resolution, an amendment later dropped in conference between the House and Senate, which called for indexing social security benefits in each year by the lower of either the price or wage index. Today, we address this issue in the context of a growing inclination on the part of many Members to modify cost-of-living adjustments.

In reviewing the alternatives we have, it is important to bear in mind the tremendous responsibility the Congress has for the economic well-being of our older, retired citizens. For this group of Americans alone, income lost through changes in adjusting benefits cannot easily be made up from other sources. In periods of normal economic growth, price adjustments minimize benefit increases. They are intended only to hold the elderly at a constant standard of living. Once on social security, older Americans neither share in the real gains in income during periods of growth, nor do they share in the real losses in income during periods of stagnation.

If the Congress makes changes in the cost-of-living adjustments to social security benefits, it must insure that those changes do not unfairly penalize retired persons who depend on social security for the economic well-being.

We have three witnesses today who will be assisting us in these inquiries: Joseph Minarik, James Storey, and James Hacking.

Gentlemen, will you please come forward to the table? I am going to ask Mr. Minarik to lead off. Then we will proceed to Mr. Storey, and then to Mr. Hacking. When the bells go off, I will have to disappear and go over and vote and come back. Unless a member of the committee shows up, I will have to temporarily recess the hearing.

So, Mr. Minarik, would you please proceed—well, would you please withhold and the hearing will recess for about 5 minutes.

[Whereupon, a brief recess taken.]

Senator CHILES [presiding]. We will bring the committee back to order.

I would like to—here comes the chairman now.

Senator HEINZ [presiding]. I want to thank you, Senator Chiles.

STATEMENT BY SENATOR LAWTON CHILES

Senator CHILES. I was going to put my statement in the record. If you stayed a minute longer, you would not have had to hear it.

I welcome these witnesses here today to discuss cost-of-living adjustments to social security. This is a sensitive subject.

No aspect of social security is valued more than the annual, guaranteed automatic cost-of-living adjustment provided each July to beneficiaries. I know that from what Floridians tell me and from what I learned during this committee's social security hearings last year. That is something they consider sacred.

Any changes in the cost-of-living adjustment could have far-reaching effects. The protection it offers against inflation is essential to social security beneficiaries. That is why I have not proposed any changes in the COLA in the Social Security Reform Act of 1981. I am committed to a full, fair, annual COLA.

I am glad that social security COLA changes are not a part of the budget reconciliation bill now being debated on the Senate floor—even though the Budget Committee approved a 3-month delay and going to the lower of wages or prices to calculate the increase.

I argued against these changes on the floor in the Budget Committee—several times, as a matter of fact. My position has been that any decisions on COLA changes must not be made in haste. We may not have to make any changes at all.

If some change is necessary, there are a number of ways this could be done. Congress must calmly and carefully examine all these positions. That is the process this committee is now engaged in—and I commend the chairman for holding this hearing.

Senator HEINZ. Senator Chiles, thank you very much. I thank you for your great contributions to this committee this year and many previous years.

Senator Pryor has a statement that he would like put in the record and, without objection, his entire statement will be made a part of the record.

[The statement of Senator Pryor follows:]

STATEMENT OF SENATOR DAVID PRYOR

This is the third in a series of hearings to explore the needed changes in the social security system. I believe that the Special Committee on Aging, under the able chairmanship of Senator Heinz, has to date gathered a wealth of information in this area, and am certain that this hearing will provide additional insight, particularly regarding the cost-of-living adjustment and Consumer Price Indexing of that adjustment.

Under current law, the Secretary of Health and Human Services is authorized to automatically increase social security benefits effective each July 1 whenever the cost of living, as measured by the CPI, has risen 3 percent or more over the rise in the cost of living over the same period in the previous year. This automatic increase was established in 1975 as a result of historic neglect of the severe financial difficulty which many of our Nation's retired elderly were experiencing. Before that time, these citizens were subject to sporadic initiatives by the Congress to make retirement income levels more adequate and equitable.

Most recently, however, increasing financial strains on social security have raised some serious questions about the ability of the system to support these automatic increases. This is primarily due to rapidly rising inflation, high rates of unemployment, and slow economic growth.

It is clear that we cannot just sit back and hope for the best.

The Congress must face the difficult issue of modifying the system to insure its short- and long-term financing this year. Yet, it is vital that we not make precipitous cuts in the benefits upon which many of our elderly rely as a primary or even sole source of income.

In addition to basic financing issues, there are other vital issues which must be addressed today.

Recent congressional actions have threatened reduction in annual adjustments through an indexing formula change on the pretext that these adjustments are overly adequate for retirement needs. However, I have serious concerns that current price indexing may actually be inadequate for our senior citizens needs. Recent studies suggest that three of the most rapidly rising household expenditures are in the areas of health care, food, and energy costs. Our Nation's elderly expend most of their disposable income in these three areas.

Mr. Chairman, I commend you for the timely scheduling of these hearings, and look forward to the testimony of our distinguished witnesses.

Senator HEINZ. Mr. Minarik was just about to begin his statement when the bells went off.

Would you begin?

STATEMENT OF JOSEPH J. MINARIK, WASHINGTON, D.C., RESEARCH ASSOCIATE, ECONOMIC STUDIES PROGRAM, THE BROOKINGS INSTITUTION

Mr. MINARIK. I am Joseph Minarik. I am a research associate from the Brookings Institution. I have been urged by the staff to make my opening statement in great haste and I will try to do that.

Taking the statements of the two Senators at the opening of the hearings as a kind of prolog, I would like to get right down to my conclusions on this subject.

I believe that the Consumer Price Index is subject to a very serious error in its construction; that over the last 5 years, it has seriously overestimated the rate of inflation in consumer prices in the United States. As a result, I believe that the indexing of social security by the Consumer Price Index over the last 5 years has exceeded the actual rate of increase of prices in the United States.

I have written in my own research on the distributional effects of inflation that the elderly are the disaster area of inflation. That is not because of the indexing provision in social security benefits. This is perhaps the main protection of the incomes of the elderly

relative to inflation. The elderly are hurt relative to inflation for the most part because they have accumulated assets which, due to market conditions, they are generally forced to save at rates of interest that are less than prevailing market rates. Therefore their wealth is eroded over a period of time.

The indexation of social security is not a part of this problem and, therefore, I believe it should be considered separately.

The question is whether the inaccuracy in the Consumer Price Index that overstates actual inflation might be used as a protection for the losses of the elderly in other connections, for the erosion of their wealth by inflation. That is apart from the question of whether the social security benefits themselves keep up with inflation. I believe that using that error in the Consumer Price Index as a means of protecting the elderly is a very serious mistake.

In effect, what it is doing is using a lottery to provide a certain amount of protection for the elderly in any given year which is dependent on forces which are not correctly, scientifically measured in the CPI.

I think it would make much more sense if we had a systematic policy that dealt with this question directly.

Another question that has been raised frequently is why it is that poverty among the elderly has been increasing over recent years. I do not believe that this has anything to do with the indexing of social security benefits.

No. 1, by definition, social security benefits keep up with the rate of indexation because they are indexed.

No. 2, we have to keep in mind if the CPI overstates the rate of inflation in consumer prices, then the poverty standard is being increased more rapidly than it should be because the poverty standard is indexed by the CPI. So it is important to keep the question of the accuracy of the CPI in mind in all estimates of this question.

I would recommend that the first step in dealing with the problem of indexation would be to fix the Consumer Price Index. The best alternative that is available would be to go to something like the CPI X-1 variant using a rental equivalent of the cost of owner-occupied housing. Once this is done, the conflict that we have experienced in recent years between the rates of increases between wages and prices will be greatly mitigated. A great deal of the problem we have had with overindexation and the excess of indexation of social security benefits over the rate of growth of wages is directly a function of the fact that CPI has been mismeasuring inflation.

After that is done, I believe that a wage cap with a catchup provision to allow any pain of falling real wages to be spread between taxpayers and beneficiaries of the social security system would be a reasonable way to help share the pain of a stagnating economy.

It should be kept in mind that in recent experience it is the definition of the CPI which makes us think the wage cap would be frequently used. In fact, over recent years, the problem we have had is not that wages have fallen behind prices but that wages have fallen behind the CPI.

If beyond that point we believe that the elderly need greater income support, I think it more reasonable to attempt to measure what those needs are and to legislate well directly, rather than to use a faulty measure of the rate of increase of consumer prices to decide for us what additional support is necessary for the elderly.

I will stop there, Mr. Chairman.

Thank you very much.

Senator HEINZ. Mr. Minarik, without objection, your entire testimony, which is quite detailed and quite comprehensive, will be made a part of the record.

[The prepared statement of Mr. Minarik follows:]

PREPARED STATEMENT OF JOSEPH J. MINARIK

The rapid inflation of the late 1960's and early 1970's caused an equally rapid growth in the frequency of indexing provisions in both public laws and private contracts. It has been estimated that almost one-half of the Federal budget is now subject to indexing provisions of one sort or another, and that 57 percent of the organized workers under contract are protected by cost-of-living adjustment (COLA) clauses. This boom in indexation is now widely regarded as more than just an afterthought of inflation, but rather a significant phenomenon in its own right.

REASONS FOR CONCERN

Generally speaking, there are four reasons why the increasing frequency of indexing agreements and provisions has caused such interest and concern. First, it is clear that indexing more Federal programs makes Government outlays more sensitive to the price level. Given the current law, each 1 percent increase in the Consumer Price Index increases Federal spending by almost $3 billion. Thus, a rapid inflation adds directly to the Federal Government's deficit. To counteract this tendency, the Government would have to reduce spending elsewhere, which may be difficult in times of fiscal stringency. While this argument would be part of a case against indexing, there is another side to the coin. The revenue side of the Federal budget increases as the price level increases, just like indexed outlays; in fact, the most important revenue source, the individual income tax, grows substantially faster than inflation. Thus, advocates of indexing the outlay programs that benefit primarily low-income persons and the elderly might ask why those groups should suffer if the budget will keep pace despite the indexed outlays.

The second cause of concern is the implication of widespread indexation for future inflation. One extra percent of increase in the CPI adds almost $3 billion to Federal spending, increasing total demand, and thus inflationary pressures (unless counteracted by cuts in other spending programs). If the Federal Reserve steps in to reduce the rate of growth of the money supply, it will neutralize the growth in demand, but it will also directly increase interest rates and thus inflation in the short run. Further, the employers of the 57 percent of organized workers who receive COLA will have immediate increases in their costs. While COLA coverage typically compensates for only about half of the measured inflation, labor costs average over two-thirds of total business costs economywide; so even the limited response of indexed wages to inflation causes a substantial increase in costs, and all else equal causes price increases and future inflation.

Again, this argument would lead us to oppose indexation in principle, but again there are counterarguments. As was noted above, the aggregate demand effect of increased Federal spending on indexed benefit programs would be offset by increased tax revenues caused by the same inflation. Further, while indexed wage increases do add to employer costs and thus future inflation, it is likely that any elimination of indexation from the current economic system, however achieved, would simply shift collective bargaining practices toward other methods of compensation. Likely candidates would be greater use of deferred wage increases that are not conditional on inflation, or even shorter term contracts that would allow more frequent negotiation based on the recent inflation experience. Thus, an unindexed collective bargaining system might yield wage increases that track the rate of inflation less precisely in the very short run, but there is little doubt that wages would follow prices over the long haul.

A third question regarding indexation has been the fairness of a system that indexes some incomes but not others. For example, some would oppose a growing payroll tax on a worker stuck near the minimum wage to finance indexed and tax

exempt benefits to an upper income elderly person. In recent years, that case goes further; it is fair to tax a working population whose real wages are falling in order to index the incomes of a nonworking beneficiary population? Again, the debate can go either way; if benefits are designed to provide some minimum standard of living, then one could argue that their real level must be maintained in the face of all but dire emergency. This point has been debated with increasing vigor of late, and while we all hope it will soon become moot, we should brace ourselves for further argumentation, even in this testimony.

A fourth and final issue in indexation is the maintenance of fairness among the beneficiaries of indexation. This question arises in the private sector; COLA provisions vary according to the degree of protection they provide for any given increase in the CPI, and also in whether they take effect monthly, quarterly, semiannually, or only once a year. However, any debate on the fairness of this diversity of provisions falls rather flat. All workers can presumably bargain for some given amount of purchasing power based on their productivity (though I fear that market power may enter in as well), and they can choose to bargain for COLA's, unconditional deferred increases, or cold cash up front, as they prefer.

This argument takes its real force among beneficiaries of Federal indexed programs. Why should Federal employee pensions be indexed twice a year, while social security benefits are indexed only once (especially when Federal employee pension benefits so far exceed contributions that it is obvious the benefits are paid by the general public, just like social security)? And there is another entirely different angle to this issue of equitable treatment of beneficiaries. We have only one Consumer Price Index, and it is designed to represent the consumption habits of the "average" household. Are we fairly treating classes of households who are not "average" but receive indexed benefits? How about the elderly? The poor? Should these groups have their own special price indices? This is a question with which I will deal at some length.

SPECIAL GROUP PRICE INDICES

There have been numerous pleas in the popular press over recent months for special group price indices of one sort or another. Some groups say that the elderly or the poor are not adequately protected by indexation, because their cost-of-living increases faster than the CPI. Other groups say that the CPI overstates inflation for these groups, and that using a different index would reduce the drain on the budget. To decide whether special price indices for these groups would be a good idea, I will examine three questions in turn: (1) Has any group been hurt because it was indexed by the CPI rather than a special price index of its own? (2) Are any groups likely to be hurt in the future by indexation by a general rather than a special group index? (3) Should we, in principle, want to develop or not to develop special group indices?

Has any group been hurt through indexation by the CPI?—Central to some arguments for special group price indices is the notion that inflation has hit some groups much harder than the CPI indicates. Close examination finds these allegations groundless, to the extent that they can be researched with existing data.

Research in these areas is limited by existing data. The Consumer Price Index (and the Survey of Consumer Expenditures, on which it is based) is designed to measure inflation in the prices of goods and services purchased by an average household. Shifting over to a special group is not just a question of changing the "mix" of products in the market basket. The survey to determine what households buy was designed for a large, middle group of the population; if the objective were the consumption of a smaller special group, a specially targeted survey of almost equal size would be required. The prices now collected for the CPI may well not include items purchased with some frequency by any given special group. Finally, the retail stores sampled for prices paid by the average family may not be the stores frequented by a special group, and that may have an impact on measured inflation. But given all of these limitations, we can examine the existing data for some sign that a significant and continuing differential exists between the average family's inflation rate and that for a special group. These is no such indication in the data.

For example, there is the case of the elderly. Some observers have claimed that the CPI understates the inflation rate faced by the elderly, because the elderly spend more of their income on medical care, a high inflation item, than the rest of the population. While the elderly do spend more on medical care, they also spend less than the average share of their consumption dollar on gasoline and the purchase of homes. A complete adjustment of the CPI market basket to represent the consumption patterns of the elderly, for the period 1969 through 1979, shows an average compound rate of increase of 7.1 percent—compared to 7.4 percent for the

CPI. Further, the rate of change of the index for the elderly is less than the CPI for each year 1975 through 1979 (see table).

RATES OF CHANGE OF SELECTED PRICE INDICES, 1970–79

	CPI [1]	Implicit PCE deflator [2]	Elderly CPI [1]	Necessities [1]	Improved necessities [1]
1970	5.5	4.5	4.6	5.5	3.6
1971	3.4	4.4	3.6	3.7	3.7
1972	3.4	3.5	3.4	4.1	3.8
1973	8.8	5.5	10.0	13.0	11.9
1974	12.2	10.8	12.8	12.9	10.8
1975	7.0	8.1	6.9	7.7	6.3
1976	4.8	5.1	4.6	3.7	3.5
1977	6.8	5.7	5.3	8.2	7.0
1978	9.0	6.8	8.7	10.9	8.7
1979	13.3	8.9	11.2	17.4	12.5
Average	7.4	6.3	7.1	8.6	7.1

[1] December over December.
[2] Fourth quarter over fourth quarter.
Sources: Economic Report of the President, January 1980, and data supplied by the Bureau of Labor Statistics.

Another special group often mentioned as more affected by inflation than the CPI indicates is the poor. The poor, through the widely publicized "necessities price index" (using the food, housing, medical care, and energy components from the CPI), are claimed to face dramatically faster inflation than the average family. The necessities inflation concept has seemed so warm and cuddly that many people have taken it to their hearts. Unfortunately for them, it proves on close examination to be a rock in sheep's clothing. The necessities price index in no way represents the market basket of the poor; in fact, as of December 1980, over 52 percent of the most quoted version of the index represents housing costs, and almost 30 percent is principal and interest on newly purchased homes. These weights are way out of line for any reasonable measure of the consumption habits of low-income groups. Correction for this distortion yields a price index that has inflated slower, not faster, than the CPI over the past 10 years. (The original and the improved necessities indices are shown in the table.)

More detailed work on these questions confirms that significant differences among special group indices would be unlikely. Robert T. Michael found that demographic group inflation rates do vary over short periods of time, but that the signs of the differences often change between periods.[1] Robert P. Hagemann estimated a rental equivalence price index for an average household and another for a retired household over a period from 1972–73 through the second quarter of 1980, and found that the index for the retired increased faster; but the margin can be judged quite small. (Note that the rental equivalence price index for the average household would have behaved quite differently from the actual CPI, so no conclusion can be reached about the fairness of actual indexing experience over the same time period.) The estimated rental equivalence price index increased at 7.54 percent per year over the period; the equivalent index for the retired increased 0.35 percent per year faster. The total cumulative difference would have been 2.46 percent; thus, a monthly social security benefit that would have been $500 under a general rental equivalence price index would have been $12.30 higher after 7½ years of indexing by a price index for the retired.[2] Thus, currently available evidence indicates that indexation by the CPI has not hurt the poor or the elderly, and that the CPI and special group indices look quite alike. Without computing alternative results for all of the myriad possible demographic subgroups, it seems likely that divergences would be few and small.

Would special group indices make any difference in the future?—Even if the historical record shows no meaningful small group effects on the measured rate of inflation, is it possible that in some future measurement period indexing outcomes

[1] Robert T. Michael, "Variation Across Households in the Rate of Inflation," Journal of Money, Credit, and Banking, 11 (February 1979), pp. 32–46.

[2] Robert P. Hagemann, "Inflation and Household Characteristics: An Analysis of Group-Specific Price Indexes," Bureau of Labor Statistics Working Paper #110, December 1980. Hagemann emphasizes that these estimates from his work in progress are subject to all of the data limitations discussed in this testimony.

would be different with special group price indices rather than the CPI? The answer depends on the time horizon.

If only from sampling variation, the measured consumption patterns of small groups will differ from one another. If at any given time some price increases at a rate sharply different from the average, as has happened with some frequency in the recent past, the group specific inflation rates will differ. In the examples used above, a price index for the elderly increased more slowly than the CPI over the 1970's as a whole, but faster in 3 of the 10 years. An improved version of the necessities price index also increases more slowly than the CPI over the decade, but faster in 4 individual years. Thus, random fluctuations can be expected to cause special group price indices to differ over short periods.

Over the long haul, however, it is reasonable to expect the prices indices to stay more or less together. Even when prices of individual items race away from the pack, as did petroleum in the 1970's, there are compensating effects. For example, higher oil prices increased all prices through their effect on wage, transportation, and utility costs. While energy prices remain differentially high relative to 10 years ago, the gap is not as wide as if the rest of the economy had been unaffected.

But given the existing differential between energy and other prices relative to the past decade, shouldn't we have group specific prices indices to protect the most affected? Some people use this argument to protect the elderly in drafty houses. Before we jump at the special index, we should consider the implications. First, do we want to pay all of the additional overhead and accept all of the additional complication to have special group indices on hand, just in case they might make a difference? (More on the cost and complications later.) Second, are we sure the special group indices will give us the results we want? (For example, the elderly spend more of their budgets on household utilities, but less of their budgets on gasoline, than the population at large; so if the purpose of a special index is to help the elderly with their energy costs, the impact would be very small.) Finally, would indexing with a special group index be a better way of achieving our goals than some more direct alternative? (For example, if we want to help the elderly in drafty homes, might we do better by insulating those homes, rather than raising indexing adjustments for all of the elderly?)

Do we want special group indices on principle?—Given the uncertain past and future of special group price indices, is there anything in our first principles to suggest that we should or should not develop them? Here again, all of the answers are in the negative.

First of all, once the door is opened to special group price indices, how far do we go? If we give the poor their own index because food prices are rising, and the elderly their own index because energy costs are rising, will we give the disabled their own index because medical appliance costs are rising? Will regional indexing follow? There is no firm guide once this process starts, so we must be prepared for some interest group battles.

Second, if we do allow a number of indices, are we prepared for political battles based on the results? For example: Suppose that a price index for the elderly increases faster than another for the poor in a particular period. Would we actually raise Federal employee pensions more than SSI benefits to the needy? And what about SSI elderly beneficiaries, who are both elderly and poor? Or if we had geographic price indexing, would we take the political heat if sun belt benefits were to be indexed faster than frost belt benefits, or vice versa? The affected groups will not stop arguing once they get their indices; the results will be political events in themselves.

Third, who is so politically pure as to be able to mandate the details of special group price indices? The process itself will be a political hotbed. For example: California has developed its own low-income price index to save money on welfare benefits (or so the motivation is described by some Californians) by eliminating home purchase costs (among other things) from the CPI. A political judgment was made in the formulation of the index to omit alcoholic beverages entirely; the legislature wanted no part of raising welfare benefits because the price of liquor increased. Once one such political decision is made, where does scientific measurement end and arbitrary judgment take over? Would the legislature have chosen differently if it had understood that the price of booze has increased far slower than prices in general, that their necessities index was increasing faster because of this political decision, and that omitting alcoholic beverages from the welfare market basket was costing the State money? How will the legislature react when the next statutorily mandated adjustment of welfare benefits yields an increase larger than would have been required using the CPI, as it is expected to? Would the process at the Federal level be any different?

Finally, are we willing to accept the added costs of separately sampling any given number of demographic groups to determine their consumption habits, and to separately sample different products for each group, at different points of purchase? Could we live with a social security system with different price indices for the elderly, the disabled, and for nonaged survivors? Could we accept the same complexity in the SSI program?

In sum, a multiple price index system representing several special groups would cause numerous administrative and political problems relative to our current, simpler system. Given the absence of solid evidence that such a system would yield different indexing outcomes over the long haul, we should probably leave special group indices alone.

ALTERNATIVES TO THE CURRENT SYSTEM

If special group price indices would not help our current system, how do we assess our status? Is there an indexing problem? If so, what is it, and how do we solve it? Understanding the task force's mission as finding facts rather than formulating policy, I should disclose that I feel strongly that there is an indexing problem, and that it is a serious flaw in the Consumer Price Index; and that flaw is the treatment of owner-occupied housing. Solving that problem alone would leave our indexation system on the right track.

Measuring the price of owner-occupied housing.—The current treatment of owner-occupied housing in the CPI is essentially the same as it was 28 years ago. When the CPI was revised in 1953, inflation and interest rates were considered much more stable in the long run. Homes increased in price at much the same rate as other goods. The result was that virtually any system of measurement of housing prices would have yielded plausible results.

The measurement system chosen was to count as part of the market basket, (a) the total selling price of newly purchased homes (except if the buyer sold another home at the same time, in which case the difference is counted); and (b) the total interest cost over the expected duration of the mortgage before repayment (approximately one-half its stated term). In 1953, this method was quite reasonable. Today, putting an entire home and 15 years' worth of mortgage interest in an annual market basket along with 1 year's purchases of bread, navy beans, and athletic socks is patently absurd. The resultant weight on home purchase costs is far greater than either cash outlays on home purchase in the average family budget, or housing costs on the national income accounts basis as a share of total consumption.

Equally important as how we weight home purchase, in my view, is what we count as the price. Homeownership has increasingly become an investment rather than a mere purchase of housing services. This is obvious from the willingness of investors to purchase homes to let, accepting monthly rental payments that fall far short of their own mortgage liabilities. If investors are willing to accept negative cash flows on homes, the cost of the shelter services of a purchased home must be only part of the total; the investment value to the investor must be at least equal to the negative cash flow. To an owner-occupier with the privilege of rolling over capital gains, the investment value would be even greater. The obvious solution to the measurement problem, espoused by many policy analysts, is to count the price of purchasing *only* the shelter services of a home, the *rental* price, in the CPI. This is the method (called "rental equivalence") used in the BLS's X1 version of the CPI, and in the personal consumption expenditures (PCE) deflator of the national income accounts.

The treatment of housing and the budgetary cost of indexation.—How much of the burden of indexed costs is the result of the CPI's flawed treatment of housing? There are two available pieces of evidence on this question. The major difference between the CPI and the PCE deflator is the treatment of owner-occupied housing. Over the 1970–79 decade, the PCE deflator increased at a compound average rate of 6.3 percent—substantially less than the CPI at 7.1 percent.

