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THE PRESIDENT'S AND OTHER BIPARTISAN ENTITLEMENT REFORM PROPOSALS

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

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THE PRESIDENT'S AND OTHER BIPARTISAN ENTITLEMENT REFORM PROPOSALS

THURSDAY, APRIL 18, 2013

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:31 a.m. in Room B–318, Rayburn House Office Building, the Honorable Sam Johnson [Chairman of the Subcommittee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairman Johnson Announces Hearing on the President's and Other Bipartisan Entitlement Reform Proposals

B–318 Rayburn House Office Building at 9:30 AM
Washington, Apr 11, 2013

Hearing is the First in the Committee's Hearing Series on Entitlement Reform

U.S. Congressman Sam Johnson (R–TX), Chairman of the House Committee on Ways and Means Subcommittee on Social Security, today announced the first in a series of hearings on the President's and other bipartisan entitlement reform proposals. This hearing will focus on using the Chained Consumer Price Index to determine the Social Security cost-of-living adjustment. This proposal was included in the President's Fiscal Year 2014 Budget, the report by the National Commission on Fiscal Responsibility and Reform, and the report of the Bipartisan Policy Center's Debt Reduction Task Force. **The hearing will take place on Thursday, April 18, 2013, in B–318 Rayburn House Office Building, beginning at 9:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

Social Security beneficiaries receive an increase in their benefits, known as the cost-of-living adjustment (COLA), each year there is inflation. Prior to 1972, Congress enacted increases in Social Security benefits on an ad hoc basis. The Social Security Amendments of 1972 (P.L. 92–603) established an automatic process for determining whether a COLA would be provided beginning in 1975.

The Social Security COLA is based on the percentage change in a measure of inflation known as the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI–W). The percentage change is measured by comparing the highest third calendar quarter average CPI–W previously recorded to the average CPI–W for the third calendar quarter of the current year. The COLA becomes effective in December of the current year and is payable in January of the following year. If there is no percentage increase in the CPI–W between the measuring periods, no COLA is payable, as happened in 2009 and 2010. In 1975, the CPI–W was the only inflation measure produced by the Bureau of Labor Statistics (BLS). Since then, other indices have been developed by the BLS.

In December 1996, a Senate-appointed commission to study the CPI, chaired by Michael J. Boskin, Ph.D. (the Boskin Commission) found that both the CPI–W and the later developed Consumer Price Index for All Urban Consumers (CPI–U) overstated inflation in a number of ways. The BLS modified the indices to respond to a number of the Commission's recommendations regarding how these two indices were measured, but did not address their inability to account for the fact that as prices change, consumers will adjust their spending habits across categories of goods (e.g., if the price of beef goes up, consumers might buy pork instead).

In 2002, BLS introduced the Chained Consumer Price Index for All Urban Consumers (C–CPI–U), which accounts for consumer substitution between CPI item categories, as well. According to the 2003 BLS report, *Introducing the Chained Consumer Price Index,* the C–CPI–U is "designed to be a closer approximation to a 'cost of living' index than existing BLS measures." This index cannot be used to deter-

mine Federal program adjustments unless Congress passes, and the President signs, legislation permitting the change.

In announcing the hearing, Social Security Subcommittee Chairman Sam Johnson (R–TX) said, **"Americans deserve action to protect and preserve Social Security, and the inclusion of Chained CPI in the President's budget is a welcome acknowledgement that we must take action to shore up the program for future generations. Since 2010, Social Security has been paying more in benefits than it receives in revenue. According to the Congressional Budget Office, the cash flow deficit for the 10-year period ending 2023 is projected to reach $1.3 trillion. Beginning in 2033, Social Security will be unable to pay full benefits, according to the Social Security Board of Trustees. In other words, when today's 47-year-old workers reach their full retirement age in 2033, they and everyone else already receiving benefits face a 25 percent benefit cut unless Congress does its job and steps in to fix this problem. The President likes to say that if we agree on a policy, then we should act and not let our differences hold us up, and I agree. This hearing will include a full discussion of a policy with bipartisan support—more accurately measuring inflation in order to strengthen the Social Security program.**"

FOCUS OF THE HEARING:

The hearing will examine proposals by the President and bipartisan groups to more accurately measure inflation.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov/*, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, May 2, 2013**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721 or (202) 225–3625.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days' notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://www.waysandmeans.house.gov/*.

Chairman JOHNSON. Good morning. Thank you all for being here. This is the first in the Committee's hearing series on the President's and other bipartisan entitlement reform proposals.

We need to protect and preserve Social Security. That is what this Committee is all about.

According to the Social Security Board of Trustees, beginning in 2033, Social Security will be unable to pay full benefits. In other words, when today's 47 year old workers reach full retirement age in 2033 and everyone else is already receiving benefits, they will face a 25 percent benefit cut unless Congress reforms Social Security, which we can do.

The inclusion of using a more accurate measure of inflation in President Obama's budget is a welcome acknowledgement that we must take action to make sure that Social Security is there for our future generations.

The purpose of this hearing is to have a full discussion of a policy with wide bipartisan support, more accurately measuring inflation in order to fix the Social Security system.

Congress passed the first benefit increase in 1950, later increased benefits ten other times before passing a law in 1972 that created a formula to determine the cost of living adjustments or COLAs.

