IRET Congressional Advisory

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FIX THE CPI, BUT DON'T KILL JOBS

Federal budget makers may think that tinkering with the consumer price index would be an easy way to cut the deficit. Slower growth of the CPI automatically would trim Social Security cost of living adjustments (COLAs) and would raise taxes by providing smaller yearly increases in the income tax brackets, personal exemptions, and the standard deduction under tax indexing. Social Security recipients who pay income tax on their benefits would lose twice.

Tinkering with the CPI would result in bad tax policy and would be a bad way to deal with the problems confronting Social Security.

Deficit reduction should not be the objective of fixing the CPI. Tinkering with the CPI would result in bad tax and economic policy and would be a bad way to deal with the problems confronting Social Security. There are better ways to balance the budget.

Rising marginal tax rates would reduce incentives to work, save, and invest and would weaken the economy more and more each year compared to current procedures. The weakening economy would eat away at the projected revenue gains, as well as costing jobs and lowering wages.

The CPI is generally viewed as overstating inflation. Some budget makers want the Bureau of Labor Statistics to improve its calculation of the CPI (which it is already doing) or, if BLS won't move far or fast enough, want ad hoc cuts in the annual adjustments to save money for the Treasury.

The Boskin Commission's estimate that the CPI increase may be overstated by 1.1 percent per year may overstate the real problem. The Commission's estimate of errors in the index that were related to quality adjustments - about half the total - is more guess than hard fact. BLS has been studying some of the non-quality technical reforms discussed in the Commission report, and is more likely to adopt them than the quality changes. Also, the CPI - a measure of inflation, not the "cost of living" - fails to incorporate fully the effect of rising taxes on the amount of pretax income needed to buy a given basket of goods and services, and so understates some of the changes in the "cost of living".

But these are quibbles. The more important issue is whether to reduce the adjustments of the tax brackets and exempt amounts. Trimming tax indexing would result in ever-increasing average tax burdens and gradually but continually rising marginal tax rates. Rising marginal tax rates would reduce incentives to work, save, and invest and would weaken the economy more and more each year compared to current procedures. The weakening economy would eat away at the projected revenue gains, as well as costing jobs and lowering wages.

The tax increases associated with the CPI assumptions are designed not only to help reduce the deficit, but also to make room for a variety of tax reductions proposed as part of the budget deal. One of these, the child credit, is an income redistribution policy based on social, not economic,

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objectives. The credit has no redeeming economic virtues and no positive economic incentives. Paying for it with a tax increase that has perverse incentive effects will cost the jobs and reduce the incomes of many of the families with children that the credit is supposed to help. It would be better to substitute additional restraint of government spending to balance the budget and, if necessary, to pay for various non-economic tax cuts, than to tamper with the CPI.

The CPI should be improved for information purposes, not to raise taxes or redistribute income. Not one cent of the projected tax increases from an improvement in the CPI should be kept by Washington. Every penny should be earmarked for incentive-creating tax reduction. Here are four incentive-restoring options: 1) broaden tax indexing to offset inflation plus a bit more (perhaps by some measure of productivity or real income growth); 2) legislate a gradual reduction of marginal tax rates; 3) gradually trim taxes on saving by raising IRA and 401(k) contribution limits, and reduce the payroll tax rate on labor income; 4) totally overhaul the tax system to end its current bias against saving and investment and to flatten and lower the tax rate structure.

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The Congressional Budget Office told the Boskin Commission that, over the first decade, 40% of the direct budget savings (excluding interest) from trimming the CPI would come from tax increases, 60% from cuts in Social Security benefits. No one mentions, however, that the tax increases would eventually outstrip the spending cuts. The tax increases would forever widen over time, as the brackets and exempt amounts are narrowed a bit more each year relative to current practice. If CPI growth were trimmed by 1.1% per year, by the 10th year, the tax on middle income families would be about 10% higher ($200 to $350) than under current procedures; by the 20th year, twice that, and so on. The COLA savings would be much more limited, however, because retirees receive benefits and COLAs only until they die, and life expectancy is rising only slowly. This mix of limited spending cuts and unlimited tax hikes would be as bad a budget agreement as could be devised.

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The CPI does overdo Social Security COLAs, but only modestly. There is no downside for the performance of the economy in correcting the over-payments (only for the welfare of the beneficiaries). However, COLAs aren't the source of Social Security's looming deficits, and trimming COLAs won't save the System. (See Congressional Advisories 59 and 60 for a discussion of Social Security COLAs, the source of the Social Security deficits, and better policy choices.)

We don't need yet another commission to second-guess the experienced people at the Bureau of Labor Statistics. The BLS should continue its efforts - already well advanced - to develop better technical procedures for compiling the CPI free from political manipulation. We don't want a politically appointed panel of experts to meet each year to set ad hoc adjustments of the tax structure, federal retirement programs, and indexed Treasury debt.

Taxpayers and retirees would not be well served by a budget balancing effort that would impose an ever-expanding tax hike and would make Social Security recipients bear most of the spending cuts.

If Congress and the President want to balance the budget by their self-imposed deadline of 2002, they should not rely on stealthy changes in the CPI, but should openly find other spending to trim.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.