Bringing this difference closer to home, social security benefits were first indexed in July 1975, on the basis of the CPI for April through June 1974. The CPI has increased by 62.6 percent from that period through the first quarter of 1980, the most recent time the CPI was indexed; the PCE deflator increased only 48.9 percent over the same period. Thus, for those beneficiaries who were on the rolls in 1975, benefits are more than 13 percent higher than they should be because of the flaw in the CPI. (Total benefits have been increased by less than that margin, however, because beneficiaries who retired in the intervening years were not indexed over the entire period.) Or to carry the point still further, the cost increase of social security indexing in mid-1980 would have been about $5.5 billion lower if the PCE deflator had been used instead of the CPI. This saving is about half of the expected revenue increase of the January 1, 1981, payroll tax increase.

It is not clear that redefining the CPI now would reduce benefits over future years by the same margin. Because the overstatement of the CPI is highly related to the level of mortgage interest rates, and interest rates have been highly unstable, the future path of the index is uncertain. When mortgage rates fall, they have a tremendous downward leverage on the CPI. However, the step is still worth taking; the greater stability of the index with a rental equivalence treatment of housing would itself be desirable, and no one can say for sure that interest rates will not take another jump.

The effect of correcting the CPI on future inflation.—A corrected CPI would help in the fight on inflation in two ways. First, if it prevented future unjustified surges in indexed benefits, it would limit Federal outlays. Second, if it were the only index published, it would stop the addition of unjustified indexing costs to businesses in the private sector. This would require taking on organized labor.

Correcting the CPI and fairness.—It may seem strange to some to think of lower social security benefits as a "good thing." What about all of that inflation the beneficiaries have had to absorb? This reasoning is circular. Most people think that inflation has been rapid because the CPI said it was, but the CPI was wrong! By any measure, we have an inflation problem; but the CPI has exaggerated that problem, and benefit increases based on that index rather than the slightly lower PCE deflator (or an equivalent) are not justified. If we want higher incomes for social security and other program beneficiaries, using an inaccurate indexation system is a silly way to do it. It was that kind of ad hoc planning that caused the decoupling crisis of the mid-1970's.

Another provocative fairness issue is the indexation of benefits to a price index in a period of falling real wages. Here again, correcting the CPI is the solution, at least in the historical sense. While real average gross weekly earnings fell by 0.4 percent per year over the 1970's (though this drop is probably exaggereated by other measurement problems), they did so only when deflated by the CPI. If the PCE deflator were used instead, they would have increased by 0.4 percent per year. Obviously, these are historical artifacts and not a blueprint of the future, but one must accept the CPI to believe that real wages fell in the 1970's.

To summarize briefly, fixing the CPI would prevent the recurrence of the drain of unjustified indexing costs from the budget. Further, a better measure of inflation would give us a correct perspective on the relative rates of growth of wages and prices. These are important elements of the problems of indexation discussed at the beginning of this testimony.

Other indexing provisions.—Some analysts have suggested that the indexation of benefits be limited to 85 percent of the rate of increase of the CPI to cut budgetary costs. This is a very rough-and-ready approach. If we are willing to run the political risks involved in such an ad hoc benefit reduction, we should instead make the system work for the long run.

In another setting, some might think that correcting the CPI's measurement of housing costs and setting an 85-percent indexing limit would somehow "turn back the clock" as though we had corrected the index earlier; we could then remove the 85-percent cap when we reached a correspondence to some desired past level of a corrected CPI. Unfortunately, the system is more complicated than that. Recent retirees would be penalized by limited indexation for past overindexation that occurred before they retired. Differentiating indexation rates for recent versus previous retirees to avoid this problem would be excessively complicated. Further, such a "rollback" might be considered inequitable by some; long-time retirees, with the lowest wage bases (and thus the lowest benefits) would have their indexation capped, while very recent retirees with higher bases (and higher benefits) would not. It would be best to correct the CPI and let bygones by bygones on past overindexation.

Another detail of the system would be a provision explicitly limiting the rate of indexation to the lesser of the rate of growth of prices and the rate of growth of wages. As was noted above, real wages have not fallen over any appreciable length of time unless the CPI is accepted as the measure of the rate of inflation; but, this does not guarantee that real wages might not fall under a corrected CPI. A real wage cap on indexation, with a catchup provision to bring benefits back in line when next real wages do grow, deserves careful consideration.

Finally, on another equity issue, the Congress should examine critically the twice annual indexing of Federal Government pensions.

Appendix

A Consumer Price Index for the Elderly

This is a technical description of the computation of the tentative consumer price index for the elderly used in the testimony to the Task Force on Entitlements, Uncontrollables, and Indexing of the House Budget Committee. The testimony compared the rates of inflation as measured by the standard Consumer Price Index with a specially constructed price index for the elderly. This special index is described below.

THE ELDERLY CPI

The special index is a consumer price index modified better to represent the spending patterns of the elderly. The description that follows will cover first the price series used, then the relative weights assigned to them and finally some technical questions.

Price series.—All of the price series used in the elderly CPI are standard components of the regular CPI. The index was disaggregated to the following items: Food at home, food away from home, alcoholic beverages, homeownership, residential rent, household operation, fuel and utilities, apparel and upkeep, transportation, medical care, entertainment, personal care, and other.

In the December 1977 revisions, the Bureau of Labor Statistics made slight changes in the entertainment, personal care and other components which had to be reflected in the methodology. Another complication was that the alcoholic beverage component and the food away component were usually published as a residual to the total food and beverage index, and had to be inferred from other data.

While the use of the CPI price data was unavoidable, it is subject to some reservations. The items sampled to provide the price index are chosen according to general consumption patterns, and may not closely correspond to those of the elderly. Also, even if the items chosen were representative of the elderly's consumption, the retail outlets sampled may not be those frequented by the elderly. One would think that these influences would have only a very subtle impact, but it is impossible to be sure.

Weighting.—All of the weights for the computation of the index, except for the homeownership weight, were derived from the published data of the 1973 Survey of Consumer Expenditures. The share of each expenditure item in total money consumption for the elderly was compared with that for the total population, and the CPI weights were adjusted accordingly. For example, if the elderly spent only half as much of their total budget for eating out, the relative importance of the food away from home component was reduced by half.

The major parts of the homeownership index (purchase and financing) are not weighted by actual cash costs in the CPI, but rather by net outlays on home purchases. In order to approximate such a system for the elderly, data were used to compare the frequency of home purchases by the elderly and the general population. The 1973 Census Bureau Annual Survey of Housing was used to insure time comparability with the 1973 SCE. The CPI homeownership relative importance was then reduced in proportion to the lower frequency of home purchases by the elderly.

These procedures have certain limitations. The actual CPI population is not identified in the SCE tabulations, and so the comparison of the elderly's consumption with the entire population is not precise for this application. The consumption patterns of the elderly are probably quite complex in many respects, particularly involving medical insurance and out-of-pocket expenses; one might wonder whether the survey adequately covered these matters with a questionnaire designed for the general population. Finally, the homeownership weights are based on the financial characteristics of home transactions (price of purchased home and price of sold home, if any) and not merely their frequency, though data for such computations for the elderly do not exist. Also, the weights for property taxes and insurance are set by cash costs rather than home purchases, though those indices are not published separately and thus could not be used in the elderly index in any event.

Computation.—The alterations of the standard CPI weights described above were performed on the December 1977 CPI relative importance figures for the unrevised CPI–W (for 1977 and earlier) and for the CPI–U (for 1978 and 1979). All computations were done on a December over December basis. The December 1977 relative importance figures were converted back to a 1967 equals 100 basis and then used as true weights.

Senator Heinz. Mr. Storey.

STATEMENT OF JAMES R. STOREY, WASHINGTON, D.C., DIRECTOR, INCOME SECURITY AND PENSION POLICY CENTER, THE URBAN INSTITUTE

Mr. STOREY. Mr. Chairman, I would also like to request that my statement appear in the record, since I will be skipping over some parts of it.

Senator HEINZ. Without objection.[1]

Mr. STOREY. First of all, I would like to say my views are only my own and do not reflect those of my employer or those of our sponsors.

I would like to start by reviewing some of the facts we have developed at the Urban Institute in a study funded by a grant from the Administration on Aging.

We have been studying the impacts of inflation on the elderly in the 1970's and, in particular, we focused on a set of longitudinal data from 1972 to 1974 on how income and expenditures actually changed over time for people entering their retirment years.

We found that about 60 percent of income was fully protected against inflation for the married couples in the sample group and about 70 percent of income was fully protected for single individuals. This gap in protection mainly results from the inability of employer pension benefits to keep up with inflation.

In fact, our study shows that the real value of employer pension benefits fell by 14 percent on average from 1972 to 1974. I might comment that from a separate data source produced by the Bureau of Labor Statistics on the characteristics of these plans, we have identified only one out of over a thousand plans that provides an automatic adjustment for the full CPI increase each year.

Based on these findings for 1972 to 1974, we projected that the experience for 1974–80 probably resulted in declines in real income of the aged of 7 to 8 percent for older married couples and 3 to 4 percent for single individuals.

With respect to spending patterns of the people in the study, little change in expenditures was seen for food, fuel, or housing due to changes in the relative prices of these goods as long as total spending kept pace with the average inflation rate.

However, when we took into account the fact that real income was declining, over a period of years we did find that older people changed their budget shares for different items.

To give an example, in 1973, retired couples who owned their own homes were spending about 11 percent of their budgets on fuel and utilities. By 1980, because of the fact that fuel prices outstripped general inflation and because they also outstripped the gains in income for this group, these households were spending about 14 percent of their budget on fuel and utilities, up 3 percentage points.

However, given higher prices in 1980, this increased spending actually represented a 16-percent reduction in the quantities of fuel consumed.

In summary, despite the indexing of social security, the elderly were affected adversely by inflation during the 1970's with effects

[1] See page 282.

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strong enough to actually change their expenditure patterns on basic commodities.

I would like to comment on the general problem that you have in developing a price index and then comment specifically on two things—the idea of having a special index for the elderly, and some of the proposals that have been discussed for limiting the annual cost-of-living increase.

With respect to price indexing generally, a price index permits a measurement over time of a composite price for a fixed set of goods and services that a typical household might consume. While such a data series is useful to show the implications of price changes for that market basket over time, it has an inherent conceptual flaw when used to measure the level of well-being for a particular group of people.

The flaw stems from the fact that as relative prices among goods change or as the quality of those goods changes, or as the real income of the individuals rises or falls, people alter the mix of goods that they purchase, and the makeup of the standard market basket would change. Thus, a measure such as the CPI declines in accuracy as a measurement of that composite price of the fixed market basket over time.

I found a recent quote from a Congressional Research Service report to the Senate Budget Committee on indexing Federal benefits that I want to call to your attention: "There is no unique, indisputable yardstick" for indexing Federal benefits.

The BLS does periodically take a snapshot for a new consumer market basket as new consumer expenditure data become available. However, this revision does not serve in any way to correct errors that may have already occurred in the adjustment of Federal benefits for inflation, since the Government would obviously never go back and retroactively recompute benefits for a past period to reflect how the CPI basis had changed.

Turning to the issue of the idea of a special CPI for the aged, in preparing for this testimony I looked at three recent studies—one done by Mr. Minarik, one by Ben Bridges and Michael Packard of the Social Security Administration, and one by Robert Hagemann at the Bureau of Labor Statistics. I was struck by one similarity in all of these studies and that is, although obviously there are differences in the prices faced by the aged versus consumers generally, when you look at how these prices change over a reasonable period of time and the differences for the aged versus the general population, the differences are not that great. In fact, of the three studies that I cited, looking at the indexes over a period of 8 to 12 years, as all of these studies did, the annual price differential for the aged versus consumers generally did not differ by more than three-tenths of 1 percentage point per year, which is, of course, a very modest difference in the measure of inflation.

To translate that into actual dollars, a three-tenths of 1 percentage point increase in inflation, if applied to the average social security benefit today, would raise the benefit by $1.02 per month. Applied to the total fiscal 1982 budget for social security, it would raise the social security benefit cost by $480 million, which is a lot of dollars, but in the context of a $150-billion program, it is a fairly modest change in the budget.

In considering this idea of whether there should be a special index for the elderly, I conclude that there should not be, for several reasons, the primary one being that you produce a very modest difference in the ultimate outcome of indexing of programs at the cost of a sizable Federal outlay for new data collection and analysis. However, there are several other reasons why I come to this conclusion.

One is that it would be applied to a system which includes many people who are not over age 65. Another reason is that one might anticipate a proliferation of special CPI's for different groups who could also claim that the prices of goods they face are different from the general population. Another reason is that the CPI, as stated earlier, is not a true measure of inflation. It is an imprecise measure, and to try to refine this further for specific groups would be an imprecise refinement of what is a fairly crude measure to begin with.

And finally, if one assumes that Congress will act to adopt retirement policies that will encourage people at today's retirement ages to work longer, particularly if something like the elimination of the social security earnings test comes to pass, one would assume that people on social security are going to work more, at least part time, and their spending patterns will begin to look more like those of middle-aged workers than is true of today's beneficiary population.

Turning now to the question of whether Congress should act to restrict the automatic cost-of-living increase, first of all let me state that I think the full protection for the aged against inflationary erosion in the value of social security benefits should be retained as a top priority if at all possible. Given the fact that those who retire are living longer and longer with income from pensions and savings that do not keep up with inflation generally, and with the uncertainty of facing future health care costs that may be financially catastrophic, a floor of income protection provided by social security that retains its purchasing power over time is even more crucial today than when adopted by Congress in 1972.

As you all know, there has been a proposal this year that has received a lot of consideration and that is to limit the cost-of-living adjustment to the average increase in wages in any year when prices increase faster than wages.

I understand full well the popular appeal this has because it means the increase the social security beneficiaries would receive would never exceed that of the average taxpayer supporting the system.

However, there are some disadvantages to this approach that I would like to point out.

Even though such a restriction on the cost-of-living increase would have been in effect for 4 out of the last 8 years since the automatic increases began, if you look back over longer periods, it would only have affected the system in 5 of the last 20 years, and 6 of the last 30 years. Thus, it is a limitation that would have peculiar effects on particular age groups of social security beneficiaries, depending on when they happen to retire.

Another disadvantage is that one can make an argument that it is a one-sided policy for Government to automatically penalize the

real incomes of beneficiaries during periods of economic decline but refuse to automatically share with the aged the rewards of economic growth when there is an increase in the economy.

And finally such a measure would not serve budget planners well over the long term, since it is awfully difficult to predict the precise relationship between wages and prices over any significant period of time.

Let me conclude by saying that if Congress should find it absolutely necessary to limit COLA's for social security, I think a flat percentage reduction in the full CPI would be a good way to go because, as Mr. Minarik indicated, the CPI is an imprecise measure anyway, you can make a good case that it does overcompensate for inflation, and it could certainly be a rational public policy to adopt a position in times of high inflation that everyone, even the aged, should bear at least some modest cost in efforts by Government to hold down spending and helping to turn inflation around.

Thank you.

Senator HEINZ. Thank you, Mr. Storey.

[The prepared statement of Mr. Storey follows:]

PREPARED STATEMENT OF JAMES R. STOREY

Mr. Chairman and committee members, thank you for inviting my testimony today on the issues currently being raised about indexing social security benefits. My views on this topic are solely my own and should not be attributed to the Urban Institute, its staff, or the organizations that fund the institute's research program.

I want to begin by reviewing why Congress chose to adjust social security benefits automatically to changes in the Consumer Price Index. Prior to 1972, it had been customary for Congress to adjust benefits on an ad hoc basis about every 2 years. In fact, during the 1960's and early 1970's these ad hoc increases often exceeded the rate of inflation. As a result of this process, automatic adjustments came to be embraced by policymakers for two quite different reasons. For some, it seemed to offer a mechanism that would limit the growth in future social security costs. For others, automatic adjustments provided greater security and predictability to older workers and to beneficiaries in estimating their future retirement incomes. Because the CPI, then as now, was the most widely accepted measure of price changes, this data series was adopted as the index to be used for benefit adjustments.

Before I speak to the issues now being raised about the CPI adjustment, I would like to provide background on how inflation has affected the elderly since 1972. We have recently completed a study at the Urban Institute on the impact of inflation on the aged that was funded by a grant from the Administration on Aging. The period studied was 1972-74, a time for which we have longitudinal survey data from the Social Security Administration showing the actual income and expenditure changes over time. The study report written by Sheila Zedlewski and Robert Barnes indicates that only 60 percent of income is fully protected against inflation for older married couples and only 70 percent for single individuals. This gap in protection mainly results from the inability of employer pension benefits to keep up with inflation. In fact, our study shows that the real value of employer pension benefits fell by 14 percent on average from 1972 to 1974. From a separate data source on the characteristics of these plans, we have identified only one out of over a thousand plans that provides an automatic adjustment for the full CPI increase each year. Based on these findings for 1972-74, we projected that the experience for 1974-80 probably resulted in declines in real income of 7 to 8 percent for older married couples and 3 to 4 percent for single individuals.

With respect to spending patterns, little change in expenditures was seen for food, fuel, or housing due to changes in the relative prices of these goods as long as total spending kept pace with the average inflation rate. However, as soon as real spending levels dropped, elderly households spent a greater share of their budgets on necessities like food and utilities. Furthermore, the combination of declining real income and rapid escalation of fuel prices meant that the units of fuel consumption dropped, even though the elderly households devoted a larger share of the budget of this item. For example, we estimate that retired couples who own their homes spent about 11 percent of their budgets on fuel and utilities in 1973. By 1980, the price of fuel and utilities rose by 122 percent compared to an average increase in prices of

86 percent. At the same time, income typical to this type of household rose by only about 46 percent. In 1980, we estimate these households spent 14 percent of their budget on fuels and utilities. However, given the higher prices, this represents a 16-percent reduction in the units of fuels consumed.

In summary, despite the indexing of social security and SSI benefits, the elderly have been affected adversely by inflation, and the effects were strong enough to change expenditure patterns.

Before I delve into the specific policy issues concerning inflation adjustments, I want to mention a general problem with any price index. A price index permits a measurement over time of the composite price of a fixed set of goods and services that a typical household might consume. While such a data series may be useful to show the implications of price changes for consumers who continue to buy the standard market basket over time, a price index has an inherent conceptual flaw when used as a measure of the level of well-being for a particular group of people. The flaw stems from the fact that, as relative prices among different goods shift, people alter the mix of goods purchased, and the makeup of the standard market basket changes. Also, as the real purchasing power of household income rises or falls, families alter their consumption behavior. Thus, over a period of several years, the CPI declines in accuracy as a measurement of a composite price faced by the typical consumer.

The Bureau of Labor Statistics periodically takes a new snapshot of the typical market basket for the CPI as new consumer expenditure data are available. However, this revision does not serve the Government as a corrective to any past deviations in indexed benefits from the true measure of the inflation experienced by program beneficiaries. It is not self-correcting because the Federal Government does not go back and revise benefits retroactively to reflect the new CPI market basket, nor, I am sure, would such adjustments even be seriously suggested.

Turning to the issues being raised about the use of the CPI for benefit indexing, I will first discuss whether a special CPI for the aged should be used that reflects the spending patterns of people over age 65. I will then discuss the issues of whether and how Congress should limit CPI increases to less than the full adjustment.

With respect to the special CPI for the aged, I want to comment on the findings of three recent studies. I refer to Joseph Minarik's work for the National Commission on Social Security, a Social Security Bulletin article by Ben Bridges and Michael Packard of the Social Security Administration, and a BLS working paper by Robert Hagemann.

All three studies used statistical techniques to estimate changes in prices for a market basket typical of aged household expenditure patterns and compared the inflation measured by these indices against the CPI over several years. I was struck by the similiarity of their findings. While they all found differences in the inflation rates faced by the aged versus the general population, as one would expect, the differences were quite small when viewed over a number of years.

Minarik's study spanned the decade 1969-79. He found the average annual price increase for the aged to be 0.3 percentage points less than the CPI increase. Bridges and Packard found a higher inflation rate for the aged during the 1967-79 period, but the increase over the CPI averaged less than 0.1 percentage point a year. Hagemann's study, which covered 1972-80, compared an aged index with the CPI based on three different measures for the housing price component. His indices also rose faster for the aged but by no more than 0.3 percentage points a year.

Of course, in any one year the rate of inflation can vary significantly among different groups. For instance, Minarik's aged index rose 10 percent in 1973 compared to 8.8 percent for the CPI. But public policies must be applied for the long run, and these studies found the prices faced by the aged did not differ greatly from the general price index when 8 to 12 years of data are analyzed.

To place these longer run differentials in perspective, a 1-percent increase in social security benefits currently raises the average monthly retired worker's benefit by $3.43. Thus, a 0.1 to 0.3 percent additional increase would add from $0.34 to $1.02 to that monthly payment. In terms of total program cost, a further increase of 0.1 to 0.3 percent would add from $160 to $480 million in fiscal year 1982. Thus, the special CPI would have only minor effects either on benefit amounts or on budget outlays.

In considering this indexing issue and the studies that have been done, I conclude that the development of a special CPI for the aged for use in benefit indexing would be inappropriate for several reasons. First, it would produce very little difference in the outcome of benefit adjustments while costing the Government a sizable outlay for new data collection and analysis. Second, it would be applied to benefits for a system that aids many people who are not aged and presumably have somewhat different spending patterns. Currently, about a third of social security beneficiaries

are under age 65. Third, an aged index might lead to a proliferation of special CPI's as other groups brought arguments to Congress that their unique situations also require redress. Fourth, since the CPI cannot truly measure the cost of living over several years anyway due to the consumer responses to income and price changes, special indices would amount to fairly imprecise refinements of what is already a crude measure by which to adjust benefits. Finally, if retirement policies are soon revised to encourage older people to work longer, such as by eliminating the social security earnings test, then the makeup of the "retired" population will include more and more people who work at least part time and are likely to have spending patterns closer to those of middle-aged workers than is true of today's beneficiaries.

Turning now to the question of whether Congress should restrict cost-of-living increases to something less than the full CPI increase to meet trust fund limits or Federal budget constraints, I feel that full protection for the aged against declines in the value of social security benefits should be retained as a top priority. Given the fact that those who retire are living longer and longer, with income from pensions and savings that cannot keep up with inflation, and with the uncertainty of facing future health care costs that may be financially catastrophic, a floor of income protection provided by social security that retains its purchasing power over time is even more crucial today then when adopted by Congress in 1972.

One proposal to limit increases that has received a great deal of attention this year is to limit the benefit adjustment so that it does not exceed the average increase in wages in any year in which prices rise faster than wages. This approach has the popular appeal of keeping the rise in social security income from exceeding the wage increases of the taxpayers who finance the system. Had such a limitation been in place since indexing was enacted in 1972, it would have restricted the cost-of-living benefit adjustment in 4 of those 8 years. However, looking back to see what would have occurred over longer time periods, such a restriction would have been applicable in only 5 of the last 20 years and 6 of the last 30 years. Thus, it is a limitation that would peculiarly affect the retirement incomes of those who happened to be on the beneficiary rolls during periods of real wage declines and thus treat different age groups of retirees quite differently. Another disadvantage is that such a limitation can be viewed as one-sided public policy in that Government would automatically penalize retirees for economic declines but not automatically share the rewards of growth through real increases in benefits during good times. Also, this measure would not serve budget planners well since the relationship between wage growth and price increases is difficult to forecast.

Should Congress find it absolutely necessary to limit social security benefit increases to meet short-term budgetary constraints, an approach that is more equitable among different cohorts of retirees and more predictable in its impact should be sought. Setting the adjustments equal to a percentage of the full CPI increase—for example, 90 percent of the annual CPI rise—would be one such approach. During times of rapid inflation, Congress may determine that the best economic policy requires that all but the neediest of Americans bear a part of the cost of inflation in any national effort to bring inflation under control. The low-income elderly could retain full inflation protection under such a limitation if full CPI increases were still provided for the SSI and food stamp programs.

I want to emphasize in closing that cost reductions in social security are best sought through longer run measures. These would include changing the system to encourage later retirement, phasing out benefit provisions that are not essential to the adequacy of retirement income in old age, and taking steps through tax and pension legislation to stimulate more saving for retirement and less dependence on social security.

Senator HEINZ. Mr. Hacking.

STATEMENT OF JAMES M. HACKING, WASHINGTON, D.C., ASSISTANT LEGISLATIVE COUNSEL, NATIONAL RETIRED TEACHERS ASSOCIATION/AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. HACKING. I am representing both the National Retired Teachers Association and the American Association of Retired Persons. The associations have a collective membership of 13 million persons aged 55 and older.

With your permission, I would like to introduce the associations' statement for the record and proceed on the basis of an edited summary of that statement.

Senator HEINZ. Without objection, so ordered.[1]

Mr. HACKING. The debate over automatic indexing of social security benefits has been spurred, as far as we can see, by social security's short-term financing difficulties, by allegations that the CPI overcompensates the elderly for the effects of inflation and by allegations that it is somehow unfair that benefits should increase from time to time at rates in excess of the rate of increase in wages of those who support the system through their payroll tax payments.

I am here before this committee to point out that for millions of older persons, social security cost-of-living increases are the only thing that stands between them and poverty. This is largely the only inflation protection they have. A decade of high inflation has eroded the value of their non-social-security sources of income, such as private pensions, savings, and other dollar-denominated assets, which represent about one-third of their total income, and which are not indexed for inflation.

As reductions in social security's cost-of-living protection are proposed, Congress must consider the potential consequences of such actions. Those consequences for the elderly are—a resurgence of poverty among them, and an acceleration in the rapid erosion that is already occurring in their real income situation.