The Social Security COLA increases benefits each year that there is inflation. If there is no inflation, there are not any COLAs, as was the case in 2009 and 2010. If prices fall, benefits cannot be reduced.

At the time automatic COLAs were enacted, the Bureau of Labor Statistics or BLS only produced one measure of inflation, which remains the inflation measure used to determine Social Security COLAs today.

However, BLS has since developed other measures including the Chained Consumer Price Index or Chained CPI, which we will discuss today.

The President's own budget says most economists agree that the Chained CPI provides a more accurate measure of the average change to the cost of living than the standard CPI.

In testifying before the full Ways and Means Committee last week, Treasury Secretary Jacob Lew stated "The Chained CPI is a more accurate measure of inflation in that it does a better job of reflecting the substitution of goods in response to relative price changes."

Today we will hear from the Commissioner of BLS why that is. Some say using the Chained CPI to measure inflation would result in a benefit cut, but that is plainly false.

The truth is that benefits will continue to grow, only more slowly than under the current less accurate measure. Only in Washington would that be called a "benefit cut."

That said, I fully recognize and am sensitive to the impact this change could have on some beneficiaries' pocketbooks, especially those who receive benefits for a long time.

The fact of the matter is the current measure overstates inflation and ignores that it is simply unfair to your children and grandchildren who rightly expect us to make sure Social Security will be there for them.

Let me be clear. Determining the adequacy of Social Security benefits especially for those who are most vulnerable is an important discussion to have, and we will as part of this hearing series on bipartisan entitlement reforms.

The President likes to say that if we agree on a policy, then we ought to act and not let our differences hold us up.

We owe it to every American to carry out our responsibility and carefully examine each bipartisan policy option, and we will through this hearing series.

Mr. Becerra is not here yet. Without objection, all written testimony will be made part of the record.

We have one witness panel today. Seated at the table are Erica Groshen, Commissioner, accompanied by Michael Horrigan, Associate Commissioner, Office of Prices and Living Conditions, Bureau of Labor Statistics, Department of Labor. That is a mouthful.

Jeffrey Kling, Associate Director for Economic Analysis, Congressional Budget Office.

Ed Lorenzen, Executive Director, The Moment of Truth Project, Committee for a Responsible Federal Budget.

Nancy Altman, Co-Chair, Strengthen Social Security Coalition, and Charles Blahous, III, Public Trustee, Social Security and Medicare Board of Trustees, and thank you for being here again.

Welcome. Thanks to all of you for being here.

Commissioner Groshen, will you go ahead with your testimony?

STATEMENT OF ERICA L. GROSHEN, COMMISSIONER, ACCOMPANIED BY MICHAEL W. HORRIGAN, ASSOCIATE COMMISSIONER, OFFICE OF PRICES AND LIVING CONDITIONS, BUREAU OF LABOR STATISTICS, DEPARTMENT OF LABOR

Ms. GROSHEN. Good morning. I thank the Subcommittee for this opportunity to talk about the family of Consumer Price Indexes published by the BLS.

As you know, we produce some of the nation's most current and important economic statistics, including the inflation measures under discussion today.

In doing so, we help policy makers, businesses and households to make the best decisions for themselves and others.

I will start by describing the CPI–U. The measurement objective of all of our CPIs is to estimate changes over time and the cost to consumers of maintaining the same standard of living.

How do we construct the CPI–U? We estimate the change in prices that consumers pay for a market basket of goods and services in urban areas. This market basket is divided into item categories, such as uncooked beef steaks.

We collect prices for goods across 211 item categories in 87 urban areas, resulting in over 8,000 unique item area cells. We collect expenditure weights for each of these cells, such as steak in Chicago.

The weights represent shares of total consumer expenditures across all items and areas. The data source for the weights is our consumer expenditure survey.

With prices and weights in hand, we produce the CPI in two stages, and understanding these stages is the key to understanding how our indexes differ.

In stage one, we calculate a CPI–U for each cell. That is the average change in prices, and for most cells we use a formula that assumes that consumers actually do substitute among products within the cell.

In stage two, we combine our indexes across all the cells to produce a national number. CPI–U uses a formula that assumes consumers do not substitute across items or areas. That is we assume they do not adjust their purchases between steak and chicken in Chicago as prices change.

What is the CPI–W? It aims to estimate price changes for households that receive more than half of their income from wage and clerical jobs. The formulas and the prices that we use in the CPI–W are the same as for the CPI–U. The only difference is the CPI–W uses consumer expenditure weights that are based on the wage and clerical group.

What about the experimental CPI–E? Again, we use the same formulas and the same prices as the CPI–U, but we use expenditure weights for households with a respondent or spouse age 62 or older.

Over the past 20 years, while the CPI–U and the CPI–W increased at an average annual rate of 2.4 percent, the CPI–E rate was 2.6 percent. This reflects only differences in expenditure patterns of these populations. For example, older Americans relatively heavy spending on health care.

We call the CPI–E experimental partly because the expenditure weights are based on smaller sample sizes, but also our CPI–U sample may not represent well where the elderly shop, where they live, what they buy, and the prices they pay. Moving to an official CPI–E would require a thorough research effort.

Finally, what about the Chained CPI–U? This differs from the indexes I just talked about in weights and formulas. Furthermore, we revise it twice before it is final.

