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STATEMENT OF

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ASSISTANT COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON CONGRESSIONAL OPERATIONS AND OVERSIGHT

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

118138

ON

A CONSUMER PRICE INDEX FOR RETIREES AND ALTERNATIVES FOR CONTROLLING INDEXING

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to discuss our assessment of the need for a separate Consumer Price Index for retirees and our views on how the indexation of Federal programs might be modified.

NEED FOR A SEPARATE CPI FOR RETIREES?

From time to time it has been suggested that a separate price index be constructed for retirees and used, in lieu of the existing Consumer Price Index (CPI), as the basis for adjusting benefits under the various Federal retirement programs. Some have argued that retirees have been inadequately compensated for increases in the cost of living, while others maintain that adjustments based on the CPI have been overly generous.

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We undertook to test these arguments by constructing a CPI for retirees, using readily available data from the Bureau of Labor Statistics (BLS). We reweighted the expenditure and geographic data to reflect the consumption patterns and geographic distribution of the retired population. Using BLS's methodology for the CPI, we then recomputed the consumer price index for each of 39 months, starting with January 1978, and compared the resulting index with the existing CPI.

There are certain unavoidable technical limitations in the GAO-constructed CPI for retirees, but we believe it gives a reasonable approximation of how such an index would have behaved during the period covered by our review. Because it was already a matter of debate, we also decided to test the consequences of using a new method of calculating the housing component of the CPI. The results of this work and the details underlying it will be contained in a report which we expect to issue shortly. We will supply copies of the report to the committee as soon as it is published, but the main points can be summarized rather briefly.

We found no evidence that a separate CPI for retirees in the aggregate would have deviated markedly from the current CPI during the period covered by our review, once the treatment of housing in the CPI is corrected. In our view--a view which is widely shared --the current treatment of housing costs in the CPI has significantly exaggerated the measured rate of price increase in recent years.

BLS has decided to revise its way of computing housing costs. We agree with the need for that change. To all intents and purposes, making this change in the current CPI would eliminate the differences between that index and the one we constructed for retirees. Accordingly, we recommend against creating a separate price index for retirees.

We note, however, that BLS does not plan to make this change to the CPI-W (the index currently used to make adjustments in Federal retirement programs) until 1985, even though the data needed to make the change is expected to be available in January 1983. But, there is another available index, called the CPI-U. This one is based on the consumption patterns of all urban households, rather than being limited to urban wage earners and clerical workers, which is the population base of the CPI-W.

The broader population base of the CPI-U appears to make it better suited for use in indexing programs. A second advantage is that the housing component of the CPI-U will be corrected in 1983, two years earlier than for the CPI-W. In a report we issued in April of 1981, entitled "Measurement of Homeownership Costs in the Consumer Price Index Should Be Changed," (PAD-81-12), we recommended that Congress enact legislation requiring that the CPI-U be used, rather than CPI-W, for future cost-of-living adjustments in Federal retirement programs. The results of our recent study add further support to this view.

It is impossible to predict with confidence the budgetary effect of our recommendation. Such a prediction would entail forecasting future movements of specific components of the CPI. Such forecasts are notoriously difficult to make and unreliable. OMB has estimated that the change might increase outlays by $2 billion. There are other forecasts, however, which indicate that the costs would be negligible. To this we can only add that, if the change had been in effect during the period covered by our study, it would have reduced outlays in the four major Federal retirement programs by $13.8 billion.

To return, for a moment, to the question of a separate index for retirees, our conclusion that one is not needed now does not permanently foreclose the issue. Consumption patterns of retirees have certainly differed from those of the working population. And it is possible that future price changes would yield divergences greater than those we observed, although it would be highly speculative to predict whether or not this will occur, or in which direction any divergences might appear.

Because of this uncertainty, combined with the sheer size of the Federal retirement programs and their widespread effects, we believe it would be useful to monitor the situation through periodic updating of our work. We suggest that this be done by BLS, which is equipped to do so quite efficiently. If, in the future, a substantial divergence emerges, it might be worth reopening the question.

BRINGING INDEXING UNDER CONTROL

Thus far, we have been focusing on the technical adequacy of the CPI as a mechanism for adjusting Federal retirement benefits. Even if the changes we suggest are made, however, we believe the time has come to face a larger issue, the need to bring indexing as a whole under control. I would like to turn, now, to a discussion of that issue.

We have testified on other occasions that some means of limiting the present indexing system is essential. This view is based on the following considerations:

1. Explicitly indexed programs account for about one-third of the budget. To exclude from consideration the issue of indexation would unnecessarily limit the options available to the Congress as it seeks ways to constrain the budget.
2. The actions necessary to reduce the deficit will require some sacrifice by most Americans. To continue insulating the benefits of one group would be inequitable and would increase the sacrifice required in other sectors.
3. The indexation of entitlement programs has been a major factor in the growth of that portion of the budget which is uncontrollable in the short run. Constraints on indexation are, we believe,

indispensable if the Congress and the President are to regain an increased measure of short-run control over the budget.

We issued a report on this subject in March 1981 entitled "What Can Be Done to Check the Growth of Federal Entitlement and Indexed Spending?" (PAD-81-21). One option which we reviewed involves limiting the inflation adjustment to the level of the average increase in worker pay or the CPI, whichever is less. This alternative moves away from the exclusive use of a price index. The argument for making such a change is based on equity considerations. While, at present, income from indexed entitlement programs is protected against inflation, not all entitlement programs are indexed, and wage earners income is certainly not protected. The result is that in any period in which prices are rising more rapidly than wages, present formulas redistribute income in favor of the indexed groups--thus increasing the burden on wage earners. Using the lesser of a wage or price index would have wage earners and entitlement recipients share equally in the burdens imposed by falling real incomes.

This apparent equity during hard times, however, would not be balanced by equity in good times. Historically, wages have risen more rapidly than prices. If we return to that situation, the proposal would limit benefit increases to the rate of increase in the CPI. Thus beneficiaries would share in the burden of falling real incomes, but not in the benefits of rising real incomes. Such an unbalanced approach appears unfair. While saving money in the short run, it would also leave the indexing system unduly rigid and mechanistic. It does not restore the element of flexibility to the process which we believe is necessary to control and reduce the budget deficit.

The option we prefer for constraining the indexation process is to give the President and the Congress the discretion to modify, through the budget process, the amount of the adjustment indicated by the index. The President could be authorized to recommend a specific percentage adjustment to benefit levels that would take effect unless the Congress acted to change it. This is the same procedure now used to adjust Federal white collar pay. The President might also be authorized to use different rates of indexation at different benefit levels in order to mitigate adverse effects when conditions warrant. This approach would restore flexibility by permitting the President and the Congress each year to make decisions balancing budgetary considerations against the desire to maintain the real level of benefits.

That completes my prepared statement. My colleagues and I would be pleased to answer any questions.