Consider briefly the startling facts and statistics that have brought us to defend full cost-of-living increases for retirees. We ask you to keep in mind that in 1979, despite full social security cost-of-living increases, the elderly poverty rate rose dramatically—from 13.9 to 15.1 percent, the largest increase ever recorded since the Census Bureau began collecting poverty data. At the same time, however, the poverty rate for the nonelderly remained unchanged at 11.1 percent.

Although over the past two decades much progress was made in reducing poverty and improving the income status of the aged, these recent statistics and forecasts indicate that the elderly are most vulnerable to inflation, that they are sustaining disproportionately larger losses as a result of it, and that a reversal of the progress made in the past has already begun.

With regard to social security's indexing mechanism, the associations maintain that it is flawed in two ways: First, benefit increases are provided long after inflation has had its effect on the purchasing power of benefits; and, second, the standard used in making adjustments, the CPI itself, does not always accurately reflect the true impact that inflation has on elderly budgets.

With respect to the first point, regarding the lengthy lagtime in making benefit adjustments, a January 1981 OMB study indicated that since 1975, when automatic indexing of social security and SSI payments began, beneficiaries of these programs have experienced a 3.4-percent decline in real benefit levels due to the lengthy lagtime in adjusting benefits. As should be apparent, proposals to delay payment of cost-of-living increases another 3 months, from July to October, would exacerbate this loss in benefit purchasing

[1] See page 287.

power over time and make the current indexing mechanism far more inadequate and flawed than it already is.

As for the second point, many economists have argued that the construction of the current CPI tends to overstate inflation for the elderly because of its faulty treatment of housing costs. Detailed studies of this issue do not confirm this contention.

An exhaustive study conducted for the associations by an independent economist, Dr. Thomas Borzilleri, investigated the accuracy of the CPI and found no consistent pattern of overcompensation or undercompensation for inflation to date. I would like to introduce a copy of this study for the record of this hearing.[1]

Based on data collected from the 1972-73 Consumer Expenditure Survey, Dr. Borzilleri constructed a special CPI or social security market basket that reflected the elderly's particular expenditure patterns. In constructing the special social security market basket, he utilized the most conservative possible definition of homeownership costs—a house payment that was fixed throughout the entire 8-year period of analysis.

Given this definition of homeowner shelter costs, the major findings of the study were as follows: First, differences between the rate of inflation produced by the general CPI and the rate of inflation produced by the social security market basket were found to be extremely small. No major overcompensation or undercompensation has occurred.

Second, expenditure patterns for the retired are radically different from those reflected by the CPI. It should be obvious from the table in our statement that food, fuel and utilities, and medical care play a much more important role in the market basket of the retired. This greater importance, coupled with the higher inflation rates in these three categories in the 1970's, offset the major differences in shelter costs between the two inflation measures.

The major differences in expenditure patterns have obvious implications for future benefit increases and for the method of indexing utilized by the social security program. To the extent that increases in the CPI are driven by increases in the price of homes or in mortgage interest costs, social security recipients will be overcompensated. To the extent that increases are driven by rises in the price of food, fuel, and medical care, the aged will be undercompensated.

Given the importance of cost-of-living protection for retirees, the high cost involved in providing such protection and the major differences in the elderly's expenditure patterns, the necessity for developing and utilizing a separate and accurate CPI to adjust social security benefits is obvious. Until this is done, there will be no assurance that major over- or under-compensations will not occur in the future.

The associations continue to resist proposals that would alter the construction of the CPI strictly for the purpose of curbing the rate of increase it registers. Some analysts have endorsed the use of the CPI-X-1, recently developed by BLS, because it would supposedly correct the CPI's flawed treatment of homeownership costs. The Borzilleri study clearly indicates that there are several flaws that need to be corrected as far as the elderly are concerned.

[1] See appendix 2, item 2, page 335.

Another prominent proposal to alter indexing would cap cost-of-living increases at either the average rise in wages or the average rise in prices, whichever is lower. This "wage cap" as well as any other capping proposal, such as 70 or 80 percent of the full CPI, would result in a severe downward ratcheting of real benefit levels, particularly if imposed over a period of years.

Some proponents of the wage cap proposal argue that it is inequitable to allow the incomes of retirees to rise more rapidly than the income or wages of workers who must support Government programs through taxes.

First, it must be pointed out that wages represent the overwhelming bulk of workers' incomes. Therefore, any wage increase received tends to protect most of a worker's income. In contrast, social security does not represent the elderly's total income. In fact, social security cost-of-living adjustments maintain the real value of less than half of the elderly's income.

Second, it must be pointed out that wage increases have historically exceeded price increases and this trend is expected to resume within 2 years. Unless Congress is willing to adjust benefits according to the rise in wages on a permanent basis, even when wages begin to outpace increases in prices, then wage indexing cannot be sold on the grounds of equity. Beneficiaries will feel—and rightly so—that they will always get the "short end of the stick."

Moreover, unlike retirees who are not in the work force, workers have reasonable expectations over their future working lives of making up any real income loss they are currently suffering as a result of high inflation. Retirees, because they are not wage earners and have many fixed components to their income, have no expectations for recouping the inflation losses they have already incurred and will continue to incur as long as inflation is with us.

The elderly's real income situation and their standards of living are declining. Poverty rates among them are rapidly escalating. All this deterioration is occurring despite the provision of relatively full cost-of-living increases by the major income support programs.

If these increases are curtailed in any manner, especially by a relatively permanent change in the indexing through use of a wage or overall cap or CPI-X-1, then the Nation's elderly could easily be reduced to the economic level that prevailed a decade ago, when one out of every four of them were below the poverty level.

Thank you, Mr. Chairman. That concludes my remarks.

Senator HEINZ. Mr. Hacking, thank you very much.

[The statement of the National Retired Teachers Association/American Association of Retired Persons follows:]

STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION/AMERICAN ASSOCIATION OF RETIRED PERSONS

SOCIAL SECURITY INDEXING: BULWARK AGAINST POVERTY

Automatic indexing of social security benefits has recently become the focus of heated legislative debate. Social security's cost-of-living adjustment mechanism has been labeled inaccurate by some analysts, overly generous by some politicians, fuel for inflation by various economists, and the main cause of social security's short-term financing ills by many actuaries.

We are here before this committee to point out that for millions of older persons, social security cost-of-living increases are the only income that stands between them and poverty. The elderly have become critically dependent on social security's indexing mechanism because it is the only inflation protection they have. A decade

of high inflation has eroded the value of their non-social-security sources of income, such as private pensions, savings, and other dollar-denominated assets, which represent about one-third of their total income and which are not indexed for inflation.

As reductions in social security's cost-of-living protection are proposed, Congress must consider the potential consequences of their action. Those consequences for the elderly are—a resurgence of poverty among them and an acceleration in the rapid erosion that is already occurring in their real income situation. As inflation continues to push the elderly down on the income distribution scale by dissipating the value of their fixed income components, indexing of the major income maintenance programs is the only mechanism in place that will at least be able to sustain—although to a decreasing degree—most of them about the poverty line.

Consider briefly the startling facts and statistics that have brought us to defend full cost-of-living increases for retirees:

In 1979, despite full social security cost-of-living increases, the elderly poverty rate rose dramatically—from 13.9 to 15.1 percent (the first large increase since the Census Bureau began collecting such statistics), while the poverty rate for the nonelderly remained unchanged at 11.1 percent.

So many of the elderly are concentrated just above the poverty threshold that, in 1979, a drop in their income of less than $15 to $20 a week would have caused the elderly poverty rate to escalate from 15 to over 25 percent.

The elderly are unquestionably a vulnerable low-income group especially compared to the nonelderly—in 1979, 31 percent of them had incomes below $5,000, and 21 percent below $10,000.

According to a forecast by Data Resources, Inc. (DRI), the average income of persons age 65+ relative to those under 65 will begin to decline sharply in 1981—even if current Government programs remain in place with no legislated cutbacks.

PAST INCOME GAINS ARE BEING ERODED

Rapid growth and expansion of Government-income-support programs during the late 1960's and early 1970's caused the elderly's average income to rise over the past decade in real terms and in relative terms (relative to the income of the younger population). This trend was confirmed by a 1980 study entitled "Inflation and the Elderly," which was prepared for NRTA-AARP by Data Resources, Inc. (DRI). A copy of this study is made available for the committee's hearing record.

According to the DRI study, average elderly income (in aggregate terms) managed to keep pace with, and slightly exceed, the inflation rate from the late 1960's into the late 1970's. Taking into account the higher incomes of elderly persons newly retiring during this period, as well as elderly persons already retired, elderly incomes rose at an average annual rate of 7.7 percent versus an annual CPI rate of 6.1 percent over the period 1967 through 1976. As a result, the average incomes of those over age 65 increased from about 48 percent of the average incomes of the nonelderly in 1965, to about 55 percent by the end of the 1970's—just about where the elderly's average incomes had been in the mid-1950's.

A recent study, authored by Bridges & Packard of the Social Security Administration (published in the January 1981 Social Security Bulletin), refines this analysis by examining what has happened to the average incomes of one cohort or class of families headed by elderly persons over the 1970–77 period. It was found that despite the large social security benefit increases that were provided in the early 1970's, average real incomes of this cohort of families fell by 4 percent. This occurred for two reasons: First, the earnings component of their income dropped significantly as their advancing age decreased their labor force participation; and second, their private sources of income (namely private pensions, savings, and assets) declined in value since these private sources have little or no inflation protection.

POVERTY DECLINE IS BEING REVERSED

The incidence of poverty among the aged steadily declined from the late 1960's, when one-quarter of them lived in poverty, through to the mid-1970's when the rate stabilized around 14 percent. Despite this substantial progress in reducing poverty, there is mounting evidence that inflation has begun (and will continue) to wipe away that progress. As mentioned earlier, aged poverty rates increased substantially from 13.9 percent in 1978, to 15.1 percent in 1979, representing the largest increase since the Census Bureau began collecting statistics. This increase occurred despite the provision of full cost-of-living increases under social security. Again we believe the fixed nature of over one-third of the elderly's total income contributed to this poverty increase.

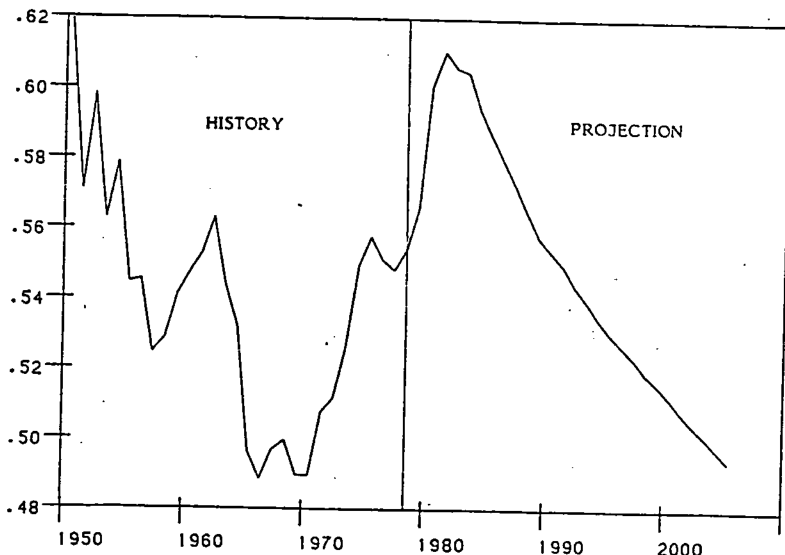
The 1979 poverty data also revealed the degree to which the elderly, relative to other population groups, are vulnerable to the effects of inflation. While the aged's poverty rate escalated, the rate for persons under age 65 remained virtually static at 11.1 percent.

Additionally, the percentage of elderly falling into the near-poverty category (defined as 125 percent of the poverty threshold) rose and is disproportionately high; in 1979, 24.7 percent of the elderly were concentrated in this income category, compared with 15.2 percent of the under-65 population. Because so many elderly have incomes just above the official poverty threshold a slight drop in income in 1979 of $868 for single, aged individuals and $1,091 for aged couples would have caused the elderly poverty rate to be nearly 25 percent.

FUTURE INCOME PROSPECTS ARE POOR

As for the future, the income situation for the elderly appears bleak. In the study previously cited, Data Resources, Inc. (DRI), forecast that even if current Government programs remain in place with no legislated cutbacks, the elderly's share of income relative to that of the nonelderly will decline sharply beginning in 1981. This decline is illustrated by the following chart. While the reasons for this decline are complex, the major factor remains the continuing high rate of inflation.

AVERAGE INCOME OF THOSE OVER AGE 65
RELATIVE TO THOSE UNDER 65



Source: "The Aged & the Future Economy: An Interactive Analysis", Data Resources, Inc., November 1980, page 19.

Although, in the past, much progress was made in reducing poverty and improving the income status of the aged, these recent statistics and forecasts indicate that the elderly are most vulnerable to inflation, that they are sustaining disproportionately larger losses as a result of it, and that a rapid erosion of progress made in the past has already begun. In short, continued high rate inflation could reduce the elderly to an economic situation worse than that which prevailed a decade ago when nearly one-fourth of them were poor.

INFLATION'S IMPACT ON NON-SOCIAL-SECURITY INCOME

Inflation is significantly altering the balance and relative importance of the various components of the elderly's income. Public programs are bearing an increasing portion of the income support responsibility as inflation constricts the "real" income received from private sources (such as private pension payments, income from savings, etc.) since those sources provide little or no compensation for inflation losses.

Private pensions, for example, are generally not indexed. A Bankers Trust study of private pension plans cited an average benefit increase of 16 percent in the period 1969–79, compared to a CPI increase of 47 percent. A 1970 retiree with a non-indexed private pension is now receiving a real income from that source of less than one-half the 1970 value.

With respect to savings, not only has the rate of interest income not kept pace with the rate of inflation (largely because interest rates have been limited to 5 to 6 percent by regulation Q), but the real value of savings accounts has also been eroding rapidly. According to DRI's calculations, $1,000 invested in a savings account in 1967 would have been reduced to $667 in 1978 if the saver decided to divide the interest between current income and reinvestment. These losses are common to most of the aged and are disproportionately borne by the low-to-middle income elderly (as this is often their only form of financial savings). It is estimated by Professor Kane of Ohio State University that regulation Q has cost older consumers almost $20 billion over the past 10 years.

Those elderly who invested in stocks and bonds to produce retirement income have sustained not only real capital losses over the past decade but also low rates of return on investment. Because stock prices (as measured by Standard & Poors) have not risen over the past 10 years, inflation has cut in half the real value of the equity in most stocks. Dividends, which are taxable, have averaged 4 percent over the 10-year period, compared to an average 6 to 7 percent rise in the CPI.

A typical pattern for many elderly households is to save for retirement, and at retirement, convert their savings to "secure" forms (such as money in the bank, or corporate bonds), sell their homes to clear themselves of any mortgage debt and to gain additional liquid resources, and then rent. A retiree of 10 years ago, following this pattern, would have been impacted quite severely by the recent inflation since the real value of their retirement savings would have likely been reduced by one-half.

As the elderly's participation in the labor force declines and as the real income derived from their private sources of income fall, the responsibility for an increasing portion of their income support is being shifted to the public programs like social security and supplemental security income which provide some measure of inflation protection.

In 1976, it was estimated by the Social Security Administration that two-thirds of the elderly depended on social security for at least one-half of their income, and for 28 percent of the aged, social security amounted to 90 percent or more of their total income.

SOCIAL SECURITY INDEXING FLAWS

Despite the elderly's high and increasing degree of dependence on social security for income, this program's indexing mechanism is flawed for two reasons: First, benefit increases are provided long after inflation has had its effect on the purchasing power of benefits; and second, the standard used in making adjustments, the CPI itself, does not always accurately reflect the true impact that inflation has on elderly budgets.

With respect to the first point regarding the lengthy lagtime in making benefit adjustments, a January 1981 OMB study (entitled "Report on Indexing Federal Programs") indicates that since 1975 (when automatic indexing of social security and SSI payments began), beneficiaries of these programs have experienced a 3.4-percent decline in real benefit levels due solely to the lengthy lagtime in adjusting benefits and the rapidly accelerating inflation rate. In social security and SSI, the cost-of-living adjustment received each July reflects the increase in the CPI from its

average level in the first quarter of the previous years to the the average level in the first quarter of the current year. Increases lag 3 months behind the measuring period and anywhere from 3 to 18 months behind the time when rising prices actually diminish benefit purchasing power. As inflation rises, particularly at high levels, the erosion in real benefits is compounded. It should be readily apparent from this data that proposals to delay payment of cost-of-living increases another 3 months (from July to October) would exacerbate this loss in benefit purchasing power and make the current indexing mechanism far more inadequate and flawed than it already is.

Although many economists and Members of Congress have argued that the current CPI tends to overstate inflation for the elderly because of its faulty treatment of housing costs and sensitivity to high interest rates, detailed studies of this issue do not confirm this contention. An exhaustive study conducted for our associations by economist, Dr. Thomas Borzilleri, investigated the accuracy of the CPI and found no consistent pattern of over- or undercompensation for inflation. A copy of this study is appended to the statement. Based on data collected from the 1972-73 Consumer Expenditure Survey, the Borzilleri study constructed a special CPI or social security market basket that reflected the elderly's special expenditure patterns. The study calculated rates of inflation under this special CPI and compared them to rates of inflation yielded by the general CPI since 1972. In constructing a special social security market basket, the study utilized the most conservative possible definition of homeownership costs—a house payment that was fixed throughout the entire 8-year period of analysis. In effect, it was assumed that no one in the social security population ever purchased a new home or ever bore higher mortgage interest rates. This definition would be sure to correct any alleged overestimate of inflation for the elderly as a result of rises in the costs of home mortgage interest rates.

Given this definition of homeowner shelter costs, the major findings of the study were as follows:

1. Past Differences in Inflation Rates Were Small

Differences between the rate of inflation produced by the general CPI and the rate of inflation produced by the social security market basket, even given the conservative shelter cost assumptions, were found to be quite small. Those differences are reflected in the following table.

	CPI	Social security market basket	
		Excluding cash contributions	Including cash contributions
1975-76	6.4	6.6	6.6
1976-77	5.9	6.2	6.1
1977-78	6.5	6.5	6.5
1978-79	9.9	8.6	8.7
1979-80	14.3	12.3	12.5

Note: The category "cash contributions" is not used in the official CPI, but such contributions were found to comprise a significant portion of the market basket. Hence, two versions were estimated.

Source: Borzilleri, "The Accuracy of the CPI for Social Security Cost-of-Living Adjustments," May 1981.

Over the entire period of automatic indexing, social security benefits increased at an annual average rate of 8.6 percent a year while the social security market basket increased at an average rate of 8 percent a year. Relaxing the shelter cost assumption would further reduce this difference. Thus, it appears that no major overcompensation or undercompensation has occurred.

2. Benefits Have Been Both Underadjusted and Overadjusted

In 1976 and 1977, benefits were underadjusted since the CPI increased by less than the social security market basket. In 1979 and 1980, benefits were overadjusted since the social security market basket increased by less than the CPI. The net effect on social security beneficiaries of both over- and underadjustment depends upon when retirement occurred. For the average single social security recipient 62 or older when the 1972-73 Consumer Expenditure Survey was taken, the gains and losses from overadjustment and underadjustment *totaled* a gain of approximately $82. For couples, the net gain over the 6-year period was $133.

3. Expenditure Patterns for the Retired Are Different From Those Reflected by the CPI

Major differences in expenditure patterns are indicated when the general CPI is compared to the social security market basket. The table below helps explain why the social security market basket increased almost as rapidly as the CPI in spite of the fact that mortgage interest rates and home prices were not included in it. (The CPI weights are as of December 1979, while the social security recipient market basket weights are as of the first quarter 1980.)

PERCENTAGE OF THE MARKET BASKET, BY CATEGORY

	CPI	Social security market basket
Food and beverages	20.4	25.5
Shelter	28.0	17.9
Fuel and utilities	6.4	12.2
Furnishings and operations	7.3	6.2
Clothing	5.1	4.8
Transportation	20.9	17.7
Medical care	4.4	9.9
All Other goods and services	7.5	5.8
Total	100.0	100.0

Source: Borzilleri, "The Accuracy of the CPI for Social Security Cost-of-Living Adjustments," May 1981.

It should be obvious from this table that food, fuel and utilities, and medical care play a *much* more important role in the market basket of the retired. This greater importance, coupled with the higher inflation rates in these three categories in the 1970's, offset or almost offset the major differences in shelter costs between these two inflation measures.

These major differences in expenditure patterns have obvious implications for future benefit increases and for the method of indexing utilized by the social security program. To the extent that increases in the CPI are driven by increases in the price of homes or mortgage interest rates, social security recipients will be overcompensated. To the extent that increases are driven by rises in the cost of food, fuel, or medical care prices, the aged will be undercompensated. Given the importance of cost-of-living protection for retirees, the high cost involved in providing such protection and the major differences in the elderly's expenditure patterns, the necessity for developing and utilizing a separate and accurate CPI to adjust social security benefits is obvious. Until this is done, there will be no assurance that major over- or undercompensations will not occur in the future.

Certainly, a separate index based on the market basket of goods and services consumed by the social security recipient population appears a far more appropriate public policy option than proposals to use a rental equivalent index or to cap increases at something lower than the CPI. If, for example, past benefit increases had been capped at 85 percent of the CPI increase, social security benefits would have increased by an average annual rate of 7.3 percent while the social security market basket was increasing at an annual rate of 8 percent. Thus, if such a cap had been in effect throughout the 1975–80 period social security benefits would have been significantly underadjusted throughout this period.

If the objective of public policy is to improve the accuracy of social security cost-of-living adjustments, this objective is unlikely to be realized by continuing to rely on the general CPI, by switching to another index like the CPI-X-1 or the Personal Consumption Expenditure Price Index, by switching to and from the CPI and wage index, or by arbitrarily capping benefit increases. There simply is no substitute for a cost-of-living index specific to the population in question and designed expressly for the purpose of social security benefit adjustments.

COMMENTS ON PROPOSALS THAT WOULD ALTER SOCIAL SECURITY INDEXING

Our associations urge Congress to reject proposals that would alter the construction of the CPI strictly for the purpose of curbing the rate of increase it registers. Some analysts have endorsed the use of the CPI-X-1, recently developed by BLS, because it would supposedly correct the CPI's flawed treatment of homeownership costs. The Borzilleri study clearly indicates that there are *several* flaws that need to be corrected. From the point of view of the elderly, for every overstatement of their

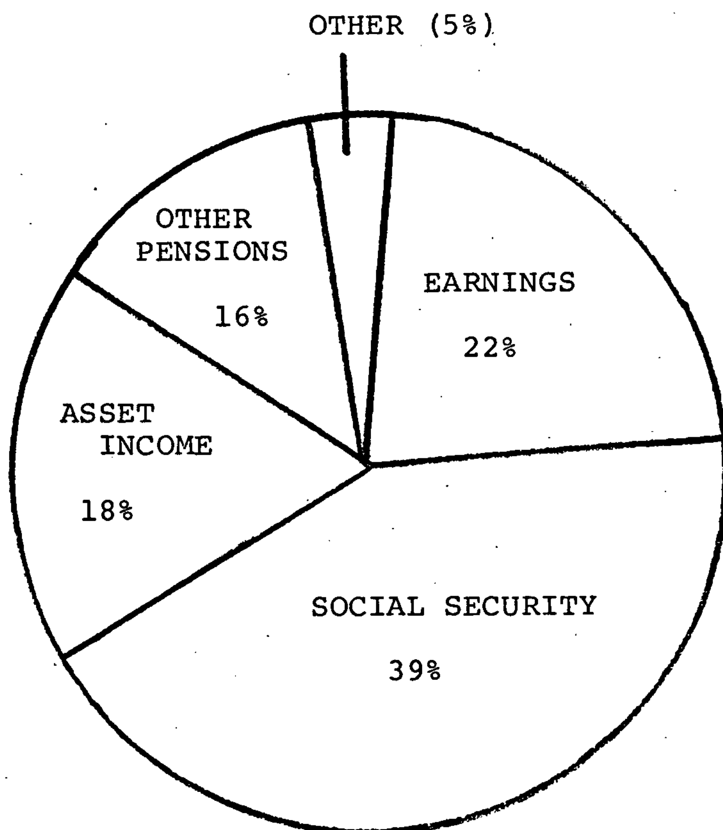
costs in the general CPI, there is at least one understatement in another expenditure category.

Another prominent proposal to alter indexing would cap cost-of-living increases at either the average rise in wages or the average rise in prices, whichever it lower. This "wage cap" as well as any other capping proposal (such as 70 or 80 percent of the full (CPI) would result in a severe downward ratcheting of real benefit levels particularly if imposed over a period of years. For instance, the CBO has estimated that the wage cap proposal could reduce social security benefits by $26 billion over the 1981-86 period. A 70-percent cap would reduce benefits even more severely. Given the vulnerability of the elderly's income situation, any cutbacks in cost-of-living protection that are repeated in several years and therefore have the cumulative effect of eroding the benefit base will assuredly be accompanied by large increases in elderly poverty rates.