Stage one is the same. Stage two uses a superlative index formula that captures how consumers actually adjust what they buy as relative prices change.

Because consumers make such adjustments, the growth in the Chained CPI–U is typically smaller than that for the regular CPI–U. For the past 12 years ending in December 2011, while the CPI–U grew at an average annual rate of 2.5 percent, the Chained CPI–U rate was 2.2 percent.

The other difference is there are lags in reporting the Chained CPI–U. It takes a long time to collect consumer expenditure shares and to estimate their weights. The final Chained CPI–U for March 2013 will be published in February 2015.

To sum up, as part of our continuing efforts to improve measurements in our dynamic economy, the BLS has created a Chained CPI–U to gauge the cost of living in a way that accounts for how consumers substitute among goods when price changes are not uniform.

I thank you for the opportunity to testify before this Committee. Dr. Horrigan and I will be happy to answer your questions.

[The prepared statement of Ms. Groshen follows:]

STATEMENT OF
ERICA L. GROSHEN
COMMISSIONER
BUREAU OF LABOR STATISTICS
U.S. DEPARTMENT OF LABOR

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

April 18, 2013

I thank the subcommittee for this opportunity to provide background on the family of consumer price indexes published by the Bureau of Labor Statistics (BLS). As you know, the Bureau of Labor Statistics produces some of the nation's most current and important economic statistics to help policymakers, businesses, and households make the best decisions for themselves and others. In addition to inflation measures, the subject of today's testimony, we produce the monthly civilian unemployment rate and payroll employment figures, productivity estimates, occupational projections, on-the-job injury rates, wage and benefits measures, and a vast array of other highly-used national and regional data.

I will begin with a brief history of the CPI, which is a Principal Federal Economic Indicator released monthly by BLS, focusing on the methodological issues and changes implemented in recent decades. I will follow that history with a description of the building blocks of the Consumer Price Index for all Urban Consumers (CPI-U). I then will highlight the relevant features and differences that exist between the CPI-U and the CPI for Urban Wage Earners and Clerical Workers (CPI-W), and the Experimental CPI for Americans 62 Years of Age and Older (CPI-E). I will follow with a discussion of the Chained CPI for all Urban Consumers (Chained CPI-U), which has been the subject of much interest lately.

The Chained CPI-U represents the latest stage in the development of our cost of living measures and improves on the CPI-U by accounting for how consumers substitute among goods when the price changes of

those goods vary. In addition, the Chained CPI-U has the advantage of being less susceptible to statistical bias from the sampling variability of price changes at the item/area level. Measuring changes in the cost of living would be easy if the array of products in the marketplace never evolved, prices all moved together throughout the nation, people never changed what they bought, and there was little variety among people or products. In our dynamic economy none of these things is true. So, the BLS uses price surveys, consumption expenditure surveys and special formulas to arrive at monthly estimates of changes in the cost of living. Over the past century, technology and research have allowed our methodology to advance considerably.

The CPI was initiated during World War I, when rapid increases in prices made such an index essential for calculating cost-of-living adjustments in wages. Periodic collection of prices was started and, in 1919, BLS began to publish separate indexes for 32 cities. Regular publication of a national index, the U.S. city average, began in 1921, and indexes were estimated back to 1913.

The CPI improvements introduced over the years have resulted from BLS research and experience, as well as from in-depth analyses and critiques by outsiders. Notably, the 1961 report of the Price Statistics Review Committee (sometimes called the "Stigler Committee") provided impetus for subsequent changes in many aspects of the CPI, including the statistical sampling of outlets and items, expansion of population coverage, use of "hedonic" methods to deal with quality changes in consumer durables, regular updating of CPI expenditure weights, and use of cost-of-living theory.

The decade of the 1990s saw a surge of research on CPI methods. Some of this research was reported in the December 1993 *Monthly Labor Review*, which was devoted to discussions by BLS economists of CPI methods and issues. In that volume, Ana Aizcorbe and Patrick Jackman compared aggregate indexes based on the CPI's Laspeyres formula to indexes employing "superlative" formulas for the period 1982 to 1991. In another article, Brent Moulton described a complex but important problem that became commonly known as "formula bias." The way the BLS was using the Laspeyres index formula in the calculation of basic CPI item/area indexes had the unintended effect of giving greater weight to price increases than to price decreases. By 1996, the BLS

had corrected that upward bias and had begun studying the geometric mean formula, which the Moulton article had shown is not vulnerable to formula bias.

In 1996, a report to the Senate Finance Committee by the Advisory Commission to Study the Consumer Price Index (the "Boskin Commission") included recommendations to adopt a geometric mean formula for basic CPI indexes as well as to use a superlative index formula for aggregating those basic indexes to higher geographic and item group levels. The Boskin Commission also recommended that the BLS establish a cost-of-living index as its objective in measuring consumer prices.

Between 1997 and 2000, we made several important improvements to the CPI. The President's FY 1998 budget funded the BLS to produce what became the Chained CPI-U, to be first published in 2002. In December 1998, the BLS announced that in 2002 it would begin updating CPI expenditure weights on a biennial schedule, to replace the previous practice of updating weights roughly once per decade. In 1999, the geometric mean formula was adopted for the calculation of most CPI basic indexes. Finally, throughout this period the use of hedonic quality adjustment was expanded to several additional components of the CPI, such as televisions.