Some proponents of the wage cap proposal seem to be advocating it on the grounds of equity—in other words, it is inequitable to allow the incomes of retirees to rise more rapidly than the incomes or wages of workers who must support Government programs through taxes.

First, it must be pointed out that wages usually represented the bulk of workers' incomes. Therefore, any wage increase received tends to protect most of a worker's income. In contrast, social security does not represent the elderly's total income. In fact, in 1976, social security accounted for only 39 percent of the elderly's total income. Income from pensions and other assets (for which little or no inflation protection is available) represented 34 percent of their total income (see following chart). Thus, full cost-of-living adjustments maintain the real value of less than half of most retirees' income. And for elderly persons who depend on social security for over 75 percent of their total income, 42 percent of single aged persons, and 20 percent of aged families in this category were living below the poverty threshold in 1979. It simply cannot be alleged that full social security cost-of-living increases are allowing retirees' incomes to rise more rapidly than the incomes of workers.

SHARES OF INCOME SOURCES FOR THE AGE 65+ POPULATION



PERCENT OF SUPPORT PROVIDED BY VARIOUS INCOME SOURCES FOR THOSE 65 AND OVER

Source	All units	Married couples	Nonmarried men	Nonmarried women
Social security	39	33	41	47
Other pensions	16	18	21	14
Earnings	22	29	17	11
Assets	18	18	15	21
Other	5	2	6	7

Source: "Income and Resources of the Aged," Social Security Administration, SSA publication No. 13-11727, January 1980.

Second, it must be pointed out that wage increases have historically exceeded price increases and this trend is expected to resume within 2 years. Unless Congress is willing to adjust benefits according to the rise in wages on a permanent basis even when wages begin to outpace prices in the future, then the wage indexing

cannot be sold on the grounds of equity. Beneficiaries will feel—and rightfully so—that they will always be getting the "short end of the stick." The overall rationale for cost-of-living adjustment mechanisms must be consistent. These mechanisms are *not* for the purpose of passing along to current retirees increases or decreases in the standards of living of current workers, but rather for the purpose of maintaining benefit purchasing power.

Workers can have reasonable expectations over their future working lives of making up any real income loss they are currently suffering as a result of high inflation. Retirees, because they are not wage earners and have many fixed components to their income, have no expectations for recouping the inflation losses they have already incurred and will continue to incur as long as inflation is with us.

We note that the National Commission on Social Security included in its wage cap proposal a provision that would allow social security recipients to recoup in later years the losses they suffer under this cap. When the details of this proposal are examined closely, one finds that, for example, a benefit loss incurred over the 1979–81 period would not begin to be restored until 1983—at the earliest—and would not be completely restored until several years after 1985. Since the restoration process could easily span a decade, many older persons who would have suffered the benefit loss will die, while many persons who did *not* suffer the benefit loss will reap the rewards of the restoration. According to 1977 statistics, approximately 1 million retired social security recipients leave the social security rolls per year and 1.6 million are new entrants.

CONCLUSION

The elderly's real income situation and their standards of living are declining. Poverty rates among them are rapidly escalating. All this deterioration is occurring despite the provision of relatively "full" cost-of-living increases by the major income support programs. If these increases by are curtailed in any manner (especially by a relatively permanent change in indexing through use of a wage or overall cap or CPI-X-1), then the Nation's elderly could easily be reduced to the economic level that prevailed a decade age, when one out of every four of them were below the poverty level.

Senator HEINZ. Senator Percy.

Senator PERCY. I have an opening statement, Mr. Chairman. I would ask that it be incorporated into the record.

Senator HEINZ. Without objection, so ordered.

[The statement of Senator Percy follows:]

STATEMENT OF SENATOR CHARLES H. PERCY

Mr. Chairman, I want to thank you for holding this series of hearings on social security. I sincerely regret that conflicting hearings by the Foreign Relations Committee have prevented me from attending until today.

I know of no issue of more concern to older Americans today than the prospect of changes in social security. Since the President announced his proposals for reform, I have received a flurry of mail from thousands of retirees who fear the benefits they are receiving will be cut off or drastically reduced without warning.

Of course, this is not true. It is very important that we send that message to the millions of Americans across the country that depend on social security benefits. That is why I cosponsored the sense of the Congress resolution the Senate passed a few weeks ago opposing the portions of the President's package that would have reduced the benefits of retirees who planned to leave the work force as early as next year.

Such major changes with such short notice are not fair, and Congress won't approve them. I agree reforms are needed—I hope we can pass some legislation this year—but we must give ample time for persons to adjust their retirement plans to changes in the social security system.

Because the President's proposals would have been effective next year, they would have made significant short-term savings, enough to see the system through its short-term financial problems. That means the alternative we adopt in Congress must find a different way to deal with the revenue shortfall in the next few years. Estimates of the amount of savings or additional revenues needed to maintain adequate trust fund balances between 1982 and 1986 range from $40 to $111 billion.

Without the President's provisions to reduce benefits for early retirees, we appear to have the following options: Use general revenues, increase payroll taxes, adjust the COLA, or reduce benefits for a group other that early retirees.

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Because some adjustment to the COLA is one of these alternatives, this hearing has special significance and I welcome this opportunity to hear these expert witnesses comment on the accuracy of the CPI as way to compute the COLA and the advantages and/or disadvantages of the several alternative inflation indexes.

Senator HEINZ. Gentlemen, thank you for some very, very interesting testimony. We have all tried to digest the more in-depth statements that you have given us. We are grateful to you for having given it to us in advance.

Each of you comes to different conclusions about the cost-of-living index. But there is one conclusion that I think that you are all closer to than any others and that is that if we attempted to change the cost-of-living index so that it reflected the market basket for senior citizens, that even though, as Mr. Hacking points out, he might favor this, my sense is that all three of you would agree that it would not make much difference in the actual level of benefits.

Let me ask you, Mr. Minarik, if that is correct.

Mr. MINARIK. I think the outcome would depend entirely on how housing were treated. If one were to go back over the last 5 years and to attempt to replicate precisely the formulation of the CPI that we now have with respect to owner-occupied housing, the work that I have done indicates that the CPI for the elderly would increase at a slower rate than the overall CPI.

If one were to take housing entirely out of the index or go to a rental equivalent approach to owner-occupied housing, the differences would be extremely small. I believe that the study that was done by Data Resources for AARP indicated that the difference over the last 5 years would have been one-tenth of 1 percent rate of increase per year. The study that Mr. Borzilleri did for the AARP suggests that the rate of increase would have been about six-tenths of 1 percent lower per year for the elderly than for the average CPI. In any event, the differences would be very small.

Senator HEINZ. Mr. Storey, would you generally agree with that?

Mr. STOREY. Yes, I would; and I would reiterate the point that it is not a homogeneous population. We are not simply talking about the elderly that receive social security.

Senator HEINZ. Mr. Hacking, do you believe it would make much difference?

Mr. HACKING. Not at this time, but it might make a difference in the future. Whether or not it does depends on the rates of increase in prices for housing and in the cost of mortgage interest relative to the rates of increase in the price of fuel, food and utilities, and medical care. These latter items loom much larger in the budget of a typical elderly household.

Senator HEINZ. Some people have said that the CPI as used to adjust the social security benefits each year has overadjusted benefits to the elderly. A few people have said that it has not been sufficient and that means that inflation has been underadjusted.

Do any of you feel that inflation has been overadjusted for social security through the existing——

Mr. MINARIK. That social security beneficiaries have gotten more than an accurate measure of inflation? I believe that is true, Mr. Chairman. In my written statement, I have shown a comparison of the Consumer Price Index which is used for indexation of the benefits under social security and the implicit price deflator for

consumption expenditure in the GNP accounts, which is a more reasonable treatment of housing; and over that period, the period from 1972——

Senator PERCY. It is difficult to hear you.

Mr. MINARIK. Over the period from 1977 to 1980, the benefits for social security on that basis were overadjusted cumulatively by about 9 percent.

Senator HEINZ. Do you agree with that, Mr. Storey?

Mr. STOREY. I guess I do not have a firm opinion one way or the other as to whether there has been overcompensation in the recent past. But I would point out two things. One is that one could assume from the studies that have been done for the aged that people on social security probably experienced a somewhat higher cost of living in the 1970's than the general population and, therefore, if there were overadjustments, it may be more accurate for the elderly population than for the general population.

Second, a big portion of that income is not indexed, so if there has been overcompensation, it has been offsetting the decline in real income that retirees have been experiencing from other sources.

Senator HEINZ. Mr. Hacking, specifically with respect to Mr. Minarik's point that in 1977, 1978, and 1979, the elderly received some kind of a windfall? Would you agree with that?

Mr. HACKING. I think you have to separate the question of whether or not the CPI overstates inflation generally in the economy from the question of whether the use of the CPI to adjust social security benefits for the purpose of maintaining the purchasing power of those benefits has in fact performed that function without significantly overcompensating or undercompensating. I think on the basis of the study that Dr. Borzilleri did for us—a study which took the CPI, disaggregated it, and constructed a market basket of what older people buy—I think we find that they were not overcompensated or undercompensated. That does not mean that continued use of the CPI for adjusting benefits in the future might have one of those effects.

Senator HEINZ. If in fact the CPI was about right or alternatively take Mr. Minarik's hypothesis, that it was overgenerous, how do we account for the decreased number of elderly over the poverty level?

Is it simply a question that the poverty level has been indexed in some way that it is misstating the number of people that are poor; or are there other dynamics at work?

Mr. MINARIK. I think there are two things. No. 1, as I said in my opening statement, the CPI is used to index the poverty level, so if the CPI is mismeasured on the high side, then the poverty level increases more rapidly than it would under an accurate adjustment of prices. Therefore you count more people under the poverty level than you would if prices were accurately measured.

No. 2 is the problem of the elderly who have either pension rights or wealth that they have accumulated over their working lives which is invested in instruments which provide them with rates of return under the rate of inflation. If they cannot afford the minimum investments that are necessary to take advantage of the money market certificate and such as well as indexed pension

benefits—in my opinion, overindexing social security benefits by using an inaccurate Consumer Price Index is not the best solution to that problem. Probably the best solution to that problem would be to issue indexed bonds in small denominations to the elderly so they could take their wealth and put it into a form of savings that would provide them with a small real rate of return. It seems to me that that is something that the Federal Government could do that would be much more sound in terms of policy, would not provide all sorts of unintended side effects, and would protect the wealth of the elderly from erosion.

Senator COHEN. Isn't that contrary to the announced policy of the administration, to encourage people to invest in savings more than in the past? How do you tell people who have been encouraged to grow up with a savings asset during their whole lives, that they will have an indexed bond? How do you reconcile that with the administration's commitment to do more to encourage people to save and invest in savings accounts?

Mr. MINARIK. I would draw a distinction between a policy of savings toward the working population and what the elderly do with their savings once they reach retirement. It seems to me very reasonable to encourage people to save over their working lives. The question is, when they retire would it be reasonable to say at that point that there is a commitment that the wealth of the elderly will not be eroded by inflation, that you can take your wealth in whatever form, be it a savings account, money market certificates, stocks and bonds; and at this point to say that the elderly will be protected from the ravages of inflation on their capital, to be able to convert them into some kind of indexed savings instrument that will protect them from the erosion of inflation over their retirement years. I think they are different.

One is aimed toward the working population; one is aimed toward the retired population. I think that policy makes more sense than taking a CPI lottery to provide some kind of protection for the elderly for losses in their income from other sources.

Senator HEINZ. I just want to complete this last line of questioning and then I will turn to Senator Percy and Senator Cohen.

Mr. Hacking, you, in your testimony, cited that the elderly poverty rate increased substantially, rose from 13.9 to 15.1 percent in just 1 year and that that was the largest increase since the Census Bureau began collecting the statistics. I think other people have recognized that.

Are the people who are being counted in there beneficiaries of the old age and survivors program or, put it another way, for those people who are full participants in the social security system, as opposed to SSI, are they—is this increase reflected among those beneficiaries?

Mr. HACKING. I am sure they must be counted in those general statistics.

Senator HEINZ. That is not my question.

Are these people who are sinking below the poverty level because they are not social security beneficiaries or are a proportionate number of them social security beneficiaries, in which case the hypothesis would be valid? It is a factfinding question I am asking, not a question of opinion.

Mr. HACKING. I have not done any detailed analysis of that question, but I would think that a proportionate portion of that group that is slipping below the poverty level is indeed on the rolls of social security programs, although if you——

Senator HEINZ. Don't suppose it. We do not know. I gather you are saying—you think that that may be the case, but you do not have any evidence one way or the other. Neither do I. I just want the facts.

Mr. HACKING. We have not examined that.

Senator HEINZ. May I request that if you have those facts you give them to us? Because this statistic is used a lot and it is important to know what it means. If it means that we are somehow not adequately taking care of the people in the lower portion of social security, we should be very alarmed. If it is a question of eligibility or somebody not having paid in or not having been a full beneficiary, that is a different problem and a different solution.

Mr. HACKING. Census data does exist on this point. We shall supply a statement for the record.[1]

Senator HEINZ. Thank you.

Senator Percy.

Senator PERCY. I was reminded of the importance of the COLA by a retired employee of the Senate that I just saw on the floor of the Senate. He retired. I said, "How are you getting along?" He said, "Wonderful. If I had only known I would have retired sooner. I was frozen at $39,000 a year and on retirement I am playing golf five times a week and I am now getting $50,000. I am much better off."

Senator HEINZ. I do not know that that is going to go over well with the folks in Pennsylvania. I do not know how it goes over in Illinois.

Senator PERCY. It is a fact of life, though, that our programs are costly, and we have to figure out how to finance them.

Mr. Hacking, as you know, an adjustment in the way COLA has been computed has been proposed as one way to meet the short-term financing problems. Since you do not support any proposal which would have the effect of reducing the COLA, what recommendations do you have for meeting a shortfall in revenues we expect in the social security system in the near future?

Mr. HACKING. Senator, for some years now, since the enactment of the 1977 amendments, our associations have been advocating that a new package be developed, one that addresses not just the short-term but also the long-term problem, which we think is much larger. It could be that over the next 5 years the excess of social security outgo over revenue income could be in the range of $100 billion, as the administration has suggested. But whether or not it turns out to be that large, there are only two basic choices. Either you cut spending for the programs in the short term or you add more revenue over and above what can be expected to come in under the payroll tax structure that supports the program.

The administration's decision was to cut spending in the short term. Here again they were faced with two choices. Either they could cut spending for people on the rolls, primarily by capping or limiting cost-of-living adjustments, or they could concentrate the

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[1] See appendix 2, item 1, page 334.

cuts on those not yet on the rolls and that is what they chose to do. Early retirees and the disabled are to be cut.

The associations have suggested all along, with respect to the short-term problem that, given the nature of that problem which is primarily the result of malperformance in the economy, the appropriate solution would be to put together a legislative package that would interject into social security some nonpayroll tax revenue to the extent that such additional revenue would be needed to maintain the contingency reserve funds and balance income with outgo over the next 5 years. We do not know what the magnitude of the shortfall is going to be at this point because we do not know what the rate of inflation and unemployment are going to be and what real GNP and real wage growth rates are going to be. Yet it is these economic factors that will determine the magnitude of the excess of outgo over income

So we are suggesting that mechanisms be constructed to back up the payroll system, to get the system over the short-term problem but at the same time changes must begin to be made to carry out the kind of long-term restructuring in social security that will be necessary to adequately address the much larger, more serious and more important long-term financial imbalance that will occur as a result of the demographic shift in the population.

I would just add one other point here.

What we are calling for is the introduction of more revenue in the social security programs. We suggest that this should not be done through increases in payroll taxes. We have had enough of that. But to the extent that revenue is taken from some other tax mechanism or revenue source, this should not result in any increase in the Federal budget deficit. We want the budget brought into balance and the sooner the better. The sooner that and other actions are taken that are effective in getting the inflation rate down, the sooner many of the problems we are discussing today will be solved.

Senator PERCY. Thank you very much.

Mr. Minarik, you do strongly support a change in the CPI because of its treatment of owner-occupied housing.

How do you respond, however, to the critics' charge about the adverse effects such a proposal would have on the poor whose social security benefits will be reduced?

Mr. MINARIK. Well, if I were to give my proposal for dealing with social security over the long haul, I am not sure that it is one that would meet with a tremendous amount of political support.

Personally, if it were my choice to make, I would begin to treat the social security system for tax purposes identically with the way the private pension is treated now; that is to say that beneficiaries would be allowed to recover their own previously taxed contributions without tax and that the excess over the previously taxed contributions would be subject to the income tax. All of this is to say that social security would be treated in the same way as a private pension plan.

The revenue that the Treasury collected could be pumped back into the system. It could provide an additional across-the-board increase in benefits. It could provide a reduction in the deficit or reduction in future tax increases. It seems to me that that is the

most equitable way to treat the problem in a period as we have now when most beneficiaries recover their previous contributions over a very, very short time and then in the future receive indexed benefits which far exceed their contributions.

Senator PERCY. Mr. Storey, you support setting a COLA at a certain percentage of the full CPI rather than using a special elderly index or the lesser of the CPI or wage index.

You state that the low income and elderly could retain full inflation protection from CPI increases still provided for by SSI and food stamps.

I wonder whether your position would change if the SSI or food stamps did not continue to be indexed by the CPI?

Mr. STOREY. First of all, let me say that I hope I made it clear that I would hope Congress could retain the full cost-of-living increases; and I raise that point in the event that the budgetary constraints make it necessary to make this kind of cut. I guess I would still prefer a flat reduction across the board in the CPI increase rather than something tied to the wage increase, regardless of the level of increases that could be afforded. I realize that if you limited the CPI increase for social security, it would be very difficult to justify not limiting it for any other indexed program, including veterans' benefits as well as SSI and food stamps.

Senator PERCY. Finally, you stated that you do not support a special index for the elderly.

Do you support Mr. Minarik's recommendation that the CPI be changed because of its treatment of owner-occupied housing?

Mr. STOREY. He has studied that problem in great detail and I have not. At this point, I would defer to his judgment on that.

Senator PERCY. Any other comments?

Again, I want to thank you, Mr. Chairman, for holding these hearings and I am sorry that other conflicts have prevented me from being with you for the full series of them. They are very, very timely. I continue to get alarming reactions from the initial position taken by the administration. I think the reassurance that we provided on the Senate floor was terribly important.

But still the problem is there. The President certainly got our attention and the attention of the country without any question and we do have a problem that has to be faced up to.

This panel and others that we have had in the hearings have been extraordinarily helpful to us in giving us an objectivity that we must have in order to get a proper answer and I know this committee will help find that answer and carry out a policy that will be a balanced policy in fighting the battle against inflation, but also protect and not pull the rug out from under those that are counting on the social security system.

Senator HEINZ. Thank you.

Thank you for your very excellent questions.

I want to observe one thing that struck me in the 3 days of hearings that we have had on these issues, and that is that with respect to the President's proposal to dramatically and suddenly lower the benefits at age 62 for early retirees, I think it is worth noting that there has not been a single witness that has come before this committee to advocate that and I single that out now for one reason.

The fact that the President made that proposal has resulted in a large number of people who are now working, who are now 62, saying to themselves, I am not going to take a chance and retire today because something might happen to my benefits and I better work a little longer, another year or 2 or 3; and the problem that that causes, by the way, is that at a time of relatively high unemployment, people who would have been taking early retirement and opening up a spot for other people are not doing that and so we have an interesting psychological effect that is devastating to younger people. I think it is worth noting for all those in doubt out there that the Congress is not going to change the rules on early retirement. We are not going to do it. We voted and that is what the 96 to nothing vote meant.

I hope that point is well registered.

Senator Cohen.

Senator COHEN. Thank you, Mr. Chairman.

Coming at the end of the line of questions, I have no penetrating insights into the testimony offered by our three witnesses. I do apologize to all of you for being late. I was in my office meeting with a group of steelworkers. I thought that might be of importance to our chairman, who is a leading voice in the steel caucus.

I would like to point up a political problem. The reason it took me so long to get here is, among a number of other issues they wanted to discuss, one was social security.

I said, well, I am being delayed here right now from attending a meeting to deal with that issue. The essence of the conversation was that they do not think there is a problem. According to them, we are trying to rip off the old folks of this country and this social security reform is simply a way to take away what they have earned and accumulated, and we do not care what they are talking about, they do not believe us.

So I spent about a half hour talking to these gentlemen trying to persuade them as to the reality of the challenge that we face. I am talking about steelworkers in my office who made a categorical statement to me that there was no problem in social security. In fact, this is something conjured up by the Republican administration in order to scare the hell out of old folks in the country.

I must tell you I was not persuasive with them that that was not the case; that there is a serious financial problem with the social security trust fund as it is currently structured; that it is going to have to be changed, and the only admonition extended to me is, we are going to watch you, and how you vote on this matter.

So in addition to the problems that you have been discussing here, it struck me, and I think the word I heard as I came in was that equity has to be the underlying perception as well as the reality of whatever we do in trying to correct the deficiencies that exist in the short term and also in the long term. That is what struck me, Mr. Storey.

I think you had indicated in your written testimony that changing the CPI index to wage and price index is a bit too complicated and perhaps you ought to have just a flat percentage reduction; and the question that came to my mind was, how do you justify that? Do you do it because it has been too high in the past and therefore should be lowered? If so, by how much and what do we

use for the underpinning? What do we use as the rationale for any particular percentage—1, 2, 5 percent? What is it that we use as politicians, elected officials, to persuade a very large and, I must add, powerful interest group in our country that what we are doing is fair, equitable, and ultimately necessary?

Mr. STOREY. Well, aside from the arguments that are set forth within various budget resolutions and the limitations on the social security trust fund which Congress ultimately has to meet, I think there are two additional arguments.

One would be that the CPI is not a precise measure of the cost of living over a long period of time and that there is no particular reason to be wedded exactly to the last decimal place to what that index suggests.

And the second rationale I think is that during a time when people are very concerned about rampant inflation and rising energy costs, it certainly makes sense as part of a national policy to combat those economic forces that everyone bear some part of the pain. Obviously, you do not want to subject people whose incomes are mainly fixed to the full force of inflation. But the idea that all Americans should share in at least some modest part of the pain inflicted by a decline in real income in the society overall would seem to be a pretty powerful argument to me.

Senator COHEN. Are you saying that for everyone who is retired there should be a flat percentage reduction in all of the social programs we have at the Federal level and which are currently indexed? Would you reduce it by the same percentage? Is that correct?

Mr. STOREY. That is right.

One thing that ought to be clear, whatever Congress might decide to do on indexing social security, which might be purely in the context of short-term financing problems of the trust fund, for example, would probably have ramifications for other programs because social security is certainly not the only program tied to the CPI. I think that Congress would find it difficult to reduce the increase for social security and not reduce it for veterans and for other programs.

Senator COHEN. How does that deal with the issue raised by Chairman Heinz? I think he asked you that Mr. Minarik.

You suggested the increase in the poverty rate was unrelated to the CPI, since the poverty level is indexed by the CPI. So as we went up, the CPI went up and the poverty level went up. I suppose as you come down with the CPI you would come down at the lower level so that that will not ultimately change in terms of the people affected at the poverty level.

Mr. MINARIK. That is correct. If someone had only social security income and if in one particular year the CPI overstated inflation because market interest rates went up and if in the next year the CPI understated because mortgage interest rates went down, that person's position relative to the poverty line is not changed. Whether that person's income at the end of those 2 years is equal to what it should be based on a correct measure of inflation is another question.

If I may go on for one second about the wage cap question, I disagree with Mr. Storey on the question on the choice between a

wage cap and a percentage cap. I think one of the problems is it has an arbitrary nature, as was suggested with respect to the choice.

I think the other point that is in favor of the wage cap is that one can, in a very sensible way, put a catchup provision on a wage cap such that a shortfall of wages relative to prices in 1 year that would lead to an indexation of benefits less than at the rate of price increase, could be reversed the next year if wages increased faster than prices. I do not know how one would rationally say with last year's 15-percent reduction in indexation across the board because of prices, what you do next year.

The rationale, it seems to me, is not clear. The rationale of the wage cap is that in times when wages increased at a slow rate and therefore a draw on the trust fund, that that drain is reduced somewhat because the indexing of benefits is held down. The next year we put the beneficiaries with a catchup provision back to where they would have been if there had not been a cap the first year. So you can save a little bit when you have a stagnating economy, and after that you put the beneficiaries back.

Senator COHEN. Mr. Hacking.

Mr. HACKING. Yes.

I would like to comment on a number of these points.

First of all, with regard to the point Mr. Minarik just made, the Social Security Commission came up with a recommendation for this kind of a wage cap with a catchup feature. We looked at that and decided it was probably a Rube Goldberg kind of proposal, because, given reasonable estimates as to what is going to happen in the economy, the people who would suffer the inflation loss today might well die before they got any compensation for the catchup feature that would operate once wages began to outpace prices. In the meantime new people would be coming onto the rolls who never suffered the loss but who would get the benefit of the catchup.

Rather than do that, we would rather resort to some other means of dealing with social security financing problems.

The second point I wish to address concerns the poverty measure. In 1979, we saw a very dramatic increase in the incidence of poverty among the elderly. The rate jumped 1.2 percent that year. The poverty rate among the nonelderly, however, remained relatively constant at 11.1 percent. I think the members of this committee, when considering any change from the use of the CPI to the use of some other index to measure inflation in the economy and to determine the percentage rise in poverty, should look at the relative change in the incidence of poverty among elderly versus the nonelderly. It is important to determine why it is that the poverty rate, using this perhaps flawed CPI index, is increasing among the elderly but not among the nonelderly.

Finally, Senator, with regard to the meeting you just had with the steelworkers, I would just say that any group that comes in and says that there really are no financial problems in social security or that social security is not really facing a long-term problem or that all you need to do is just sort of patch up the system, is doing a great disservice to the elderly on the rolls today and to the nonelderly who will be on the rolls in the future. The

associations think that social security's financial problems are real and significant and that the system's long-term problem makes its short-term problem look mild in comparison.

Senator COHEN. I do not disagree with you. I spent a good portion of a half hour saying what you said, and it proved totally unpersuasive to these gentlemen.

I am not sure whether or not this has percolated to our population today.

When the chairman mentioned the President getting our attention, sort of hitting us with a 2 by 4 with the suggestion of reducing the amounts received if he or she retires early—it did exactly that.

But I would submit that whatever the President recommended initially would come under fire. If he had come up with a proposal to change the cost-of-living adjustment in some fundamental way, that, too, would have been severely criticized. If the President came out and recommended that we extend the retirement age from 65 to 68, that, too, would have come under criticism. So my own judgment is that whatever was initially advanced would come under fire.

I share the view that making an immediate change, as proposed by the President was not fair to people who are planning for the reasonable future to retire under those circumstances. But I think that the message has to be conveyed. I think these hearings are serving a very important function.

The ones we had with Senator Armstrong will do even more; that is, we have to educate ourselves that we do indeed have a problem which is not simply a political effort on the part of this administration to cheat somebody out of what they are entitled to. The fact is that unless we make some fundamental changes for both the long term certainly and for the short term—whether it is commingling of the three funds we have and borrowing between the three with perhaps the budgetary restraints as suggested by the CBO office—we are in fact going to cheat the millions of people that have come to rely on this money each month.

Mr. HACKING. On that point, I would say that while the associations agree that it is outrageous and unfair to come along and change the rules of the game at the last minute on people who are in the work force and planning to retire, it is even worse to come in and change the rules retrospectively on people who are out of the work force and are already on the social security rolls by cutting back or limiting the cost-of-living adjustments on which those people rely. If short notice or retrospective benefit cuts are eliminated as reasonable options for dealing with the short-term problem, then you are left with only one other option—and that is to add some revenue to the system to get it over the short-term 5-year period.

Senator COHEN. That is all I have.

Senator HEINZ. One of the questions raised by critics of the social security system is one that recently was emphasized in a column by William F. Buckley, where he noted that while social security benefits increased by 14.3 percent, wages only increased by 9.1 percent. In his words—

> The indexation is a double whammy. The worker is not protected by indexing. The social security recipient is. The net effect is then to polarize, i.e., as things get harder for the worker, they get better for the social security recipient.

And he went on to recommend indexing benefits only for the recipients below the poverty level, or putting a wage cap on social security indexing—for wages after taxes.

I do not happen to agree with his conclusions, but there are some people who say that, as Mr. Buckley has articulated or asked the question, how do you justify to the country, to the taxpayer, to the wage earner, a full indexation of social security benefits being paid out of wages that are not in any way, shape, or form fully indexed.

Who wants to take a crack at that?

Mr. HACKING. Let me start, Senator.

First of all, keep in mind that the typical elderly household has a total income that is only half that of the typical nonelderly household. Also keep in mind that social security accounts for only 40 to 50 percent of the elderly household's total income whereas wages account for around 90 percent of the total and much larger income of nonelderly headed households. So when you begin to look at who is doing better relative to inflation, you have to compare total income of both households and where they stand relative to each other. Finally, you should also remember that, historically, wages have increased at rates in excess of the rate of increase in prices. We expect that historical patter to resume in the near future. So, to the extent that wage earners are suffering losses right now because their wages are not keeping up with the increases in prices, they at least have a reasonable expectation that this will change and that they will recoup those losses. The elderly, on the other hand, have no means of recouping losses they sustain today.

Senator HEINZ. Do any of you gentlemen have any comments on that?

Mr. MINARIK. One question is how you would justify on a basis of equity a system wherein the beneficiaries receive benefits that are indexed and the contributors receive incomes that are not. The other question is, how do you maintain it over a long period of time? If that phenomenon continues, given the other structural problems we have with the social security system, you have big trouble. That is the $111 billion shortfall horror story that we are facing now as one possible fate for this system over the next few years.

Personally, though, on the equity side of it, given that a lot of that 14.1 percent was phony, based on how the CPI was based and that therefore that margin it seems to me should have been smaller, I do think that Mr. Buckley has a point. I do think that a cap based on a reasonable measure of price increases would be reasonable.

It seems to me also that some of the problems Mr. Hacking mentioned in terms of a catchup are probably not for real. The first problem in terms of a catchup provision, some people die before the catchup comes through and therefore do not get an indexation of the benefit—some people die after paying payroll taxes and do not get a penny. We do not worry about that. So I am not sure that the smaller amount of money involved in the catchup is a problem.

The second point is that new retirees would get a bonus if a catchup provision were to be enacted to make up a reduction in indexation. I do not think that is necessarily true. It seems to me

that a sensible system would provide for a catchup for people who were retired and not for new retirees.

So it seems to me again Mr. Buckley has a point. I think a correct CPI would have mitigated the shortfall of wages relative to prices over the last few years, and it seems to me a catchup provision would provide us with something of a solution to that problem over the coming years.

Senator HEINZ. If we assume that we would like to find $25 billion, and I take that number only semiarbitrarily, in savings in social security outlays over the next 4 or 5 years, between now and 1985 when we have the combined trust funds run into a cash-flow problem, and we were looking at a way to save that amount of money through adjusting, in some way the cost-of-living benefits, and there are other ways of finding it, obviously, what would be the fairest, least painful way of picking up that $25 billion.

Do any of you have a suggestion?

Mr. STOREY. I would suggest first of all, what Congress has already been considering this year; namely, phasing out student benefits and the minimum benefit——

Senator HEINZ. We cannot do that. I am already counting that someplace else. That has already been done.

Mr. STOREY. I would argue that some modest across-the-board reduction in the CPI adjustment would be the fairest thing to do under the circumstances.

Senator HEINZ. Like what? That is the problem; what is easy, what is fair?

Mr. STOREY. I do not have a budget in front of me and I do not know what it would take to get that particular saving over the next 5 years. But a reduction in the CPI-related increase of 1 or 2 percentage points in a year when the inflation rate is 8 to 10 percent is what I would call a pretty modest rollback in the cost-of-living adjustment.

Senator HEINZ. What you are saying is you would take some percentage cap.

Mr. Minarik.

Mr. MINARIK. Since the ground rules have taken my first two suggestions out of the ball game, there is one other possibility in terms of a rollback type of approach, which I am sure Mr. Hacking is going to immediately disagree with. Actually, I disagree with it too, as my written statement will describe.

But one of my colleagues, Charles Schultze, in testimony a couple of months ago, suggested that we have overindexed social security benefits over the last 4 to 5 years because of the problem with the Consumer Price Index. Therefore, he suggests we could try to, in effect, lower the trajectory of future social security benefits for people who were overindexed to get them back in the future to a level where they would have been if we had indexed by a more correct price index from 1977 through 1980. That would be very, very difficult to do. It would require treating differently different classes of retirees according to when they have retired, whether they were indexed in all 4 years or whether they retired in 1978 or 1979, or 1980. The reaction I have gotten when I have asked people at the Social Security, "This sounds difficult to do, isn't it?" is,

"You just said a mouthful." Therefore it seems to me it is a very difficult way to go.

But if I were pressed to wring $25 billion out of the system in addition to the minimum benefits and the student benefits, I think that is where I would turn in desperation.

Senator HEINZ. Mr. Hacking, you are so fortunate you can bat cleanup.

Mr. HACKING. If I understand your question, you want to know what the associations would prefer if the system has to——

Senator HEINZ [interrupting]. Without arsenic, laughing gas is not permitted.

Mr. HACKING [continuing]. If the system is to accrue $25 billion in savings over 5 years? And this is to be done solely through changes in the indexing mechanism?

Senator HEINZ. Or shifting it around.

Mr. HACKING. You are not talking about changing basic benefit components or the basic benefit structure or——

Senator HEINZ. You could advocate or advance that. I do not want to count what the Senate Finance Committee has already done because that decision, frankly, will have been made by the close of business tomorrow when we pass reconciliation. So it is a rather academic point. So I am looking for things beyond that.

Mr. HACKING. We would apply some general rules to all the possible options. The first rule would be that the groups which would bear the cuts that would accrue the savings should be primarily those groups that have the greatest number of options available to recoup or make up their losses. Generally speaking, people in the work force would have greater options to recoup losses than people not in the work force and already on the rolls. Therefore we would look first to persons who are still employed and who have a relatively greater ability to compensate for any loss of expected benefits.

Senator HEINZ. What are the options that people in the work force have, take a second job?

Mr. HACKING. Remain in the work force and not come on the rolls. That is the primary thing. It is much more difficult for a person who is retired to come back into the work force. But if still greater expenditure cuts were still needed then I guess you have to spread the rest of the pain among people on the rolls. Exactly how you would do that, given this basic criterion of concentrating any benefit expenditure reductions on people who have the greatest number of options is a difficult matter. You would have to look at all the possible combinations of curtailments in benefits, both derivative benefits——

Senator HEINZ. And that is why I am asking you the question, because I assume you have done some of that.

Mr. HACKING. One benefit cut that is coming through the legislative process now is the elimination of the social security minimum benefit. The minimum benefit gives something of a windfall to persons who were not low-wage earners necessarily, but were simply able to split their employment between work covered by social security and that not work covered by some other retirement system. Those people in effect pick up an advantage from a feature of social security that is welfare in nature and that was never

intended for them. Obviously, persons in this category are better able to bear these kinds of losses than others, but I do not think you will get a lot of savings.

Senator HEINZ. That picks up $3 or $4 billion at most.

Mr. HACKING. If you wish to cut social security expenditures concentrate the cuts on people not yet on the rolls you almost have to reduce substantially early retirement benefits and drastically tightening up disability criteria for disability insurance benefits. Those are the basic options.

Senator HEINZ. What about the option of delaying for a period of time, from July to December, the payment of the increase of the CPI?

Mr. HACKING. There are a number of proposals to delay the timing of the increase in the cost-of-living adjustment. We would suggest that if any savings are to be accrued by tampering with the indexing of benefits, whatever is done should not be done on a permanent basis.

A one-time delay, as the administration recommends, is obviously not as painful as some other more drastic change like an outright cap on cost-of-living adjustments or a shift to the lesser of the rate of increase in prices or wages.

Senator HEINZ. It is my understanding, and correct me if I am wrong, that if you move from a July to October for each of the next 4 years, that you would save about $7 billion a year, that that would be a little more than $25 billion and at that end of the 4-year period you could either all in one jump or a month at a time move it back to where it was.

Now, how fair is that proposal? How equitable—be a severe critic of that proposal?

Mr. HACKING. Well, to the extent that——

Senator HEINZ. Or is it reasonable?

Mr. HACKING. To the extent that the system accrues savings as a result of this kind of a proposal, you have to keep in mind that the savings to the system directly translate into income losses to the beneficiaries on the rolls and that will show up in terms of the poverty incidence and in other ways, by a lowering of the standard of living of those on the rolls. Any savings to the system accomplished in that way translates into losses to people on the rolls. However, what you have suggested is a less drastic cutback than some others that have been proposed with respect to cost-of-living adjustments.

We shall have to set priorities. There are things less unacceptable to us. The administration's proposal for a shift from July to October is moderate relative to other things that might have been proposed but were not.

Senator HEINZ. It seems to me that the problem with either the 90 percent or the 85 percent of full benefits is that that is likely to be a permanent proposal, and what it says is that the elderly will be guaranteed that they will not keep pace with inflation and that poses a problem, I think, as a matter of public policy.

The proposal to do wages or prices saves money if, and only if, prices rise faster than wages. This year so far we are getting lucky. Wages are rising at 8 or 9 percent and prices are not exceeding that. How long we will be lucky, we do not know. Maybe we will

stay lucky for 2 or 3 years if OPEC keeps producing. Therefore, that does not necessarily offer us a saving.

On the other hand, we have the postponement proposal which avoids some of the pitfalls I just mentioned plus the pitfall of trying to confront one leading possibly to more individual CPI kinds of questions.

There was general agreement that the existing CPI is not all that bad. Constructing another CPI is not going to put senior citizens much further ahead than the existing one. So why do that if it is not going to accomplish anything. It seems to me that of the choices of poisons before us, the temporary postponement of the cost-of-living increases might be the best.

Would you agree or disagree?

Mr. HACKING. The temporary postponement is less unacceptable to us than a cap.

Senator HEINZ. What a warm, glowing endorsement of that idea.

Mr. Minarik, Mr. Storey, you have been silent on that.

What do you think?

Mr. MINARIK. I would only add to your list of alternatives fixing the CPI, having one index, having that corrected. Again, one does not know whether that will give you savings or not because one does not know what mortgage rates will be and right now they wave the CPI like the dog waving his tail. If you take that out, there is no telling what the next round will do for you on benefits.

I would do it because I would like to have a good price index. I think it is a nice thing to have.

The only facetious recommendation I would have is if we get lucky on OPEC and if wages exceed prices, maybe we should count the additional tax income as savings.

Mr. STOREY. As a former staff member of the Senate Budget Committee, I would be foolish not to support making the increases effective at the beginning of the fiscal year. It certainly would make the work of my former colleagues easier.

Senator HEINZ. That is not supposed to be a factor.

Mr. STOREY. It is only a one-time delay in payment adjustments, and adjustments would continue at that date from there on.

With respect to your point——

Senator HEINZ. It does have the drawback of making every single person on social security mad at the Congress. But we do not think about things like that.

Mr. STOREY. With respect to your point that a limitation on the full CPI index could become permanent, I would hope that as the rate of inflation came down that would not be the case, and that Congress would move back to the full increase. But even in the event that it did become permanent, I think one thing that everybody in the country must realize by now is that our society, at least in the post-World War II period, has experienced some rate of inflation almost every year. Fortunately, it was at a very modest rate for most of that 35-year period. But if we can achieve a situation where people are better able to plan their retirement income from all sources, including social security, one would presume that people would take into account the fact that there is going to be some modest degree of inflation, just as they did during their working lives.

Senator HEINZ. One last question.

Do you think that we should tax social security benefits as somebody—I think Mr. Minarik—suggested?

Mr. STOREY. Recognizing that there could be a 96 to nothing vote against such a proposal——

Senator HEINZ. Sooner than you may think.

Mr. STOREY. I think logically it makes a lot of sense to treat social security the way other pension income is treated.

Mr. MINARIK. And put the money back in the system.

Senator HEINZ. Mr. Hacking.

Mr. HACKING. We have a problem with that.

First of all, there is the rationale—this is not a new proposal. The rationale on which this proposal is based is that social security ought to be treated like any other pension for tax purposes. The problem is that social security is not, strictly speaking a pension. It contains pension elements, yes, but it also contains welfare elements and other elements that are characterized as social adequacy in nature.

I wonder if Mr. Minarik would be in favor of sorting out the various functions of social security and creating one social security program that is, strictly speaking, a pension that closely relates benefits to earnings records and contributions? If so, then his proposal would make more sense than it does at this point.

Mr. MINARIK. If I may answer, the welfare elements of social security, to the extent that they provide people with very low incomes with some modicum of support, would not be an issue in the taxation of social security benefits because we have a personal exemption and a standard deduction under the income tax system. Most of the operational schemes for taxing social security benefits at the present time would make it theoretically and practically impossible for anyone who relies entirely on social security for support to pay 1 penny of taxes.

Essentially, what such a system would do in practice, because of the standard deduction and certain personal exemptions, it would tax certain groups of people who have substantial other sources of income and that is why I think it would be a good step from an equity point of view. You would get tax collections from the elderly who are better off and you could pump money back into the system and thereby benefit the elderly who are less well off.

Senator HEINZ. Any other comments?

Mr. HACKING. First of all, with respect to any proposal to tax social security benefits, the associations are strongly opposed. While it may be true as Mr. Minarik says that lower income elderly would not have any tax liability even if their social security income were counted in gross income for income tax purposes, this change would still affect many social security recipients who are on the rolls. They would argue that you are changing the rules of the game because they counted on tax-free benefits when they retired. If you tried to tax benefits prospectively, only for people coming on the rolls at some point in the future, then you would be lowering the expected rate of return of people who would be subject to this tax in the future and these people would likely lose a good deal of support and enthusiasm for the program because as higher earners and higher contributors they get a relatively lower

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benefit as a percentage of final earnings. That should not be lost sight of.

If you want to sort out the functions of social security and create a program that relates future benefit awards strictly to earnings and contributions, then this proposal would make a little more sense. It does not at this point, given the structure of the system.

Senator HEINZ. Thank you all. You have been excellent witnesses.

The hearing is adjourned.

[Whereupon, at 4:25 p.m., the committee adjourned.]

APPENDIXES

Appendix 1

BRIEFING MATERIAL FOR HEARING

SOCIAL SECURITY: THE AUTOMATIC BENEFIT INCREASE PROVISION

ISSUE BRIEF NUMBER IB80073

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ISSUE DEFINITION

The June, 1981 increase in social security benefits will be the seventeenth across-the-board increase since the program's inception. It will be the seventh consecutive automatic increase under provisions enacted in 1972 and amended in 1973. This increase also applies to Federal Supplemental Security Income (SSI) benefits. It is based on the change which occurred in the Consumer Price Index (CPI) between the first quarter of 1980 and the first quarter of 1981. This June's increase became known on Apr. 23, 1981 when the March 1981 CPI was announced by the Bureau of Labor Statistics. The size of this increase and the previous one (14.3%) has raised concerns about (1) the fairness of such large increases in benefits relative to the typical wage increase given workers whose taxes support the system, (2) whether the CPI is the appropriate measure for adjusting benefits for inflation, (3) the difficulty it creates for balancing the Federal budget and controlling inflation, and (4) general questions about the reasonableness of the CPI as a measure of change in the cost-of-living. Other concerns have been raised about the strain placed on the household budgets of social security beneficiaries by having benefits adjusted only once a year, particularly during periods of high inflation. Numerous proposals have been made to increase the frequency of the benefit adjustment to twice a year.

BACKGROUND AND POLICY ANALYSIS

The Mechanics of the Automatic Benefit Increase

Generally speaking, if the cost of living, as measured by the Bureau of Labor Statistics' Consumer Price Index (CPI for urban "wage and clerical workers") rises by 3% or more over approximately a one-year interval, a benefit increase for social security and SSI recipients will be triggered. The change in the CPI is measured from the first calendar quarter of one year to the first calendar quarter of the next year. If it shows a 3% or more increase, a benefit increase of equivalent amount will be due for the month of June following the end of the measuring period. The CPI for the two calendar quarters used to measure the change represents the straight average of the CPI for each of the 3 months in both quarters. The following example, which uses the latest benefit increase computation, illustrates how it is done:

1. The CPI for the first quarter of 1980 was 236.6. This was the arithmetical average of the CPI for January, February and March, 1980.

Month in 1980	CPI
January	233.3
February	236.5
March	239.9
Total	709.7

The average CPI for the 1st quarter of 1980 is thus: 709.7 = 236.6

2. The CPI for the first quarter of 1981 was 263.1. This was the arithmetical average of the CPI for January, February and March, 1981.

Month in 1981	CPI
January	260.7
February	263.5
March	265.2
Total	789.4

The average CPI for the 1st quarter of 1981 is thus: $\frac{789.4}{3} = 263.1$

3. The percentage increase in the CPI from the first quarter of 1980 to the first quarter of 1981 is:

$$\frac{263.1 - 236.6}{236.6} \times 100 \quad 11.2$$

The benefit increase is rounded to the nearest 0.1%. It applies to all types of beneficiaries.

The Secretary of Health and Human Services (HHS) is required by law to publish the amount of the increase in the Federal Register within 45 days after the close of the measuring period (which typically means by May 15th of each year). The change in the CPI for March of each year (the closing month of the measuring period) is announced by the Bureau of Labor Statistics somewhere between the 20th and 25th of April, at which point the amount of the benefit increase is known and is disseminated by the press. The benefit increase first appears in the July benefit checks, i.e., 3 months after the close of the measuring period.

The automatic benefit increase cannot be triggered under three circumstances:

(1) as mentioned above, when the CPI does not rise by at least 3% during the measuring period;
(2) an ad-hoc or general benefit increase is enacted by Congress in the year before the automatic increase would become effective;
(3) an ad-hoc or general benefit increase is actually due in the year before the automatic increase would become effective.

Whenever there is an automatic benefit increase, an automatic increase in the social security taxable earnings base is triggered for the following calendar year. (The earnings base is the maximum amount of earnings subjected to the social security tax and creditable for figuring social security benefits in any one year.) This triggering mechanism did not apply to calendar years 1979 and 1980 and will not apply to 1981. The triggering mechanism was in effect for earlier years (1975-1978), but was altered by the 1977 Social Security Amendments in order to increase revenues to the social security system. The earnings base was increased to higher levels than what would have arisen under the automatic provision and thus a greater amount of earnings was subjected to the social security tax.

TABLE 1. The taxable earnings base - 1979 to 1981

	calendar years		
	1979	1980	1981
taxable earnings base			
'77 amendments	$22,900	$25,900	$29,700
old law	$18,900	$20,400	$22,200

Note: 1978 earnings base also was ad-hoc but it turned out to be no different from the earnings base resulting from automatic provisions.

For years beginning in calendar year 1982, the earnings base again will rise by way of the automatic procedure. Typically under this procedure, the increase in the earnings base is calculated by measuring the change in average wages in the economy, in contrast to the automatic benefit increase which is based on changes in the CPI. The earnings base goes up by the percentage increase in the reported wages for the year immediately before the year of changeover the average of total wages reported to the Secretary of the Treasury in the second year preceding the year in which the earnings base is to change. In effect the increase in the earnings base represents the rise in average wages from the third to the second year before the increase becomes effective (wage reports are filed in the year after wages are paid). The amount of the change is rounded to the nearest multiple of $300.

When the earnings base is increased, the table of benefits also is extended to reflect the higher benefits that are payable because greater "average monthly earnings" can now be calculated as a result of the higher earnings base.

The automatic benefit increase also triggers an increase in the amount of earnings which are to be exempted from the social security "earnings or retirement test" (generally, benefits are reduced if earnings exceed the exempt amount). The automatic procedure here is based on increases in average earnings levels determined by the same calculation used to compute the automatic increase in the taxable earnings base. The increase is rounded to the nearest multiple of $120. This automatic adjustment does not apply to persons 65 and older during calendar years 1979 through 1982 since ad hoc increases in the exempt amount were enacted for this group of beneficiaries for those years. After 1982, the exempt amount will rise for this group in accordance with the automatic provisions again, although the exempt amount will continue to be larger for them than for beneficiaries under age 65. (See CRS report 78-76 EPW for a detailed description of the social security retirement test and how it works).

Increases in the earnings base and retirement test exempt amount are not triggered by general or ad hoc increases in benefits. Further, the law does not allow for any adjustments below existing levels, if for instance average wages were to fall.

Legislative History of the Automatics

While the first automatic benefit increase under social security did not

take place until 1975, the thrust for such a mechanism goes back at least to the mid-1960s. Former Commissioner of Social Security Robert M. Ball wrote in a 1966 Social Security Bulletin article:

> In addition to the need for improving the adequacy of social security benefits as initially awarded, there is also the question of keeping the benefits up to date once they have been determined. Many people are on the benefit rolls for 15 or 20 years, or even longer, after entitlement. Both the civil-service retirement system and the military retirement system now include provisions to automatically adjust benefits to increases in the cost of living. Certainly such a provision should also be considered for the social security system.

Numerous proposals arose during that period, and in 1968 the idea received national prominence when both the Republican and Democratic parties included proposals of this nature in their platforms. In 1969 and each year thereafter through 1972, the Nixon Administration proposed an "automatic" procedure as part of the Administration's legislative program for social security. The first serious action taken by Congress to create an "automatic" procedure was with H.R. 17550, the Social Security Amendments of 1970. This was an omnibus bill containing significant measures for social security, welfare, Medicare and Medicaid, trade and other programs. The bill as reported by the Committee on Ways and Means only provided for a one-time increase in social security benefits of 5% to be effective for January, 1971, but a floor amendment resulted in an additional House-passed provision which would automatically tie future benefit increases (for 1973 or later) to changes in the consumer price index. A similar measure was passed by the Senate; however, it passed the Senate late in the session, and while conference was requested by Representative Wilbur Mills, chairman of the Ways and Means Committee, the session expired before a conference could be convened.