More recently, a 2002 report by a National Research Council panel of the National Academy of Sciences made numerous recommendations, including that the planned Chained CPI-U should include a real-time advance estimate and that we continue and expand our development and testing of advanced quality-adjustment methods.

I will return to most of these methodological issues and changes in the remainder of my testimony. To start, let me clearly state that the measurement objective of the CPI is to approximate a cost of living index, or COLI. This means the monthly CPI is an estimate of the changes over time in the cost to consumers of maintaining the same standard of living.

The CPI-U seeks to measure the change in the cost of living by estimating the change in prices that consumers pay for a market basket of goods and services in urban areas of the U.S. The CPI-U basket is divided into 211 item categories. An example of an item category is Uncooked Beef Steaks, or what the Committee might think of as types of steak bought at a grocery store. We collect prices for thousands of goods across the 211 item

categories in 87 distinct urban areas, which results in 8,018 unique item/area "cells" that form the building blocks of the CPI-U. Each month about 450 BLS employees collect more than 83,000 prices from about 23,000 retail establishments in the 87 areas to provide the prices that we use to develop price indexes. With about 10 observations per item/area, price movements are necessarily measured with some sampling variability. Robert McClelland and Marshall Reinsdorf in 1999, Ralph Bradley in 2005, and others have found that sampling variability can cause a Laspeyres index like the CPI-U to overstate inflation when a geometric formula is used to estimate price growth at the item/area level. It turns out that in the Chained CPI-U, which uses a Törnqvist formula rather than a Laspeyres formula in Stage 2 (as defined below), this bias from sampling variability is effectively eliminated.

For any given item/area cell, such as steak in Chicago, we also calculate expenditure weights. These weights represent the shares of total consumer expenditures across all items and areas. The source of data for these weights is the BLS Consumer Expenditure (CE) Survey. The CE is a household survey consisting of quarterly interviews and weekly expenditure diaries. We use interview and diary data taken over two years to construct weights for each of the 8,018 item/area cells. For example, the current CPI-U weights represent average expenditures over the 2009-2010 period.

We collect prices at a sample of retail outlets—basing our sample on telephone interviews of consumers who identify where they shopped within each of our 87 geographic areas. All consumer goods and services are potentially eligible for pricing, as are the locations at which the items are purchased. These include brick and mortar locations as well as web sites. The BLS pricing survey provides field collectors with a list of item categories they will price at each retail outlet. When specific items are brought into the survey for pricing, we select them according to standard statistical practices.

The CPI seeks to collect the retail, transaction price paid by the consumer, including sales and excise taxes. When we bring an item into the survey for the first time, our field economist records information on the detailed characteristics of the item. The list of detailed characteristics ensures that we can identify the same exact

item when we collect prices in subsequent months. If the item's characteristics change, we determine (statistically) what proportion of an observed change in price is due to the change in the quality characteristics of the item and what proportion is pure price change. If an item disappears permanently, we follow statistical procedures for selecting the best substitute item to price.

Once we have collected prices and weights for each of our cells, we are ready to produce a CPI. There are two distinct stages to this process. I would like to note for the Committee that these stages are critical for understanding the similarities and differences among our family of indexes—the CPI-U, the CPI-W, the experimental CPI-E, and the Chained CPI-U. For the CPI-U for each cell, we calculate an average change in prices using one of two mathematical formulas. For a small number of cells, prices are averaged using a Laspeyres formula, which assumes that consumers do not make substitutions in their purchases of goods as prices for the goods change. For example, we assume that consumers do not substitute among different types of surgery as relative prices change. By contrast, prices for most item categories (such as Uncooked Ground Beef in San Diego) are averaged using a geometric mean formula. This formula assumes that consumers substitute, to some degree, among unique products within an item category. For example, price change can influence choices among different brands of ground beef, ground beef sold at different stores, and ground beef with different percentages of fat. This formula generally shows a lower rate of inflation than a Laspeyres formula does.

Once stage 1 is complete, we have calculated price indexes for each of the cells. For the CPI-U in stage 2, we use a Laspeyres formula to combine our indexes across items and areas to produce the national CPI-U. When we use this formula, we are assuming consumers do not substitute across items or across areas. That is, we assume that they do not adjust their relative purchases between steak and hamburger in Chicago as the relative prices of those two items change. Similarly, we assume that they do not substitute among types of steak between Chicago and San Diego (or between steaks in Chicago and hamburger in San Diego).

To summarize, in the CPI-U we use a formula that assumes some substitution behavior <u>within</u> most item/area cells in stage 1, but we use a formula that does not allow any substitution <u>across</u> item/areas in stage 2.

Let me now turn to the CPI-W and the experimental CPI-E. As a starting point, let me note that the formulas and prices used in stages 1 and 2 for the CPI-W and for the experimental CPI-E are exactly the same as for the CPI-U. Therefore the source of differences between these two indexes and the CPI-U arises from the other building blocks of the CPI.