Early in the next Congress, a one-time benefit increase of 10% was enacted (P.L. 92-5), effective Jan. 1, 1971 (the Senate-passed version of the benefit increase provision of H.R. 17550 called for a 10% hike, rather than 5% as contained in the House-passed bill). In signing the bill, the President again restated his desire to see future increases placed on an "automatic" basis. Shortly thereafter, the 1971 Social Security Advisory Council made a similar recommendation. Later that spring, the Committee on Ways and Means reported out, and the House passed, H.R. 1, another omnibus set of major social security and welfare amendments, which included provisions calling for another 5% increase in benefits to be effective for June, 1972 and for future benefit increases to be pegged automatically to changes in the CPI, effective for January 1974 (if triggered) and thereafter. The Senate Finance Committee held hearings on the bill that summer, but no further action was taken until 1972. The committee held hearings again early in 1972, but in the meantime interest had already begun to mount for another major benefit increase. In February 1972, Representative Mills introduced H.R. 13320 calling for a one-time 20% increase in benefits and automatic increases thereafter.

Later that spring, when the Senate was considering H.R. 15390, a bill to extend the public debt limit, an amendment introduced by Senator Church was agreed to which for the most part contained the same benefit increase provisions of the Mills bill. H.R. 15390 was passed by both the Senate and House on June 30, 1972, and was signed into law by the President on July 1,

1972. It became P.L. 92-336.

This legislation provided for future automatic cost-of-living increases, beginning in January 1975. The law provided that benefits could be increased automatically each January whenever the cost of living rose 3% or more between specified base periods. However, an automatic benefit increase would not take effect if in the preceding year a general benefit increase (other than an automatic benefit increase) had become effective or had been enacted.

The maximum earnings taxable for social security purposes was also increased from $9,000 a year to $10,800 for 1973 and to $12,000 for 1974. Starting in 1975 the base was to be automatically increased in proportion to the increase in the level of average covered wages in the first calendar quarter of the year in which the computation was made over the level of average covered wages in the first calendar quarter of the later of: the most recent year in which an increase in the tax and benefit base was enacted, or the most recent year in which a determination was made to automatically adjust the contribution and benefit base.

The Consumer Price Index rose rapidly in the first 6 months of 1973. Reacting to this situation, in June 1973 the Senate Committee on Finance added an amendment to a House-passed bill authorizing a continuation of the temporary increase in the Public Debt Limit (H.R. 8410). Under the committee amendment, the first cost-of-living increase would have been provided with the benefits payable for January 1974, rather than January 1975, with the percentage rise measured over the 12-month period from June 1972 to June 1973. (When the previous benefit increase had been considered by the committee, it was estimated that benefits would be increased by 5.6%. However, the actual rise in the Consumer Price Index was greater than anticipated and when the index for June 1973 was published, the rise was actually 5.9%.)

The committee thought that because the benefit increase provided by the amendment was only an advance on an increase that otherwise would be payable automatically later, there was no need to provide additional revenue to pay for the additional benefits.

When this legislation went to conference, the Administration objected to the benefit increase on grounds that it would ruin the budget for FY74 by increasing expenditures without increasing revenues. Accordingly, the conference agreed to postpone the increase until June 1974 (the check would be issued in July) so that the additional expenditures would not come until the start of the next fiscal year (1975). In addition, to help meet the additional costs provided, the annual tax base scheduled to go into effect in January 1974 was raised from $12,000 to $12,600.

Because of the parliamentary situation in the House, these provisions agreed to by the conference on the debt ceiling bill became a Senate amendment to a bill extending the Renegotiation Act and were enacted as part of Public Law 93-66.

Following enactment of Public Law 93-66, pressures arose to make the increase payable earlier than July 1974. Moreover, the Consumer Price Index continued to rise at a rapid rate and there were complaints that the 5.9% increase provided would be inadequate. The Committee on Finance, therefore, announced on Oct. 30, 1973, that it had ordered reported a bill (H.R. 3153) that included a 7% increase in social security benefits, in lieu of the 5.9% increase enacted in July, which would become effective with the benefits

payable for the month of enactment. Like the earlier enactment, the proposed increase was considered an advance on the January 1975 automatic cost-of-living increase.

At the same time the Committee on Ways and Means was also considering substitute for the 5.9% benefit increase. The committee's bill (H.R. 11333) provided for a two-step 11% benefit increase with 7% payable in March 1974 and the remainder in June 1974. It also moved the date of the first automatic benefit increase from January 1975 to June 1975, and changed the CPI measuring period so that rather than ending with the second calendar quarter of the year preceding the increase, the measuring period would end with the first calendar quarter of the year in which the increase was to take place. In effect, it shortened the administrative lag period from the end of the measuring period to the month of the benefit increase from 7 months to 3. The tax base was to be increased to $13,200, effective January 1974 (rather than to the $12,600 authorized earlier in the year) and the tax rate schedule for the early years was to be revised by transferring income from the hospital insurance program (which estimates showed to be over financed in this period) and by increases in the tax rates beginning in 1981.

When H.R. 11333 was received in the Senate, the Committee on Finance reconsidered its earlier decision to provide a 7% benefit increase and recommended a two-step, 11% increase similar to that passed by the House. The Senate bill, however, provided that the first step -- 7% -- would be effective for the month of enactment (rather than for March as in the House-passed bill) with the second step to the full 11% being effective for June 1974, as in the House-passed bill. With regard to financing the cost of this increase, the committee adopted provisions somewhat like those in the House-passed bill.

When the Senate-passed bill (H.R. 3153) went to conference, the parliamentary situation was tangled. Conferees reached an informal agreement as to what provisions would be recommended to the House and to the Senate. The conference was recessed, subject to the call of the chairman, and Senator Russell Long, the chairman of the Committee on Finance, brought House-passed H.R. 11333 to the floor. On the floor he made a motion to substitute for H.R. 11333 those provisions of H.R. 3153 that had been agreed to by conferees. The amended bill passed both houses of Congress with substantially the social security benefit and financing provisions of House-passed H.R. 11333. The legislation was approved by the President (P.L. 93-233) on Dec. 31, 1973.

The "automatic" procedure enacted with P.L. 93-233 is for the most part the procedure that exists today. A provision, however, was incorporated in the 1977 Social Security Amendments which changed the way benefit increases were computed for persons who joined the rolls under the early retirement provisions (age 62-64). Because of a technical flaw, these beneficiaries previously had been able to receive benefit increases which were actually greater than the change in the CPI. The 1977 provision altered this situation so that future benefit increases would be equal to the CPI.

The June, 1981 Benefit Increase of 11.2%

With the 11.2% increase, the maximum benefit for the month of July, 1981 and thereafter became $752.90 for beneficiaries who reached age 65 in 1981 and retired with a work history of maximum creditable earnings (i.e. whose earnings reached or exceeded the taxable earnings base throughout their countable years).

The following table of sample benefit amounts shows the impact generally of the June benefit increase on various types of beneficiaries:

TABLE 2.- Illustrative benefit amounts

Benefit Category	Monthly payment before increase	July payment with 11.2% increase	Monthly increase
Maximum and minimum Social Security benefits:			
Maximum benefit, worker retiring in 1981 at age 65	$677.00	$752.90(1)	$75.90
Minimum benefit, worker retiring in 1981 at age 65	153.10	170.30	17.20
Average Social Security benefits:			
Retired worker alone	$337	$374	$37
Aged couple, both receiving benefits	576	640	64
Mother and two children	782	870	88
Aged widow	313	348	35
Disabled worker, wife, and children	731	812	81
Disabled workers	372	413	41
SSI payment standard:			
for individual	238	265	27
for couple	357	397	40

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(1) In certain unusual circumstances, this may be higher.

Estimated Future Increases in the Automatic Benefit Increase

The following table shows the most recent projections of what the benefit increases would be under current law for the period 1982 through 1986. The possible increases are shown under three different sets of economic assumptions: (1) those contained in the Reagan FY82 Budget; (2) those contained in the Carter FY82 Budget; and (3) those assumed by the House Budget Committee in its recommended first budget resolution for FY82.

TABLE 3. Projected benefit increases, 1982-1986

Calendar Year	Reagan Budget	Carter Budget	House Budget Committee
1981 1/	11.1%	12.3%	11.2%
1982	9.3	11.3	10.7
1983	6.6	9.2	9.5
1984	5.8	8.0	8.3
1985	4.9	7.3	--- 2/
1986	4.4	6.5	---

1/ Actual increase is 11.2%. Carter budget assumption was estimated months before increase was known.
2/ not available

As for the long range, the 1980 Social Security Trustees' Report assumptions anticipate a steady decline in the size of the automatic increases between 1986 and the year 2005. On average from that point on, the increases would be 3% per year under the optimistic assumptions, 4% per year under the intermediate assumptions, and 6% per year under the pessimistic assumptions. The long-range forecasts anticipate a benefit increase will occur every year throughout the 75-year actuarial valuation period even under the optimistic assumptions.

Comparison of Benefit Increases Over Time to Changes in the Cost-of-Living

Frequently the question is asked of how benefit increases compare over time to changes that have occurred in the cost-of-living. The following table shows the change in benefits due to general or automatic benefit increases from the inception of the program to various subsequent points in time up to the present. It also shows the amounts by which the CPI has increased from the inception of the program to the month of each subsequent benefit increase.

TABLE 4. History of percentage increases in benefits and prices(1)

Effective date	Across-the-board increases in benefits		Increases in CPI	
	each amendment	cumulative since amendments of	between effective dates	cumulative since amendments of
1/40	---	---	---	---
9/50	77	77	75.5	75.5
9/52	12.5	99.1	9.3	91.8
9/54	13	125.0	0.5	92.8
1/59	7	140.8	8.0	108.2
1/65	7	157.7	7.9	124.7
2/68	13	191.2	9.2	145.4
1/70	15	234.9	10.8	171.9
1/71	10	268.4	5.2	186.0
9/72	20	342.1	5.9	202.9
6/74	11	390.7	16.4	252.6
6/75	8	430.0	9.3	285.4
6/76	6.4	463.9	5.9	308.1
6/77	5.9	497.2	6.9	336.3
6/78	6.5	536.0	7.4	368.6
6/79	9.9	599.0	11.1	420.6
6/80	14.3	699.0	14.2	494.2

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(1) NOTE: the CPI for "wage and clerical workers" is the one used for social security purposes.

One key observation from the table is that the cumulative change in benefits due to statutory benefit increases has consistently surpassed the cumulative increase in the cost-of-living at each point that a benefit increase has been provided. The table shows that since the inception of the program, benefit increases alone accounted for a 699% change through June, 1980, while the cumulative change in the CPI has been 494%. Thus it might be said that the benefit increase provisions alone have resulted in a real increase in the purchasing power of the benefit of 35%.

This difference, however, is due to the ad-hoc, general benefit increases provided before the automatic provision was put into effect. Between June, 1975, when the first automatic increase became effective, and June, 1980, the cumulative amount of benefit increases was 63%. The change in the CPI between July, 1974 (the month after the last ad-hoc increase became effective) and June 1980 was about 67%. The only reason for any difference at all is that the measuring period used to determine the benefit increases differs slightly from the two points of reference used above.

It should also be observed from the table that even though cumulative benefit increases have surpassed the change in the cost of living at the time of each benefit increase, there were often very substantial lags between the various benefit increases. For example, over the nearly 11-year period from the time the first monthly benefits were paid until the first benefit increase was provided (January 1940-September 1950) prices rose gradually by 75.5%, but benefits were not increased until September, 1950 when a 77% increase was put into effect. There was no benefit increase between 1959 and 1965 -- a period in which prices rose about 8%. The 1965 benefit increase was only 7%. The 1959 benefit increase similarly had fallen short of restoring 1954 purchasing power (the year of the preceding benefit increase). Similarly, between September 1972 and June, 1974 prices rose 16.4%. The 1974 benefit increases (4 and 7% respectively) together only amounted to 11%. While the interval period today (one-year) is considerably less than some of the lag periods of the past, the high inflation of recent years has once again raised concern about the loss of purchasing power in the period between the benefit increases. This is discussed further in the next section of this brief.

Often, observers of the program will compare the increase in the average level of social security benefits to changes in the CPI. Such a comparison is misleading because it does not reflect the numerous other factors (in addition to the benefit increases) which alter the size of the benefits over time. Wage levels tend to rise over time, for instance, and this ultimately is reflected in the average social security benefit, because benefits are based on an individual's earnings record. As newer beneficiaries come on the benefit rolls with higher earnings and older beneficiaries pass away, the average of all benefits is raised. Further, up until recent legislated changes were made, the benefit formula itself tended to overcompensate for changes in inflation and this too tended to raise the average benefit. Overall the increase in the average benefit has been considerably greater in recent years than the increase in benefits caused by statutory benefit increases. The other factors that affect the size of the average benefit generally have augmented statutory benefit increases, rather than dampening them. As the following table shows, while statutory benefit increases have more or less kept in line with changes in the CPI since 1974, the increase in the average benefit has actually exceeded the increase in the CPI.

TABLE 5. Comparison of increases in benefits to increases in the CPI between June, 1974 and June, 1980(1)

Change in CPI	Cumulative increases in various measures of benefits		
	change due only to statutory benefit increases	change in average benefit of retired worker	change in average amount of new award to retired worker
67%	63%	82%	89%

(1) Reflects benefits payable in month of July of each year.

It should be understood, however, that the change in the average benefit does not typically reflect changes in benefits for many beneficiaries who are on the benefit roll. For many beneficiaries, the only change in the benefits they receive from one year to the next is the statutory benefit increase. Beneficiaries who continue to work after first receiving benefits might receive even greater benefit increases than those which result from the statutory benefit increase because of their additional earnings, but this is not the norm. In addition, as previously mentioned, the average benefit includes the effects of new beneficiaries coming onto the rolls with higher benefits and others who have passed away with lower benefits. Thus, a comparison of increases in benefits over time to increases in the cost-of-living using average benefits in the calculation contains a number of elements that may tend to distort the ratio of the increase in benefits to the increase in the CPI, at least for the vast number of beneficiaries. It reflects the impact of rising wage levels, particularly with respect to new awards, as well as statutory benefit increases given to existing [illegible]eficiaries.

Timeliness of the Benefit Increase

Frequently, the social security benefit increase provisions are criticized for not being sensitive enough to changes in the cost-of-living, particularly when inflation is acute. It is argued that the lag between the period when inflation occurs and the payment of the benefit increase is too long. If the cost-of-living is rising quickly, the value of the benefit is eroded during the months prior to the benefit adjustment for that inflation. For example, if the cost-of-living rises by 12% over a year's time, a beneficiary's purchasing power declines steadily during that period, to the extent that by the end of the period, his benefit will be able to buy only about 88% of what it could buy a year earlier. Proposals are often made to provide social security benefit increases more frequently than once a year so that the lag time would be shorter.

The period of time that elapses from the beginning of the measuring period used to compute the automatic benefit increase and the actual month in which it first appears in benefit checks is about 18 months long. The average CPI for the first quarter of one calendar year is compared to the average of the CPI for the next year -- in rough terms, a 12-month change from mid-February to mid-February of the two years involved. The benefit increase is payable in July following the close of the measuring period, i.e. about 4 1/2 months later. Thus inflation occurring in the first month of the measuring period [illegible]lects itself in benefit levels a little more than 16 months after it [illegible]urs, and inflation occurring in the last month of the measuring period is reflected in benefits a little more than 4 months later. On average the lag

between the month in which inflation occurs and the month in which the subsequent benefit increase is provided is roughly 10 to 11 months long. If benefit adjustments were provided semiannually, the average lag would be 7 to 8 months long (assuming the administrative delay following the close of the measuring period were retained as under current law).

This shortening of the lag period which would result from semiannual, rather than annual, benefit increases is what motivated the 1979 Advisory Council on Social Security to recommend such a provision for the program. Under their proposal, whenever the cost-of-living rose at a rate of greater than about 6% per year (3% semiannually), a semiannual adjustment would be triggered. The proposal also includes a change in the effective dates of the payment of the adjustment. Instead of June, the benefit increase would be payable in March and September. The Advisory Council's proposal illustrates the major obstacle in moving to a semiannual adjustment mechanism -- namely cost. Based on assumptions being used at the time the Advisory Council's report was issued (December, 1979), if the proposal were to have been made effective for calendar year 1981, additional costs of $2.2 billion would have arisen in 1981, rising to $3.2 billion in 1985. This additional cost would have been due entirely to the "speed-up" of the benefit adjustment. It should be noted that the nature of this added cost is the subject of considerable misunderstanding. It is thought that some of the additional costs caused by semiannual adjustments would arise from the compounding of benefit increases -- in other words, real benefit increases. In fact, the entire amount of additional costs comes from the "speed-up" of the benefit increase. None comes from compounding, because the CPI itself would self-adjust for such an effect.

It also should be understood that the lag does not apply to all beneficiaries. For instance, for new beneficiaries the length of the lag period depends largely on when a person comes onto the benefit roll. A beneficiary coming onto the roll in May receives a benefit increase in the following July check even though he was not on the benefit roll during the period of time in which the inflation occurred. Similarly, a person coming onto the benefit roll in January was a beneficiary for only a little more than a month of the period when the inflation occurred, yet this person also will receive a full benefit increase the following July. Whether or not the excess benefit increase in actuality makes up for a period of inflation prior to the individual's coming on to the benefit roll, or whether it amounts to an advance on upcoming inflation, depends largely on the circumstances of the individual (i.e. whether or not he was employed immediately before coming onto the rolls, whether his employer gave him a recent wage increase, whether he was living on other unearned income etc).

Another aspect of the issue that tends to obscure it somewhat is the fact that under the new benefit formula and benefit computation procedures enacted in 1977, future beneficiaries will receive benefit adjustments after they reach age 62 even if they don't choose to receive benefits at that age. The benefit increase will be reflected in their monthly checks when they do join the roll at a later time. This was done basically to keep these beneficiaries up with other persons of the same age, having comparable work histories, who did choose to receive benefits at the earlier age. The adjustment mechanism is therefore independent of the retirement decision. This system was also intended to offset somewhat the effect on persons who continue to work after age 62 of having earnings histories indexed only up to the year they reach age 60, rather than up to the time they come onto the roll. Nonetheless, as with the previous illustration, it is not clear that these persons will suffer a lag in benefit adjustments when they do become

beneficiaries because of these pre-enrollment adjustments to their eventual benefit levels.

Concerns Relating to the Size of the Benefit Increase

As might be expected with any sort of benefit adjustment to entitlement programs, arguments are made on both sides of the question of whether the size of the increase is adequate. Some argue the automatic adjustment of social security benefits is too rich while others argue that it is too lean.

At the heart of the argument that the adjustment is too large is the fact that inflation was never expected to be as acute as it has been in recent years.

With an inflation rate in the last 6 or 7 years far in excess of the assumptions made at the time of enactment of the present provision in 1973, the costs of the "automatics" have greatly exceeded the original projections. The actuarial projections at the time of passage of P.L. 93-233 in December, 1973 assumed that the automatic increase would be 3.1% in June, 1975 and June, 1976, and that the CPI in subsequent years would increase on average by 2.75% -- a level too low to trigger a benefit increase annually. In fact, no benefit increase was projected at all for 1977 because the "3-percent trigger" was not expected to be reached. As it turned out, the first automatic increase was 8%, and every subsequent increase since then has greatly exceeded those 1973 assumptions -- the lowest increase being 5.9% in 1977.

A number of suggestions have been made in recent years that a limit possibly should be imposed on the size of the annual increase. In addition to the argument that its costs have gone far beyond expectations, critics argue that the benefit increase by its very size precludes other needed expansions of the program, that it is the root of the program's financing problems, and that coupled with inflation adjustments built in to other Federal programs it contributes to the inflationary spiral of the economy.

The largest single factor accounting for the tremendous growth in social security during the past decade has been the automatic benefit increase provision. For each 1 percentage point change in the CPI, OASDI program expenditures now will rise by more than $1 billion a year. Between FY80 and FY81, program expenditures are estimated to rise from roughly $119 billion to $140 billion. Almost $17 billion of this change will be due to the June, 1980 automatic benefit increase of 14.3% (approximately 80% of the total increase in expenditures). Further, the automatic increase will account for some 40% of the overall increase in Federal expenditures between FY80 and FY81 ($17 billion out of an overall increase of $41 billion based on the conference agreement of the FY80/81 budget resolution).

Another cause of concern about the size of the benefit increase is that it erodes confidence in the system among the workers who support it when large benefit increases are provided at a time when unemployment is rising and when general wage increases in the economy are less than the benefit increases. This has been the situation for the last 2 years, and it is expected to occur again in 1981. The following chart shows the differences between the benefit increases for CY79-81 and the average increase in covered wages in the economy for those years.

TABLE 6. Comparison of benefit increases to average wage increases, 1979-1981

Calendar Years	1979	1980	1981
Social security benefit increase	9.9%	14.3%	11.2%
Average covered wage increase 1/	8.3%	8.5%	10.4%

Source: FY82 Reagan Economic Assumptions

1/ Average wage increase, calendar year over calendar year

This is in part the issue behind one of a number of alternative proposals made by the Director of the Congressional Budget Office in a July 31, 1979 letter to the chairmen of various congressional committees, suggesting that the benefit increase be pegged to the President's wage-price guidelines as a way of avoiding financial problems expected to arise shortly in the OASI program. This too had been part of President Ford's concern in proposing part of his FY76 budget that social security, Federal salaries and other Federal benefit programs with automatic escalator provisions be constrained by a 5% limit on increases (one-time only). This was also a period of high inflation and unemployment.

Another idea frequently mentioned along the same lines would be to constrain the size of the benefit increase by pegging it to the lower of the increases in wages or prices. In this way, social security beneficiaries would receive no greater a benefit increase than the pay raise received by the typical wage earner. Senator Hollings (ranking minority member of the Senate Budget Committee) recently sponsored a proposal to limit benefit increases in social security and other government programs to the lower of increases in wages or prices. His proposal was endorsed by the Senate Budget Committee in April 1981 as part of the committee's recommendations in establishing a first budget resolution for FY82.

The Congressional Budget Office released a report in February 1981 on ways to reduce the size of the budget which included several alternatives for social security cost-of-living adjustments. One suggestion was to repeal automatic indexing for all Federal programs and to establish instead an annual across-the-board decision on the extent to which the government could afford to counteract inflation -- perhaps by presidential decision with congressional concurrence. For social security alone, CBO suggested:

-- use the lower of the increase in the CPI or in a wage index ($25 billion in savings in FY82 through FY86);

-- limit the increase to 85% of the rise in the CPI ($44 billion in savings in FY82 through FY86);

-- base COLA on the rise in the Personal Consumption Expenditures chain index of the National Income and Product Accounts, which measures housing by a rental equivalency concept and changes the goods that are used to measure the index ($10 billion in savings in FY82 through FY86); or

-- delay the increase to October of each year without changing the base period ($24 billion in savings in FY82 through FY86).

All of the above CBO figures are preliminary estimates.

Similiarly to one of the above CBO proposals, the Administration has proposed a change in the timing of the cost of living increase as part of its proposed package for solving the short and long range financing problems of the Social Security trust funds. The increase would be delayed to October of each year starting in 1982. The base period would change and would end in June of each year (unlike the CBO proposal); additionally, all 12 months of the measuring period (July through June) would be averaged to determine the percentage increase in the CPI ($6.3 billion in savings in CY82 through 86).

A counter-argument to these measures is that while social security beneficiaries and others on entitlement programs indexed via the CPI fare better than workers during adverse economic periods, they do not fare as well during relatively better economic periods. Periods in which prices rise faster than wages have tended to be far less frequent than periods when wages rise faster than prices. The latest Social Security Trustees' Report shows that in the period between 1960 and 1979 there were only a few years when prices rose faster than average wages. People on entitlement programs generally do not reap the advantages that workers do who see real gains in purchasing power because their wages rise faster than prices. A proposal to peg the benefit increase to the lower of wage increases or price increases would widen this difference. Conversely, a proposal to peg the benefit increase to wage increases only would narrow the gap but very likely would be extremely costly over the long haul, because benefit increases generally would be larger than those under the current procedure.

Another whole set of issues revolves around the question of how the consumer price index measures the cost of living, and whether it is the appropriate index to use to adjust benefits for persons on various entitlement programs. Today the arguments generally suggest that the consumer price index overstates the rate of inflation. Homeownership costs are the center of the controversy. For CPI purposes, the buying of a home and the costs of maintaining it are treated no differently from any other type of purchase. The buying of a home is simply part of the market basket of goods and services purchased by consumers. However, critics of the CPI argue that people do not buy houses very frequently, and that the relative weight given to homeownership is so large that it distorts the picture of price increases encountered by the typical consumer. The argument becomes particularly relevant when talking about persons on entitlement programs who are less likely to purchase homes than other segments of the population.

Suggestions are made that other index be used to measure price changes, such as the "implicit price -- deflator for personal consumption

expenditures" prepared monthly by the Department of Commerce, or an alternative CPI which excludes homeownership but incorporates other measures of housing costs. One such alternative would compute housing cost changes under what is called a "rental equivalency" basis, i.e., hypothetical rent that would be received by a homeowner were he to rent his dwelling. President Carter's Budget Message for FY82 proposed changing to that type of index on the basis that "the current CPI significantly overstates the importance of housing and measures housing costs in an unsatisfactory manner." The Carter Administration projected no changes in costs for FY82 if the CPI-X1, as it is called, were used. Other alternative CPIs would incorporate "user cost" concept, which involves basically assigning values to housing services that incorporate opportunity cost of capital, the cost of debt, taxes, insurance, maintenance and repair, less a deduction for appreciation (an item not considered in the current homeownership measure). Under most of these alternatives the overall increase in the cost-of-living would not have been as large as reflected by the CPI, at least in recent years. Recent analyses done by the Bureau of Labor Statistics suggest that had a "rental equivalency" approach been used in recent years, recent inflation might only have been 80% to 85% of what the existing CPI reflected. It would have been somewhat larger under some of the other alternative measures involving the "user costs" approach, but still not as large as that reflected by the existing CPI.

Some of these other measures also have shortcomings, however, and it is not clear that they always would reflect a lower cost-of-living than the current CPI does. Further, the fact that changes in homeownership prices and costs may not be relevant for most households does not in and of itself invalidate the CPI as a measure of the typical change in the cost-of-living. People don't buy TV sets or refrigerators every month either. They don't buy cars and many other durable items frequently. The fact is that people don't all have the same purchasing patterns, but this does not necessarily seriously distort the CPI as a "composite index" of changes in consumer prices.

The issue of varying purchasing patterns for various segments of the population leads to another issue with the CPI as it relates to social security, namely whether or not there should be a separate CPI or cost-of-living measure for the elderly or for persons on entitlement programs. Critics of the current CPI-adjustment mechanism argue that the elderly buy different things than the urban worker (around whom the CPI is constructed), and if their purchasing habits were reflected in the CPI explicitly, changes in their cost-of-living probably would be higher than the existing CPI shows. This argument became quite heated during the inflationary period in the mid-1970s, when both food and health costs were leading factors pushing up the cost-of-living. The argument continues today.

As yet, it is not clear whether or not such an index, especially constructed around the purchasing patterns of the elderly, would result in a higher measure of the cost-of-living. Early 1970 Consumer Expenditure Survey data do suggest that families with a head of household over age 65 have different spending patterns than families generally -- they spend more of their incomes on food, medical costs, fuel and utilities, and less on transportation and clothing. One analysis done by the Bureau of Labor Statistics based on the purchasing patterns derived from the Consumer Expenditure Survey suggests that during the period 1973 through 1978 there were few significant differences in the overall CPI versus an experimental one constructed around the elderly. This should not be taken as a conclusive finding, but only a rough indication of what the experience was.

Furthermore, there is the question of whether a CPI for the elderly would be appropriate for social security as whole, for many of its beneficiaries are younger -- they are on the rolls because of disability or as survivors of deceased insured workers. And finally the question of whether there should be a CPI for the elderly raises the question of whether there should be a CPI for various other identifiable segments of the population, such as students, the poor, the unemployed etc. -- a development which in addition to raising considerable public confusion, would be extremely cumbersome administratively.

SUMMARY OF RECENT RECOMMENDATIONS

The following chart is a summary of recent recommendations made by various groups for changes in the way the cost of living adjustments are calculated for the social security program.

Cost of Living Increases

Advisory Council on Social Security.	Adjust benefits twice a year whenever prices have increased at least 3%.
National Commission on Social Security.	Benefits should rise only as fast as wages when average wages rise slower than prices, with later "catch-up" increases when wages rise faster than prices. A special price index for the elderly should be constructed and considered for use in social security.
President's Commission on Pension Policy.	Maintain annual adjustments based on increase in CPI or through special index for the retired.
Congressional Budget Office.	Suggests several proposals to reduce size of benefit increases: 1. Limit increase to lower of wage or price index. 2. Limit increase to 85% of CPI. 3. Use Personal Consumption Expenditures chain index of National Income and Product

	Accounts, instead of the CPI.
	4. Move effective date for benefit increase to October (instead of July).
Carter Administration's FY82 Budget.	Use new CPI (rental equivalency approach to compute benefit increases beginning in 1982.

LEGISLATIVE INTEREST

A number of bills have been introduced during the 97th Congress on the automatic benefit increase provision and a number of proposals are being discussed with respect to achieving budgetary savings. The Reagan Administration proposal was described in the section on size of the benefit increase. The Social Security Subcommittee of the Ways and Means Committee gave tentative approval to a two-step benefit increase in 1982. The proposal, contained in H.R. 3207 (Pickle), would provide benefit increases in May and October 1982 which together would be larger than the present law increase in July, 1982. Subsequent increases would then be paid in October of each year (the first month of the fiscal year), rather than July. Following that tentative action by the subcommittee, the Ways and Means Committee included that provision with one modification (recommended by the subcommittee) in its recommendations for meeting its target for spending reductions for the FY82 budget: the first step of the increase would payable in July rather than May.

Bills introduced in the 97th Congress can be grouped by their general purpose:

-- provide for semiannual increases (in lieu of the present annual adjustment)
H.R. 418 (Quillen)
H.R. 534 (Roe)
H.R. 2062 (Traxler)

-- protect the integrity of the CPI, provide for a CPI for the elderly
S. 463 (protect CPI) (Goldwater)
H.R. 578 (CPI for the elderly) (Roybal)

-- provide that benefits for certain other Federal or federally assisted programs cannot be reduced or terminated because of increases in social security benefits
H.R. 192 (Duncan)
H.R. 1566 (Addabbo)
H.R. 2096 (Bouquard)

H.R. 3207 (Pickle)
-- two-step increase in 1982, moving increase permanently to an October payment

date after 1982.

LEGISLATION

N/A

96th Congress Legislation

HEARINGS

U.S. Congress. House. Select Committee on Aging. Subcommittee on Human Services. Inflation and its impact on the elderly. Hearing, 95th Congress, 2d session. Hearings held in Bridgeport, Conn., on Sept. 25, 1978.
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U.S. Congress. Senate. Committee on the Budget. First Concurrent Resolution on the Budget. Joint hearings with the Subcommittee on Intergovernmental Relations of the Committee on Governmental Affairs. 96th Congress, 2d session. Vol. II. Washington, U.S. Govt. Print. Off., 1980. 274 p.

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U.S. Congress. Senate. Special Committee on Aging. The impact of rising energy costs on older Americans. Hearing, 95th Congress, 1st session. Apr. 7, 1977. Washington, U.S. Govt. Print. Off., 1977. 410 p. Part 5: Washington, D.C.

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U.S. Department of Labor. Bureau of Labor Statistics. Consumer expenditure survey: interview survey, 1972-73. Bulletin 1997. Washington, U.S. Govt. Print. Off., 1978.

----- The consumer price index: concepts and content over the years. Report no. 517, May 1978: 27 p.

Appendix 2

MATERIAL RELATED TO HEARING

ITEM 1. LETTER TO SENATOR JOHN HEINZ, CHAIRMAN, SPECIAL COMMITTEE ON AGING, FROM JAMES M. HACKING,[1] ASSISTANT LEGISLATIVE COUNSEL, NATIONAL RETIRED TEACHERS ASSOCIATION/AMERICAN ASSOCIATION OF RETIRED PERSONS, DATED JULY 1, 1981

DEAR SENATOR HEINZ: During recent hearings held by the committee on the subject of social security indexing, you requested that I submit for the record specific information regarding the sources of income of the over 350,000 additional elderly persons whose income fell below the poverty level in 1979.

Based on 1978–79 statistics compiled by the U.S. Census Bureau, we were able to construct the following table which compares the number of poverty-status aged persons in 1978 and 1979 by their source of income. The Census Bureau tables from which Table I was constructed are also attached.

Table I indicates that the majority (59 percent) of the additional aged persons falling below poverty in 1979 were dependent upon social security and "all other" income [III(e) (2)]. "All other" income is defined as private pensions, public pensions, annuity income, dividends, interest, rent, and alimony. Thus, poverty rates increased in 1979 mainly for aged persons dependent on non-social security (or private) sources of income. It is interesting to note that poverty rates declined slightly in 1979 for elderly persons whose sole source of income was either earnings or social security, indicating the role of both sources in protecting real income.

TABLE I.—SOURCES OF INCOME OF POVERTY STATUS, PERSONS AGE 65 AND OVER, 1978–79

Source of income	Number of persons below poverty level (in thousands)		Differences, 1978–79	
	1978	1979	Number (in thousands)	Percent of total
Total	3,233	3,587	354	100
I. Earnings only	33	29	−4	—
II. Earnings and income other than earnings	182	189	7	2
III. Income other than earnings only	2,903	3,246	343	97
(a) Social security only	1,132	1,089	−43	....
(b) SSI only	165	167	2	....
(c) Other income only	73	97	24	(7)
(d) SSI—social security only	487	529	42	(12)
(e) Social security and other income only	946	1,218	272	(77)
(1) Social security and other transfer payment only [1]	49	112	63	(18)
(2) Social security and all "other income" only [2]	897	1,106	209	(59)
(3) Other combinations	99	145	46	(13)
IV. No income	115	123	8	2

[1] Other transfer payments include public assistance, unemployment compensation workmen's compensation, veterans payments.
[2] All other income includes dividends, interest, rent, pensions, government employee pensions, alimony, annuity income.
Source: U.S. Bureau of the Census, "Characteristics of the Population Below the Poverty Level: 1978" (Series P–60, No. 124) and unpublished data from March 1980 Current Population Survey.

I believe the Census Bureau statistics corroborate the contention made in my testimony that social security cost-of-living adjustments are extremely vital to the low-income elderly, since inflation is rapidly eroding the value of their non-social security income components. If high inflation continues and if less-than-full social security cost-of-living increases are provided, then we can expect even larger poverty rate increases to occur among the lower income elderly in the future as well as a more rapid decline in the real income of all the elderly.

Sincerely,

JAMES M. HACKING,
Assistant Legislative Counsel.

[1] See statement, page 284.

ITEM 2

THE ACCURACY OF THE CONSUMER PRICE INDEX FOR SOCIAL SECURITY COST-OF-LIVING ADJUSTMENTS

By Thomas C. Borzilleri, Ph.D., Consultant

May 1981

PREFACE

This study was prepared for the American Association of Retired Persons and the National Retired Teachers Association, 1909 K Street N.W., Washington, D.C.

The author wishes to acknowledge the help of a number of persons at the Department of Labor, Bureau of Labor Statistics, who provided both data and technical information on index construction: Patrick Jackman for historical data on subcomponent price indices, Ray Gieseman for assistance with the Consumer Expenditure Survey documentation, Dr. Robert Hagemann for a number of technical discussions and information developed during his own work on this subject. The views expressed in this study however are those only of the author.

Thanks are also due to Mr. Peter Moyer who processed the data used in this analysis both efficiently and successfully.

THE ACCURACY OF THE CONSUMER PRICE INDEX FOR SOCIAL SECURITY COST OF LIVING ADJUSTMENTS

Summary

The purpose of this study is to investigate the accuracy of the Consumer Price Index (CPI) in the context of social security cost of living adjustments. The CPI program prices a fixed market basket of goods and services, approximately representative of the market basket of the "average" U. S. consumer. In recent years, a significant part of the recorded increase in the CPI has been caused by rising mortgage interest rates and rising home prices. Since the retired tend to purchase homes with far less frequency than the average consumer represented in the CPI, it is argued that use of the CPI for social security cost of living adjustments has resulted in excessive benefit increases. This assertion in turn, has led to proposals to limit social security cost of living adjustments to some fixed percentage of the increase in prices indicated by the CPI.

It is also asserted however, that use of the CPI has led to an underadjustment of social security benefits. Proponents of this view *also* cite differences between the average consumer's market basket and that of the retired. Since the aged spend a higher percentage of their consumption budgets than the average consumer on food, medical care, and home fuel, and since price increases for these goods and services have been acute in the 1970's, it is argued that the CPI, rather than overstating inflation, has been understating its effects on the retired. Hence, in this view, use of the CPI has resulted in an undercompensation to social security recipients for the inflation losses they have experienced.

This study addresses these issues in detail. Using the detailed version of the same data from which the Consumer Price Index is in large part constructed, the 1972-1973 Consumer Expenditure Survey, and using much the same methodology as that used by the Bureau of Labor Statistics in the official CPI, market baskets consisting of 44 categories of goods and services consumed by the aged, social security recipient population are defined and estimated. Each of these components is updated from the 1972-1973 base period through the first quarter of 1980, using matching component price indices published by BLS. Comparisons are made between the social security cost of living adjustments made during the era of automatic adjustments with the CPI, with what these adjustments would have been if changes in the cost of the social security recipient market basket had been used instead.

FOR THE PURPOSE OF THIS ANALYSIS, HOMEOWNER SHELTER COSTS ARE DEFINED IN A TOTALLY DIFFERENT MANNER THAN THAT USED IN THE OFFICIAL CPI. The definition used here is simply the house payment, the sum of annual principal and interest payments made during the base period. Further, these payments are fixed throughout the period of analysis. In effect, we adopt the most conservative possible assumption concerning the home purchase behavior of the social security population: no one in this population ever purchased a new home or ever bore higher mortgage interest rates throughout the entire 8-year period of analysis.

Other homeowner costs, property taxes, property insurance, and repairs and maintenance, as well as rental costs for the renter population, are increased over time according to the price changes indicated by appropriate component price indices. The same procedure is followed

for 39 other components of the social security recipient market basket: average dollar amounts spent on each category are estimated for the 1972-1973 period and increased over time by the price changes indicated by matching component indices.

Although the above definition of homeowner shelter costs was adopted primarily to provide a very conservative test of the shelter cost - overcompensation argument, this definition appears superior to the official CPI definition when the purpose of the index is to adjust social security benefits or other tax financed public programs. Cost of living adjustments in this context, trigger tax increases on the working population, taxes that really reduce the worker's standard of living and disposable income. The index which triggers these tax increases should, to the extent possible, attempt to insure that the recipient of cost of living adjustments has also had a real reduction in living standards, not a theoretical one. While the CPI registers an increase when mortgage interest rates rise, would an individual increase the level of private financial support to an aged or poor, homeowning relative simply because of this factor? No homeowner, aged, poor or otherwise, bears any real increase in the cost of living when interest rates or home prices rise except indirectly through property taxes. House payments are fixed and theoretical cost definitions, the offical CPI version, rental equivalence versions, or other versions of user costs which are affected by theoretical gains and losses should not be used to trigger real tax increases.

Given this definition of homeowner shelter costs, the major findings of this study are as follows:

1. Past Differences in Inflation Rates Were Small:

Differences between the rate of inflation indicated by the CPI and the rate of inflation indicated by the change in the cost of the social security market basket, even given the conservative shelter cost assumptions, were found to be quite small.

	CPIW	Social Security Market Basket	
		Excluding Cash Contributions	Including Cash Contributions
75-76	6.4	6.6	6.6
76-77	5.9	6.2	6.1
77-78	6.5	6.5	6.5
78-79	9.9	8.6	8.7
79-80	14.3	12.3	12.5

Source: See text; the category "Cash Contributions" is not used in the official CPI, but such contributions were found to comprise a significant portion of the market basket. Hence, two versions were estimated.

Over the entire era of automatic indexing, benefits have been increasing at an annual average rate of 8.6 percent a year while the social security market basket has been increasing at an average rate of 8.0 percent a year. Relaxing the shelter cost assumption would further reduce this difference. These results are quite consistent with a very recent analysis of differences between the inflation rates for various subgroups of the U. S. population (Hagemann, 1981) and two previous studies of the CPI issue as it relates to the retired (Borzilleri, 1978, DRI, 1980). It appears that rough economic justice has been done

and no <u>major</u> overcompensation or undercompensation has occurred.

2. <u>Benefits Have Been Both Underadjusted and Overadjusted</u>:

In 1976 and 1977, the CPI increased by less than the social security market basket and benefits were underadjusted. In 1979 and 1980, the social security market basket increased by less than the CPI and benefits were overadjusted. In view of both positive <u>and</u> negative errors, no simple rule to cap social security cost of living increases at some percentage of the CPI is appropriate. If, for example, past benefit increases had been capped at 85 percent of the CPI increase, social security benefits would have increased by an average annual rate of 7.3 percent while the social security market basket was increasing at an annual rate of 8.0 percent. Again, it must be emphasized that this market basket cost was calculated with conservative shelter cost assumptions. Relaxing these assumptions would increase the losses of 1976 and 1977, reduce the gains of 1979 and 1980 and create a loss for 1978. <u>In short, if such a cap had been in effect throughout the 1975-1980 period social security benefits would have been significantly underadjusted throughout this period</u>.

The net effect on social security beneficiaries of both over and underadjustment depends upon when retirement occurred. For the average single social security recipient 62 or older when the 1972-1973 Consumer Expenditure Survey was taken, the gains and losses from overadjustment and underadjustment <u>totaled</u> a gain of approximately $82. For couples, gains and losses over the 6-year period totaled a gain of $133.00.

Clearly for this segment of the retired population, persons who are today 70 or older, "windfalls" have been very small. Again relaxing the shelter cost assumption, it would not be unreasonable to estimate such windfalls at zero.

3. Expenditure Weights for the Retired Are Different From Those of the CPI.

Comparisons of the current weights in the CPI with those of the social security market basket indicate major differences in expenditure patterns. The table below helps to explain why the social security market basket increased almost as rapidly as the CPI in spite of the fact that mortgage interest rates and home prices were not included in it. The CPI weights are as of December 1979 while the social security recipient market basket weights are as of the first quarter 1980.

Percentage of the Market Basket, By Category

	CPI	Social Security Market Basket
Food and Beverages	20.4	25.5
Shelter	28.0	17.9
Fuel and Utilities	6.4	12.2
Furnishings and Operations	7.3	6.2
Clothing	5.1	4.8
Transportation	20.9	17.7
Medical Care	4.4	9.9
All Other Goods and Services	7.5	5.8
	100.0	100.0

Source: See text; Table 8 presents this comparison for all 44 categories used in this study.

Food, Fuel and Utilities, and Medical Care play a much more important role in the market basket of the retired. This greater than average importance, coupled with the greater than average rate of inflation in these three categories in the 70's, offset or almost offset the major differences in shelter costs between these two inflation measures.

These weights also have implications for future benefit increases. To the extent that movements in the CPI are generated by changes in the price of homes or mortgage interest rates, social security recipients will be overcompensated. To the extent that such changes occur because of food, fuel or medical care prices, the aged will be undercompensated. These differential weights imply the necessity for the development of a separate price index to adjust the social security benefits of the retired.

In summary, the findings of this study indicate that in spite of differential homeowner shelter costs, the social security recipient population has not been significantly overcompensated or undercompensated with the use of the CPI over the past era of automatic indexing. The point remains however, that the CPI was not designed for the purpose of indexing public programs and it cannot do all jobs equally well.

The use of a price index should dictate all aspects of its form. Given the importance of indexing to the retired population, the high cost involved to provide cost of living protection to social security recipients, the questionable definitions used by the CPI (in a public program context), and the differential weights for various categories of goods and services reported above, there is no assurance that the rough economic justice which obtained in the past will also obtain in the future. A separate

index based on the market basket of goods and services consumed by the social security recipient population with these goods and services defined appropriately for purpose of the index, appears far more appropriate than the various ad hoc proposals currently under discussion.

If the objective of public policy is to improve the accuracy of social security cost of living adjustments, this objective is unlikely to be realized by continued reliance on the all-purpose CPI, switching to another all-purpose index like the Personal Consumption Expenditure Price Index, switching to and fro between the CPI and a wage index, or arbitrarily capping benefit increases. There is no substitute for a cost of living index specific to the population in question and designed expressly for the purpose of social security benefit adjustments.

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I. INTRODUCTION

In recent years, use of the Consumer Price Index (CPI) to calculate the appropriate cost of living adjustment to social security benefits has become quite controversial. The CPI is constructed such that it is quite sensitive to both housing prices and mortgage interest rates. In times of rising real estate prices and restrictive monetary policy such as recently experienced in the U. S. economy, the CPI overstates the actual inflation rate experienced by homeowners who own homes purchased during an era of lower prices and lower interest rates. In fact, just as is the case with any other good or service monitored by the CPI, only those who actually purchase the good in question, in this case a home, actually bear the higher price.

It is a matter of fact that the aged are far less likely to bear these higher shelter costs than is the case for the "average" consumer. More than 70 percent of the aged own their own homes and 80 percent of these are free and clear of mortgage debt. Further, according to the 1977 Annual Housing Survey (HUD, 1979), while approximately 8 percent of the overall U. S. population purchased a house in that year, only 1.7 percent of the households headed by a person 65 or older did so. Hence, whatever the degree of inflation overstatement for the average U. S. homeowner, it is even greater for the aged.

The above observations concerning the shelter cost component of the CPI have led critics of the current method of providing inflation protection to social security recipients, to charge that the aged are receiving windfall benefits and are being overcompensated for inflation

they really don't experience. This, in turn, has led to proposals to limit cost of living increases to some fixed percentage of inflation as measured by the CPI or to switch between the CPI and a wage index, whichever yields the lower measured increase.

Defenders of the current system of indexing, while acknowledging these shelter cost arguments, point out that the CPI market basket consists of more than just this one component. Previous research (Borzilleri, 1978, DRI, 1980) has indicated that a proper market basket of goods and services consumed by the aged would give much higher weight to fuel, food and medical care since these components absorb much more of the elderly's total consumption expenditures than is the case for the "average" consumer monitored in the CPI. Indeed, since these items had greater weight in the market basket and since price increases in these particular goods and services were acute in the 1970's, both studies found that use of the CPI to adjust social security benefits had resulted in a slight underadjustment of benefits. Neither of these studies, however, used data which permitted investigation of the differences in shelter costs which have now become the center of controversy.

Clearly, neither assertions of the shelter cost argument nor reference to previous research which neglected it but found other goods and services of particular importance to the aged rising faster than the overall price level, are sufficient to provide policy guidance on a matter of such importance. Social security benefits are the only source of retirement income which provides significant protection against the erosion of purchasing power and hence, proper cost of living adjustments are exceedingly important to the social security

population. At the same time however, it must be recognized that these adjustments are expensive: the 14.3 percent increase which took effect in June 1980 was expected to cost social security tax-payers an additional $17 billion in that year alone. Given the importance of the social security inflation protection mechanism to recipients and the significant costs to the taxpayer of providing that protection, is this protection being provided properly?

The purpose of this study is to address the above question in detail. Using the same data from which the Consumer Price Index is in large part constructed, the 1972-1973 Consumer Expenditure Survey (CES), and using much the same methodology as that used by the Bureau of Labor Statistics (BLS) in the official CPI, market baskets consisting of 44 categories of goods and services consumed by the aged, social security, recipient population are defined and estimated. Each of these components is updated from the 1972-1973 base period through the first quarter of 1980, using matching component price indices published by BLS. Comparisons are made between the social security cost of living adjustments made during the era of automatic adjustments with the CPI, with what these adjustments would have been if changes in the cost of the social security recipient market basket had been used instead.

FOR THE PURPOSE OF THIS ANALYSIS, HOMEOWNER SHELTER COSTS ARE DEFINED IN A TOTALLY DIFFERENT MANNER THAN THAT USED IN THE OFFICIAL CPI. The definition used here is simply the house payment, the sum of annual principal and interest payments made during the base period. Further, these payments are <u>fixed</u> throughout the period of analysis. In effect, we adopt the most conservative possible assumption concerning the home

purchase behavior of the social security population: no one in this population ever bought a new home or ever bore higher mortgage interest rates throughout the entire 8-year period of analysis.

Other homeowner costs, property taxes, property insurance, and repairs and maintenance, as well as rental costs for the renter population, are increased over time according to the price changes indicated by appropriate component price indices.

The second section of this report reviews the methodology used in this study and a number of conceptual issues, particularly the proper definition of shelter costs when the purpose of the index is to adjust income transfer programs such as social security. The findings of this study resulted from a significant amount of data processing using a particularly complicated original data source that contained over 2.2 million pieces of consumer expenditure information. As is usually the case in projects of this sort, a number of assumptions and decisions were made during the course of the project that had implications for the study's findings, yet in the final analysis reflected only the investigator's judgement. Section II attempts to make clear exactly how these results were generated.

Section III presents this study's findings. Although these results are discussed in detail in that section, it should be noted at the outset that even using the conservative shelter cost definition, differences between inflation as measured by the CPI and inflation as measured with the social security recipient market basket were found to be quite small. Further, it is important to note that use of the CPI appears to have resulted in an accurate adjustment in 1978, overcompensation in 1979

and 1980 and undercompensation in 1976 and 1977. These results do not indicate that a simple cap on cost of living adjustments is appropriate. If the purpose of such adjustments has been to prevent a significant erosion of social security purchasing power, over the entire era of automatic benefit adjustments, rough economic justice has been done.

The final section of this study discusses the policy implications of this analysis.

II. METHODOLOGY

As indicated in Section I, the procedures used in this study are very similar to those used by BLS to produce the official CPI. The same basic data source, the CES, is used to estimate the market basket of goods and services that is updated over time, except instead of estimating a market basket for the "average" consumer, we do so for the "average" social security recipient and for subgroups of this population. Once the components of the market basket are defined and the weights of each component calculated, like the CPI, the social security market basket is updated over time using official BLS component price indices. In most cases, the definitions of particular goods and services mirror the definitions used in the CPI. The major and most important exception is in the definition of homeowner shelter costs, a complete departure from the official methodology, although there are also a number of other differences. This section of the report discusses the issue of shelter costs, the social security recipient sample drawn from the CES, the reaggregation of the CES data and category definitions, and the component price indices used for the updating from the 1972-1973 base period, through the first quarter of 1980.