The CPI-W aims to estimate the cost of living for wage and clerical households in urban areas. A household that receives more than 50 percent of its income from the earnings of household members in wage and clerical occupations (for example, mechanics and retail sales workers) is considered a wage and clerical household. Thus, the CPI-W does not cover, for example, households of professional and salaried workers, the self-employed, the unemployed, or retirees. In fact, prior to 1978, the weights in the CPI were confined to wage and clerical households. In 1978, the scope of the CPI was expanded to include all urban households; since then we have published both a CPI-U and a CPI-W. Over longer periods, the CPI-U and CPI-W tend to move in tandem; for example, over the 20 years ending in December 2012, both measures increased at an average annual rate of 2.4 percent. But they do not always line up, especially over shorter periods. For example, over the last 12 months, the CPI-U has increased 2.0 percent, while the CPI-W has increased 1.9 percent.

Any measured price changes between the CPI-U and the CPI-W stem from differences in the relative expenditures of the respective CPI-U and CPI-W populations. By construction, the CPI-W uses all of the prices that are used for the CPI-U. In other words, we use prices based on a data collection methodology that identifies where all urban consumers shop, the "basket" of items they buy, and where these urban consumers live. So the formulas and the prices used for the CPI-W are exactly the same as for the CPI-U. The difference between the CPI-U and the CPI-W reflects different expenditure weights used to aggregate the indexes for the 8,018 cells. The CPI-U uses 2 years of expenditure weights representing all urban consumers, based on approximately 76,000 interviews. The CPI-W uses the same two years of expenditure weights, but only those in wage and clerical households in the CE, who constitute about 31 percent of the CPI-U household sample.

Using CPI-U prices in the calculation of the CPI-W means that we assume that wage and clerical households shop in the same retail establishments, buy the same mix of specific items in those establishments, and live in the same neighborhoods as other urban consumers. That is, we do not have a separate data collection effort to identify these building blocks for wage and clerical households. Although these dimensions are undoubtedly somewhat different between all urban and wage and clerical households, we do not believe that these differences are significant enough to compromise the accuracy of the CPI-W.

What about the CPI-E? Like the CPI-W, the experimental CPI-E depends on the exact same formulas and prices as the CPI-U for stage 1 and stage 2, and then we apply different stage 2 weights. The CPI-E uses expenditure weights for households with a respondent or spouse 62 years of age or older. For 2009-2010, these weights are based on a sample only 26 percent as large as the entire CPI-U sample. Over the past 20 years, while the CPI-U and CPI-W increased at an average annual rate of 2.4 percent, the CPI-E has increased at an average annual rate of 2.6 percent. Again, for any period, divergences between the CPI-U, CPI-W, and CPI-E are solely the result of differences in the expenditure patterns of the respective populations. For example, older Americans tend to spend more on health care than urban consumers as a whole.

We call the CPI-E experimental in part because its expenditure weights are based on sample sizes that are smaller than those of the CPI-W. In addition, a key defining feature of the experimental CPI-E is that—unlike the situation for wage and clerical households—CPI-U prices may not be sufficient to represent those paid by the elderly population. We recognize that elderly households live in different places, shop at different retail outlets, buy a different mix of products, and even in many cases qualify for different prices than other urban consumers. Moving from an experimental to an official CPI-E would require researching and addressing these issues.

Finally, let me turn to the Chained CPI-U. We have produced this index since 2002, and have values for it back to December 1999. Continuing our previous discussion, the Chained CPI-U differs from the CPI-U, the CPI-W, and the experimental CPI-E in both the weights and formulas that we use. In addition, unlike these three latter indexes, the Chained CPI-U is subject to two revisions before it is final. To convey the nature of all of these

differences and the conceptual basis for the Chained CPI-U, it is easiest to begin by describing the "final" Chained CPI-U.

The Chained CPI-U uses the same stage 1 cell indexes as the CPI-U, CPI-W and experimental CPI-E. In the stage 2 aggregation of these indexes, however, the final Chained CPI-U uses what economists call a "superlative index" formula. In particular, it is a Törnqvist index, which is a member of the family of superlative indexes. A distinguishing feature of these indexes is that they are based on how actual spending patterns change as relative prices change. For example, to calculate the final Chained CPI-U rate of inflation between February 2013 and March 2013, we will use observed consumer expenditures for each of the cells in both months.

As an example of how the Chained CPI-U takes substitution into account, consider the impact of a hypothetical 10-percent gasoline price increase on a consumer who typically spends $80 on gasoline per week. A Laspeyres index, like the CPI-U, would estimate that the consumer's cost of living has increased by $8 per week. Rather than keep her weekly gasoline purchases constant, however, the consumer might decide to cut back somewhat on driving and shift some of the money she would otherwise spend on gasoline to other products, such as groceries. She might even decide to ride the bus sometimes instead of driving. In either case, the consumer would be deciding if she would be *better off* by shifting her spending pattern than by spending the entire $8 on gasoline. Put another way, the cost of keeping her standard of living constant has gone up by something *less than* $8 per week.

As our hypothetical consumer shifts her purchases relatively away from gasoline and toward bus fares, the Törnqvist index directly measures the greater expenditure weight on the item categories toward which consumers are shifting. In this example, these categories were food and public transportation, which by assumption increased in price by less than gasoline. Note that the reverse would be true if, for example, public transportation increased in price relative to gasoline, and consumers reacted by driving more and riding buses less. In that case, the Törnqvist formula would measure more weight on the gasoline index and less on the public

transportation index. Note also that if price changes were even across all items or consumers did not change their spending patterns, the CPI-U and Chained CPI-U would always be the same.

Because prices often do not change uniformly and consumers shift purchases in response, and because price changes are subject to sampling error, the measured rate of price change using the Chained CPI-U typically is lower than that of the CPI-U. In the 12 years from December 1999 through December 2011, the CPI-U grew at an average annual rate of 2.5 percent, while the Final Chained CPI-U increased at an average annual rate of 2.2 percent. The paper by Bradley referred to above suggested that just over half of the difference between the CPI-U and Chained CPI-U was due to sampling variability and the remainder was due to substitution among item categories. In a 2006 *Monthly Labor Review* paper, the authors summarized BLS research by saying that the sampling error effect "could yield an upward bias of 0.1 percentage point or more per year" in the CPI-U.

The BLS designed the Chained CPI-U to provide a closer approximation to a cost of living index than the CPI-U. However, operationally, it is important to note that the data on consumer expenditure weights for any period are only available with a significant lag. In the example of calculating the rate of inflation on a chained basis between February and March 2013, the complete weights for 2013 are not ready for use until the end of 2014, and final 2013 values for the Chained CPI-U will not be published until February 2015.

Given the lags for relevant monthly consumer expenditure weights, BLS provides an initial and then an interim value for each monthly Chained CPI-U index before producing the final value. To accomplish this, we use the same base-period expenditure weights as the CPI-U, but in a different formula. The initial and interim versions of the Chained CPI-U use the geometric mean in stage 2. This index assumes consumers substitute across the 211 market basket categories. BLS research in recent years has identified methods that have potential to improve the closeness of the initial and interim Chained CPI-U indexes to their eventual final values.

A question often raised is whether the BLS can produce a chained CPI for the elderly. We note that the reasons cited above that make the CPI-E an experimental index, namely the relatively small CE samples for elderly consumers and the lack of adjustment for differences in where the elderly shop, what they buy or the

prices they pay, would also apply to using monthly consumer expenditure weights to create chained CPI-E estimates. Thus, development of a non-experimental chained CPI-E index would have to begin with a thorough research effort.

To sum up, measuring changes in the cost of living in a dynamic economy can be complex and the BLS has created the Chained CPI-U to provide a cost of living measure that improves on the CPI-U by accounting for how consumers substitute among goods when price changes are uneven.

Thank you for the opportunity to testify before this committee. Dr. Horrigan and I are happy to answer any questions you may have.

Chairman JOHNSON. Thank you for your testimony. That is insightful.

Mr. Becerra, do you still want to make your opening remarks?

Mr. BECERRA. I can wait until everyone testifies or I can do it right now.

Chairman JOHNSON. We will delay the rest of you for a moment and let Mr. Becerra make his opening remarks. Go ahead. You are recognized.

Mr. BECERRA. I appreciate that, Mr. Chairman. I apologize to the witnesses that I had to run a little late. Thank you for being here. We look forward to the rest of your testimony.

I want to just begin by making a quick observation. At a time when folks are talking about their economic security, this is perhaps the most important time to make sure we maintain Social Security because it is for many Americans, not just seniors—many disabled Americans, working Americans who have become disabled, to children, widows and widowers, it is their economic security.

Any time someone says to you Social Security is broke or bankrupt or causing our deficit, I will say emphatically here that is contrary to the evidence. In fact, I think I would be on very safe ground to say anyone who says Social Security is broke or bankrupt is lying because the facts show just the opposite.

Let's look at the numbers. I would say to anyone who wants to contest what I am about to tell you, show me your numbers. I will show you some numbers and you can see them on this chart.

Social Security currently has about a $2.7 trillion surplus, and that is because over more than 77 years of taking in taxes from Americans who have been working and paying into Social Security, it has brought in in tax contributions over $14.5 trillion.

It has also earned interest on those trillions that have been invested into the Trust Fund by tax, paying Americans about $1.5 trillion.

At the same time, it has only had to spend in benefits, and a very tiny sliver you see above that red bar, in administrative costs, because administrative costs are less than one percent, a total spending of $13.5 trillion.

The math is very simple. More than $2.5 trillion that Americans have contributed to Social Security through their taxes that have never been used through 13 recessions, and in more than 77 years, Social Security has never failed once to pay benefits on time and in full.

When we discuss Social Security, we should discuss it in that context of the reality and the truth of what Social Security is.

When you hear conversations about what should happen to Social Security and to those earned benefits that Americans have paid into the system so they could get them when they retire or should they become disabled or should they happen to die so their spouse, who is now a widow or widower, or their children, who are now the children of a deceased parent, have a chance to survive, those are the folks we should concern ourselves most with.

Switching to the Chained CPI, the so-called adjustment, change to the way we calculate the cost of living, the COLA increase seniors, disabled folks, survivors of an American who has perished get, is nothing more than a cut to the benefits that people receive.

The paycheck or the earned check that people receive from Social Security will decrease. It is a cut. It is a substantial cut because we know the power of compound interest. With time, that cut grows in size.

If we are talking about economic security at this time when our economy is beginning to recover from those devastations of the 2008 Wall Street crisis, you would think we would want to provide

people with the greatest economic security and that would be through their Social Security earned benefits.