Shelter Costs

The official CPI definition of shelter costs includes seven components: residential rent, other rental costs, property taxes, property insurance, repairs and maintenance, financing, and home purchase. It is the latter two about which the social security - CPI controversy has developed.

The weights or importance of financing and home purchase in the CPI were initially derived from the 1972-1973 CES from the expenditures of those consumers who actually purchased a house in those years, approximately 8 percent of the U.S. population. While other consumers represented by the CPI had weights of zero for those components of shelter costs, home purchasers had extremely large weights, consisting of the entire purchase price of the home and the total amount of interest expected to be paid over half the stated life of the mortgage.

These two initial components are updated over time by monthly changes in home prices and monthly changes in mortgage interest rates. By December 1979, these two shelter cost components comprised approximately 20 percent of the Consumer Price Index.

Consideration of this definition of shelter costs in an income transfer context, particularly that of the Social Security System, indicates that it is inappropriate. The purpose of cost of living increases is to prevent inflation from eroding the living standard provided by the benefit level. These increases are accomplished by taxes on the working population, taxes which reduce worker disposable income and worker living standards, but the CPI which in effect triggers these

taxes, does not by construction attempt to insure that beneficiaries realize inflation losses.

When mortgage interest rates increase, the CPI increases but what real losses are incurred by a homeowner who already has a fixed mortgage payment or perhaps no mortgage at all? To be sure, there are theoretical increases in the cost of consuming the services provided by your own home but the taxes that must be paid by workers are not theoretical. In fact, what goes on in mortgage markets or housing markets is irrelevant to homeowners in existing homes except through the workings of the property tax, unless of course, homeowners are considering the purchase of a new home.

As indicated in the first section of this paper, 80 percent of the aged who own homes, have no mortgage at all and the overwhelming majority of the remainder have mortgages negotiated during times of relatively low interest rates. Only 1.5 to 2 percent of the aged bought a new house in 1977 and almost all homeowners, regardless of age, have fixed house payments. None find their real standard of living reduced simply because interest rates or home prices rise. A proper definition of shelter costs in a price index used to adjust publicly funded programs should, to the extent practical, include costs likely to be realized, not purely theoretical ones.

In this study, home ownership costs are defined simply as the house payment and are left fixed throughout the period of analysis. Other components of shelter costs, property taxes and insurance, repairs and maintenance and rent for renters, are adjusted by the percent change in the official BLS index for the component in question. As

indicated earlier, the primary reason this assumption was adopted was to provide an extemely conservative test of the assertion that the aged had received significant windfall benefit adjustments because of the current CPI definition of shelter costs.

It also appears however, that on the basis of the realized versus theoretical cost of living argument discussed above, the definition used in this study is superior to the official definition when the purpose of the index is to trigger a benefit increase or alternatively, a tax to finance it. If workers are to bear a real reduction in their living standards through increased taxes when cost of living adjustments occur, it seems quite reasonable to define the price index, to the extent possible, in such a way that declines in recipient cost of living measured by the index are also likely to be real.

The Social Security Sample

The basic data used in this analysis is the interview portion of the 1972-1973 Consumer Expenditure Survey (CES) undertaken by the Bureau of Labor Statistics in those years for the purpose of revising the Consumer Price Index. The CES actually consisted of two separate components: a quarterly interview panel survey in which each consumer unit in the sample was visited by an interviewer every three months over a fifteen month period, and a diary survey completed by respondents for two consecutive one week periods. The diary portion of the survey collected information on small, frequently purchased items which are difficult to recall even over short time periods.

Investigation of the shelter cost issues in the CPI debate necessitated the use of the interview CES results, so-called "Public Use Tape Number Two". This data tape provides annual dollar expenditure amounts by approximately 2,500 separate goods and services for approximately 20,000 households over the 1972-1973 period. No merged version of both the diary and detailed interview data exists and so this analysis is based strictly on the interview portion of the CES.

From the original BLS data tape, a file was created consisting of expenditure and other information for households where the household head was 62 or older and received social security or railroad retirement income in the survey year. Additional restrictions imposed on the sample were that the household consist of only one or two persons, that the household participated in the survey for the entire survey year and that the household was a renter or a homeowner for the full survey year.

The 1972 data contained 1,616 households where all these conditions were met while the 1973 data contained an additional 1,539 households meeting the requirements. Hence total sample size consisted of 3,155 households. Table 1 displays income and social security amounts for various subgroups of the sample population.

The CES sample appears roughly comparable to U. S. averages for the aged population with respect to home ownership characteristics. The sample is comprised of 33 percent renters and 67 percent homeowners while the 1977 Annual Housing Survey indicated that of the population 65 or older, 31 percent were renters and 67 percent were homeowners.

The sample however, overrepresents single persons. It contains 52 percent singles versus 44 percent found in the above survey for persons 65 or older.

TABLE 1

Average Annual Income and Social Security Amounts, 1972 and 1973, Aged Social Security Recipient Households in the CES

	Average Income	Average Social Security	Number in Groups
1972			
One Person Households			
Owners	$ 3,552.28	$ 1,698.23	456
Renters	$ 3,459.95	$ 1,664.19	392
Two Person Households			
Owners	$ 7,761.82	$ 2,634.71	615
Renters	$ 7,529.73	$ 2,538.88	153
1973			
One Person Households			
Owners	$ 4,386.80	$ 1,868.76	441
Renters	$ 3,674.57	$ 1,921.01	351
Two Person Households			
Owners	$ 8,881.63	$ 3,122.68	609
Renters	$ 6,477.65	$ 3,066.67	138
1972-1973			
Total Sample	$ 5,841.17	$ 2,300.75	3,155

Source: Tabulations of the detailed version of the 1972-1973 Consumer Expenditure Survey

Because of these differences, five market baskets of goods and services were calculated for the 1972-1973 period: single renters, single owners, renter couples, owner couples and all social security recipients in the sample. Each was estimated and updated in the same manner and the results are presented in Section III, both unweighted and weighted, with weights derived from the 1976 Current Population Survey. The weights used are discussed in more detail in that section.

Reaggregation of Goods and Services Categories

As indicated before, the BLS tape contains 2,500 specific categories of goods and services expenditures for each of the 20,000 households on the original tape. The second step of this analysis was to define categories of goods and services and reduce these 2,500 categories to a more meaningful and manageable number.

The number and definition of expenditure categories were dictated by the number and definition of component price indices published by BLS. Ultimately, 44 categories were defined, in most cases corresponding excactly with BLS definitions, with the major exception of shelter costs. There were other exceptions however.

The CES contains not only 2,500 categories of goods and services for personal consumption, but also 2,500 categories of goods and services given as gifts. In comparable fashion to the CPI treatment of gifts, each item was allocated to its appropriate personal consumption category.

Cash gifts and contributions however, remained a significant "expenditure" category, averaging $409 in the 1972-1973 period. This category includes charitable and political contributions, as well as payments made on behalf of persons outside the household for educational and medical expenses. Two different definitions of the market basket were used, one including these cash outlays updated over time by the U. S. Average, All-Items CPI and one which did not include this component.

Besides the shelter cost definition and the category of cash gifts and contributions used in one version of the market basket, six other categories were used which do not have an exact counterpart, BLS price index. Two of these categories are in transportation and have been defined as "Miscellaneous Automobile Travel Expenses" and "Miscellaneous Other Travel Expenses". Generally, they represent small expenditure amounts and are for odd, difficult to categorize, outlays. Another is defined as "Other Fixed Outlays". This represents all interest charges incurred in the survey year except automobile and mortgage interest. "Other Professional Services" are legal fees, funeral expenses and accounting fees.

Of much more potential importance are two categories in the Medical Care area. "Health Insurance Premiums" are the outlays incurred by members of the sample in the survey year for premium payments while "Medicare Premiums" are similarly out of pocket outlays. Neither of these items is priced directly by BLS as part of the CPI program. As explained below, these components of the market basket were updated using indices for conceptually close categories of goods and services.

TABLE 2

Average Annual Expenditures, 1972-1973,
Households Receiving Social Security, Head of Household, 62 or Older

Category	Amount
Food	
Food at Home	$ 919.98
Food Away From Home	173.71
	$ 1,093.69
Alcohol	$ 30.87
Shelter	
Rent	$ 331.32
Other Rental Costs	41.56
House Payment	99.23
Maintenance and Repairs	213.66
Property and Homeowners Insurance	48.93
Property Taxes	210.06
	$ 944.76
Fuel and Utilities	
Fuel Oil, Coal, Bottled Gas	$ 76.76
Electricity	112.28
Piped Gas	64.93
Gas and Electricity (combined bills)	27.51
Other Utilities and Public Services	164.24
	$ 445.72
Furniture and Operations	
House Furnishings	$ 188.95
Housekeeping Services	121.21
	$ 310.16
Clothing	
Mens and Boys Clothing	$ 53.65
Womens and Girls Clothing	118.82
Infants Clothing	4.90
Other Apparel Goods	19.76
Footwear	32.70
Apparel Services	47.76
	$ 277.59
Transportation	
New Cars	$ 165.00
Used Cars	57.26
Gasoline	156.57
Auto Maintenance and Repairs	56.20
Other Private Transportation Goods	40.29
Other Private Transportation Services	151.09
Public Transportation	47.97
Miscellaneous Auto Travel Expenses	2.29
Miscellaneous Other Travel Expenses	44.75
	$ 721.42
Medical Care	
Medical Care Commodities	$ 75.31
Professional Services	135.69
Other Medical Care Services	28.65
Health Insurance Premiums	108.12
Medical Premiums	75.62
	$ 423.39
Other Outlays	
Entertainment Goods	$ 56.80
Entertainment Services	42.60
	$ 99.40
Tobacco	$ 52.83
Personal Care	78.46
Education	1.79
Other Professional Services	10.56
Other Fixed Outlays	86.39
Cash Gifts and Contributions	408.95
	$ 638.98
Total Market Basket Cost, 1972-1973	$ 4,985.98

Although only 44 price indices were available for the market basket updating, initial computer runs were made using 91 separate categorizations. Average annual expenditure amounts were calculated for both 1972 and 1973 for one and for two person households, further tabulated by three shelter categories: renter, owner with no mortgage and owner with a mortgage.

After analysis, the final 44 categories were selected and the category of owner with a mortgage was combined with the other homeowner category. Table 2 displays the combined 1972-1973 average annual outlays for all social security recipients in the sample. Similar tables, not presented in this report, were produced for one and two person households by the renter-owner classification.

These five tables of expenditures comprised the five base period market baskets which were updated over time.

Updating for Price Changes

Each of the 44 categories was increased quarter by quarter by the percent change in its exact counterpart price index or one closely related. Seasonally unadjusted components of CPIW were used for the updating since social security benefits are adjusted with the wage and clerical workers' CPI rather than the newer, all urban consumer index.

Since the CES expenditure information was collected over 24 months in 1972 and 1973, the arithmetic average of each index was calculated over the same period to provide an initial index point.

As indicated earlier, the component "House Payment" was left fixed over the entire period as was the category "Other Fixed Outlays". The "Miscellaneous Auto Travel" category was increased by the gasoline CPI while "Miscellaneous Other Travel", "Other Professional Services", and when used, "Cash Gifts and Contributions", were all updated using the all-items CPIW.

The two non-standard medical care categories, "Health Insurance Premiums" and "Medicare Premiums" were updated using indices that seemed quite comparable. For "Health Insurance Premiums", the "Medical Care Services Index" which monitors the prices of professional medical services, hospital and other medical care services was used. For "Medicare Outlays", the "Other Medical Care Services Index" was used. This index relates to the prices of hospital and other medical care services. It should be added that both of the above indices moved at approximately equal rates throughout the period and using one or the other made insignificant alterations to the outcome.

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III. FINDINGS

As discussed in Section II, 1972-1973 market baskets of goods and services consumed by social security recipients were estimated and updated through the first quarter of 1980 by the percent change in prices as measured by official CPI component indices. The results of this updating are presented in Tables 3 and 4 which give the dollar values of the market baskets at various points in time and Table 5 which gives the percent changes in these market baskets first quarter to first quarter. Table 5 then, yields the percent change in social security benefits which would have occurred if these alternative measures of inflation were used for benefit adjustment instead of the official CPI.

It should first be noted that differences between the measures are relatively small. Whatever "errors" were made in the past, they certainly did not result in major overcompensation or undercompensation.

Second, it appears that on the basis of these alternative measures, social security recipients have been both undercompensated and overcompensated over the years. Even with the conservative shelter cost assumptions, benefits were underadjusted in 1976 and 1977 and appeared accurate in 1978. In 1979 and 1980, the years of overcompensation, "errors" averaged 14 to 15 percent. Again, however, it must be reemphasized that these results are generated by assuming that social security recipients never bought new homes and never bore higher mortgage interest rates from the 1972-1973 period thru 1980. Clearly relaxing this assumption would reduce the "errors" involved in 1979 and 1980 and increase those of 1976, 1977 and 1978.

TABLE 3

Annual Dollar Cost of Social Security Recipient
Market Basket, 1975-1 thru 1980-1 (Excludes Cash Gifts and Contributions),
Updated by Component CPI's.

	One Person Households		Two Person Households		All Recipients
	Owner	Renter	Owner	Renter	
75-1	4138	3554	7493	6565	5526
76-1	4425	3773	7995	6978	5892
77-1	4713	3992	8489	7385	6255
78-1	5028	4254	9027	7860	6658
79-1	5445	4631	9796	8564	7229
80-1	6135	5100	11074	9492	8117

Source: Tabulations from 1972-1973 CES, updated by Component CPI's as discussed in text. "All Recipients" percent changes are unweighted.

TABLE 4

Annual Dollar Cost of Social Security Recipient Market Basket, 1975-1 thru 1980-1, (Includes Cash Gifts and Contributions), Updated by Component CPI's.

	One Person Households		Two Person Households		All Recipients
	Owner	Renter	Owner	Renter	
75-1	4546	3806	8195	7101	6023
76-1	4859	4041	8742	7548	6421
77-1	5172	4276	9280	7989	6815
78-1	5517	4557	9869	8502	7255
79-1	5982	4963	10722	9270	7884
80-1	6749	5480	12132	10299	8866

Source: Tabulations from 1972-1973 CES, updated by Component CPI's as discussed in text. "All Recipients" percent changes are unweighted.

TABLE 5

Percent Change in Prices,
Social Security Market Baskets and Official CPI,
1976-1 thru 1980-1.

Excluding Cash Gifts and Contributions

	Singles		Couples		All Recipients	Official CPIW
	Owners	Renters	Owners	Renters		
76	6.9	6.2	6.7	6.3	6.6	6.4
77	6.5	5.8	6.2	5.8	6.2	5.9
78	6.7	6.6	6.3	6.4	6.5	6.5
79	8.3	8.9	8.5	9.0	8.6	9.9
80	12.7	10.1	13.0	10.8	12.3	14.3
Mean	8.2	7.5	8.1	7.7	8.0	8.6

Including Cash Gifts and Contributions

	Singles		Couples		All Recipients	Official CPIW
	Owners	Renters	Owners	Renters		
76	6.9	6.2	6.7	6.3	6.6	6.4
77	6.4	5.8	6.2	5.8	6.1	5.9
78	6.7	6.6	6.3	6.4	6.5	6.5
79	8.4	8.9	8.6	9.0	8.7	9.9
80	12.8	10.4	13.2	11.0	12.5	14.3
Mean	8.2	7.6	8.2	7.7	8.1	8.6

Source: Tabulations from 1972-1973 CES, updated by Component CPI's as discussed in text. "All Recipients" percent changes are unweighted.

Additional perspective on this issue may be gained by considering how social security recipients who were retired in 1972-1973 have fared over the entire period of automatic cost of living increases. In the 1972-1973 CES, the average monthly social security benefit received by a single person in 1973 was $157.66 while for a couple it was $259.36. Congressionally legislated increases of 7 percent in March, 1974, 4 percent in June 1974 and 8 percent in June 1975 had increased these benefits to $189.49 and $311.71 at the outset of the automatic adjustment era. From June 1975 thru June 1981, this "average" single social security recipient will have received a total social security income of $16,411. If, over this same period benefits had been adjusted using the social security market baskets, total benefits received would have been $16,329. Hence, even given the shelter cost assumption the total six-year sum of windfall benefits for this average single social security recipient would have been $82.00.

Couples receiving $311.71 at the beginning of the automatic adjustment period would have received $26,995 over the 1975-1981 period. Had the social security market basket been used instead, payments would have totaled $26,862, a six-year windfall sum of $133.00.

Given the size of these "windfalls", the fact that the above calculations neglect losses associated with the timing of the increase, and the restrictive and unrealistic shelter cost assumptions imposed, in the author's view, these windfalls over the period are essentially zero. At a minimum, there is no evidence of past major overcompensation brought about by use of the CPI to adjust social security benefits.

Alternative Weighing of Subgroups

Results presented so far pertain to differences between the unweighted, all recipient, social security market basket and the official CPI. As indicated in Section II, however, the social security sample from the CES appears to contain proper percentages of owners and renters but more single persons than is appropriate on the basis of U. S. averages.

Table 6 presents the sample weights and those from the 1976 Current Population Survey. These 1976 weights were used to calculate alternative estimates of an "All Recipient" index, by using the subgroup market baskets weighted for their representation in the U. S. population as of 1976.

As Table 7 indicates there is very little difference between the weighted and unweighted versions of the all recipient index. In all years except 1980, the indices yield similar results and the conclusions established earlier concerning both the small relative differences between indices and both over and undercompensation over the period remain unchanged.

TABLE 6

Demographic and Homeowner Status Weights.
Current Population Survey and CES Sample Population.

	1976 U. S. Averages, Household Heads 65 +	1972-1973 Social Security Sample, Head 62 +
One Person Households		
Owners	.25	.28
Renters	.19	.24
Two Person Households		
Owners	.46	.39
Renters	.10	.09
	1.00	1.00

Source: CES weights from tabulation of CES Public Use Tape Number 2, as discussed in text. CPS weights derived from Current Population Survey, Series P-20, #311, March 1977.

TABLE 7

Weighted and Unweighted Percent Change in Prices,
All Recipient Market Basket, 1976-1 thru 1980-1.

	Social Security Market Baskets				Official CPI
	Including Cash Contributions		Excluding Cash Contributions		
	Weighted	Unweighted	Weighted	Unweighted	
1976	6.6	6.6	6.6	6.6	6.4
1977	6.1	6.1	6.2	6.2	5.9
1978	6.5	6.5	6.5	6.5	6.5
1979	8.7	8.7	8.6	8.6	9.9
1980	12.4	12.5	12.2	12.3	14.3
Mean	8.0	8.1	8.0	8.0	8.6

Source: See text

Implications for Future Benefit Increases

There is no evidence that use of the CPI has resulted in major over or undercompensation during the past five years. It is crucial to note, however, that even though the official CPI was in large part driven by shelter costs and the social security market baskets were not, overall measured price increases were similar. This, in turn, implies other differences in the two market baskets.

Table 8 bears this out. The importance of food, fuel and utilities and medical care is much greater in the social security market basket than is the case for the "average consumer" in the CPI. As a percentage of total consumption, fuel and utilities absorb approximately 6.4 percent of the average consumers' budget while they absorb 12.2 percent of that of the social security market basket. In the area of medical care, budget shares are 4.4 percent versus 9.9 percent. Food yields 20.4 versus 25.5 percent. On the other hand, the average consumer market basket has higher weights for shelter costs (given the different definitions used here), furnishings and operations, clothing and transportation.

The major implication of these differential weights is that the similarity of overall measured inflation occurred because on average over the period in question, food, fuel and medical care increased at greater than average rates, offsetting or almost offsetting movements in the CPI caused by precipitous increases in shelter costs.

TABLE 8

Relative Importance of Goods and Services,
CPIW-December 1979 versus Social Security Market Basket,
First Quarter, 1980

Category		Percentage of Consumption CPIW		SSMB
Food and Beverages		20.353		25.465
Shelter		28.038		17.881
Rent	4.982		6.212	
Other Rental Costs	.502		.963	
Home Purchase	9.137		—	
Finance, Insurance, Taxes	10.163		4.524	
Maintenance and Repairs	3.254		4.960	
House Payment	—		1.222	
Furnishings and Operations		7.256		6.221
Fuel and Utilities		6.372		12.216
Fuel Oil, Coal, Bottled Gas	1.209		3.987	
Gas and Electricity	3.375		5.556	
Other Utilities	1.788		2.673	
Clothing		5.115		4.799
Transportation		20.902		17.742
New Cars	3.946		3.203	
Used Cars	3.622		1.212	
Gasoline	6.429		6.082	
Maintenance and Repairs	1.621		1.293	
Other Private Transportation	4.344		4.024	
Public Transportation	.940		1.928	
Medical Care		4.372		9.865
Medical Commodities	.731		1.427	
Professional Services	1.843		3.051	
Other Services	1.798		.757	
Private Insurance	—		2.632	
Medical Outlays	—		1.998	
All Other Goods and Services		7.592		5.811
		100.000		100.000

Source: Social Security Market Basket from tabulations of CES, updated.
CPIW from Detailed Report, October 1980, Table 7, Pages 29-31.

Very similar results are presented in a recent study by Hagemann (1981) of the Bureau of Labor Statistics. Using the same data as is used in this study, the 1972-1973 Consumer Expenditure Survey, he constructed a price index for retirees and compared it to the CPI. Although his study uses a different definition of retiree and uses three different definitions of shelter costs roughly paralleling BLS experimental definitions ("Rental Equivalence", "Outlays Using Current Interest", and "Outlays Using Average Interest"), his findings indicate that past differences have been small and that certain components of the retirees' market basket are more important to this population than is indicated by the average weights in the CPI: food at home, fuel oil, natural gas, electricity, medical care services and hospital care and insurance. The results of this study, presented in Table 8, are quite consistent with those of Hagemann. 1/

Hence, the accuracy of the CPI future benefit adjustments depends on what prices increase and by how much, phenomenon that should be regarded as essentially random. If future increases in the CPI are caused primarily by increases in mortgage interest rates or home prices, use of the CPI will result in overcompensation of retired social security beneficiaries. If, on the other hand, the primary "culprit" is food, fuel or medical care, use of the CPI will result in underadjusted benefits.

1/ It should be noted that Hagemann found his retirees' index moving slightly faster than the CPI for the 1972-1980 period using the BLS experimental shelter cost definitions.

IV. POLICY IMPLICATIONS

The preceeding sections of this study indicate that during the past, the use of the CPI has provided reasonably accurate social security cost of living increases, but that this result occurred somewhat fortuitously. Within current definitions of CPI shelter costs, the importance of this category is clearly less for the aged than it is for the average consumer. Given the definition used in this study, one more appropriate for social security cost of living adjustments, the shelter cost component is even smaller. Yet, because food, medical care and home energy absorb a much larger share of the retired's consumption budget and because prices for these goods and services rose more rapidly than "average" prices, the cost of living for social security recipients rose almost as rapidly, if not as rapidly, as was indicated by the CPI. Indeed, in some periods (1976 and 1977 and probably 1978), the social security market basket rose more rapidly.

One obvious policy implication of these results is the inappropriateness of capping cost of living adjustments to some arbitrary percentage of CPI increases. Since the past has been characterized by both positive and negative "errors", such a cap provides no assurance that benefits will not be significantly underadjusted in the future. Had such a cap been in place throughout the period of analysis, benefits would have increased by 7.3 percent while the conservatively estimated social security market basket registered an 8.0 percent increase. On the basis of past performance it is very unlikely that this proposal will improve

benefit adjustment accuracy.

A more important policy implication is derived from the finding of significantly different weights for various categories of goods and services in the CPI market basket relative to the social security market basket. This implies that the accuracy of future benefit increases, just as was the case with past benefit increases, depends upon which prices change and by how much. <u>These differential weights point to a separate consumer price index for the retired, if accurate adjustment of benefits is the objective.</u>

The general problem associated with continued use of the CPI for social security adjustments is that it was not designed expressly for the purpose for which it is now employed. The ultimate use of any statistic should dictate <u>all</u> aspects of its form. As indicated in previous sections, the CPI can trigger real tax increases yet it is not constructed to reflect only increases in the cost of living for recipients that are likely to be realized. The shelter cost debate is a clear example of a statistical constuct being "stretched" beyond it's intended purpose. <u>These definitional problems in the CPI, again point to the need to develop a separate CPI for the purposes of social security benefit adjustments.</u>

Given the importance of indexing to the retired population, the high cost involved to provide cost of living protection to social security recipients, the questionable definitions used by the CPI (in a public program context), and the differential weights for various categories of goods and services reported above, there is no assurance that the

rough economic justice which obtained in the past will also obtain in the future. A separate index based on the market basket of goods and services consumed by the social security recipient population with these goods and services defined appropriately for purpose of the index, appears far more appropriate than the various ad hoc proposals currently under discussion.

If the objective of public policy is to improve the accuracy of social security cost of living adjustments, this objective is unlikely to be realized by continued reliance on the all-purpose CPI, switching to another all-purpose index like the Personal Consumption Expenditure Price Index, switching to and fro between the CPI and a wage index, or arbitrarily capping benefit increases. There is no substitute for a cost of living index specific to the population in question and designed expressly for the purpose of social security benefit adjustments.

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