The Chained CPI affects not just seniors, disabled, children or widows, it affects veterans who will see benefits they have earned cut. It affects any number of folks including middle income and low income tax paying families who will see their taxes rise.

The Chained CPI is coming at the worse time for all those folks who worked very hard and thought they had paid into a system on a bargain, that it would be there for them because they paid into it.

Let us remember that a typical American middle income worker at the age of 65 under the Chained CPI would lose about $140 of his or her annual benefit if Chained CPI were to become the law.

By age 75, the annual benefit would be cut by $560. By the time he or she reaches age 85, the age at which most seniors tend to depend most on Social Security, the annual benefit would be cut almost $1,000 a year.

The problem here is that we have to know our facts and we have to recognize that economic security is perhaps the most important thing for our parents, our grandparents, our children, disabled families, and certainly for American working families.

Mr. Chairman, I am looking forward to hearing the testimony because there is nothing more important than the security of Social Security. With that, I will yield back.

Chairman JOHNSON. Yes. You guys need to take what he said with a grain of salt. Some of that is shading the truth.

Mr BECERRA. Show me the numbers.

Chairman JOHNSON. Easily. We are not going to quit paying Social Security. Let's face it.

Mr. Kling, welcome aboard. Please proceed.

STATEMENT OF JEFFREY KLING, ASSOCIATE DIRECTOR FOR ECONOMIC ANALYSIS, CONGRESSIONAL BUDGET OFFICE

Mr. KLING. Thanks for inviting me to testify. As you know, the Social Security Administration increases recipients' monthly benefits in most years, for example, the 1.7 percent COLA that applied to benefits paid in January 2013 was based on the increase in the Consumer Price Index between 2011 and 2012.

One option for lawmakers would be to link to another measure of inflation, the Chained CPI. That Index generally grows more slowly than the traditional CPI does, an average of about one quarter of a percentage point more slowly per year over the past decade.

Using the Chained CPI in a variety of Federal programs and the Tax Code would reduce the deficit by a total of $340 billion over the next ten years if implemented starting in calendar year 2014, according to estimates by the Congressional Budget Office and the staff of the Joint Committee on Taxation.

The President's budget for fiscal year 2014 includes a related but less comprehensive option that would use the Chained CPI for Social Security and some other spending programs, as well as for the tax system.

CBO is currently reviewing that and other proposals in the President's budget. I will not be discussing those specific proposals today.

In my remarks this morning, I will focus on the analysis examining a generic proposal to use the Chained CPI for indexing COLAs and Social Security starting next year. Such a policy would not alter the size of people's benefits when they are first eligible, either now or in the future, but it would reduce their benefits in subsequent years because of the reduction in the average COLA relative to current law.

The impact would be greater the longer people received benefits, that is the more reduced COLAs they experienced.

For example, after a year, the Social Security benefits paid to a 63 year old who had claimed initial retirement benefits at age 62 would be about one quarter percent lower on average if the Chained CPI was used for indexing.

After ten years of COLAs, the effect for a 73 year old would be 2.5 percent on average. After 30 years of COLAs, the effect for a 93 year old would be 7.2 percent on average.

According to CBO's analysis, using the Chained CPI for annual COLAs would reduce outlays for Social Security relative to CBO's current law baseline by $1.6 billion in 2014. Those savings would grow each year reaching $24.8 billion in 2023, and would total $127 billion over the 2014 to 2023 period.

CBO projects that Social Security recipients would face an average benefit reduction of about $3 per person per month in 2014 and roughly $30 per person per month in 2023.

By 2033, outlays for Social Security would be three percent lower than they would be under current law or six percent of gross domestic product rather than 6.2 percent. As a result, the gap between Social Security's outlays and tax revenues in that year would shrink by about one-sixth to one percent of GDP.

According to many analysts, the traditional CPI overstates increases in the cost of living because it does not fully account for the fact that consumers generally adjust their spending patterns as some prices change relative to other prices, and because of a statistical bias related to the limited amount of price data that the BLS can collect.

However, using the Chained CPI instead for indexing Social Security could have disadvantages. The values of that Index revised over a period of years so the programs would have to be indexed to a preliminary estimate of the Chained CPI that is subject to estimation error.

Also, the Chained CPI may understate the growth and the cost of living for some groups. For instance, some evidence indicates that the cost of living grows at a faster rate for the elderly than for younger people in part because of changes in health care prices which play a disproportionate role in older people's cost of living.

However, determining the impact of rising health care prices on the cost of someone's standard living is problematic because it is difficult to measure the prices that individuals actually pay and to accurately account for changes in the quality of health care.

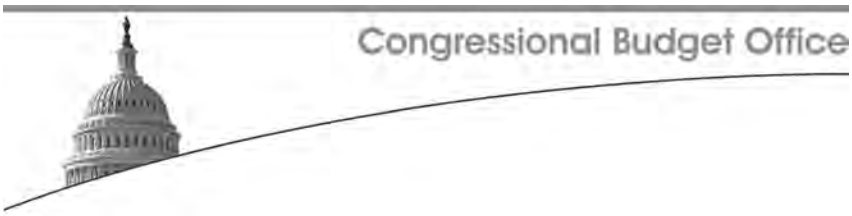
Changing the measure of inflation used for indexing is only one of many possible modifications to Social Security, if the Congress

wishes to slow the growth of Federal spending by constraining outlays for Social Security benefits or to improve the long term solvency of the program by making changes to its spending or revenues.

Many other approaches are possible, a number of which CBO has analyzed previously.

Thank you.

[The prepared statement of Mr. Kling follows:]



Testimony

Using the Chained CPI to Index Social Security, Other Federal Programs, and the Tax Code for Inflation

Jeffrey Kling
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Before the
Subcommittee on Social Security
Committee on Ways and Means
U.S. House of Representatives

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Chairman Johnson, Ranking Member Becerra, and Members of the Subcommittee, thank you for inviting me to testify this morning. As you know, Social Security law tries to protect beneficiaries from the effects of rising prices by specifying that a beneficiary's monthly payment be automatically adjusted each year for inflation, as measured by the change in a consumer price index. Similar adjustments occur in many other federal programs and many parts of the tax code. Without such indexing, a rise in the general level of prices would alter the effects of federal policies even in the absence of action by lawmakers.

My statement focuses on four questions about indexing:[1]

- How does the chained consumer price index (CPI) differ from the traditional consumer price index?
- What would be the budgetary effects of using the chained CPI to make automatic adjustments in Social Security, other federal programs, and the tax code?
- How could such a change be implemented?
- How do measures of inflation for specific populations differ from overall measures?

Changing the measure of inflation used for indexing is only one of many possible modifications to federal policy for Social Security, other programs, and the tax code. If the Congress wishes to slow the growth of federal spending by constraining outlays for Social Security benefits, or to improve the long-term solvency of the program by making changes to its spending or revenues, many other approaches are possible. Other changes to Social Security benefits and taxes would affect the federal budget and individuals in different ways, as the Congressional Budget Office (CBO) discussed in *Social Security Policy Options* (July 2010); possible changes to a broad array of federal tax provisions and spending programs were analyzed by CBO in *Reducing the Deficit: Spending and Revenue Options* (March 2011).

Summary

Cost-of-living adjustments (COLAs) for Social Security benefits and other parameters of many federal programs and the tax code are currently indexed to increases in the traditional CPI, a measure of overall inflation calculated by the Bureau of Labor Statistics (BLS). According to many analysts, however, the CPI overstates increases in the cost of living because it does not fully account for the fact that consumers generally adjust their spending patterns as some prices change relative to other prices and because of a statistical bias related to the limited amount of price data that BLS can collect. One option for lawmakers would be to link federal benefit programs and tax provisions to another measure of inflation—the chained CPI—that is designed to account fully for changes in spending patterns and that does not have the same statistical bias.

The chained CPI grows more slowly than the traditional CPI does: an average of about 0.25 percentage points more slowly per year over the past decade. As a result, using that measure to index benefit programs would reduce federal spending for Social Security, federal employees' pensions, Medicare, Medicaid, and various other programs. For example, if such a proposal took effect next year, Social Security benefits would be roughly $30 a month lower, on average, by 2023 than they would be under current law, representing a reduction of about 2 percent of average benefits. (Depending on when they started receiving benefits, some people would see a greater percentage reduction and others a smaller one.) In addition, indexing tax provisions with the chained CPI would increase revenues.

If all uses of the traditional CPI in mandatory programs and the tax code were switched to the chained CPI starting in calendar year 2014, mandatory spending would be reduced by a total of $216 billion between fiscal years 2014 and 2023, and federal revenues would be increased by $124 billion. (The President's budget for fiscal year 2014 includes a related but less comprehensive option that would use the chained CPI for Social Security and some other spending programs as well as for the tax system. CBO is currently reviewing that and other proposals in the President's budget.)

Although many analysts consider the chained CPI to be a more accurate measure of the cost of living than the traditional CPI, using it for indexing could have disadvantages. The values of the chained CPI are revised over a period of several years, so affected programs and the tax code would have to be indexed to a preliminary estimate of the chained CPI that is subject to estimation

1. This document updates earlier work by CBO about the chained CPI-U; see Congressional Budget Office, *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code* (February 2010), www.cbo.gov/publication/21228.

error. Also, the chained CPI may understate growth in the cost of living for some groups. For instance, some evidence indicates that the cost of living grows at a faster rate for the elderly than for younger people, in part because changes in health care prices play a disproportionate role in older people's cost of living. However, determining the impact of rising health care prices on the cost of someone's standard of living is problematic because it is difficult to measure the prices that individuals actually pay and to accurately account for changes in the quality of health care.

Inflation and Changes in the Cost of Living

Inflation—a general increase in the prices of goods and services—can be measured in various ways. Traditionally, the rate of inflation has been computed by multiplying the percentage price change for each item that people purchase by that item's share of consumer spending in a period before the prices changed and then adding up those changes for all items. In a simplified example, imagine that people bought only two things last year, food and clothing, and that they divided their spending evenly between the two. If the price of food rose by 4 percent this year and the price of clothing rose by 7 percent, inflation this year would be measured as (0.04 x 0.50) + (0.07 x 0.50) = 0.055, or 5.5 percent. Such price increases would reduce consumers' purchasing power (unless their income and wealth rose accordingly).

The actual growth in the cost of living, however—the amount of additional resources that someone would need to maintain the same standard of living this year as last year in the face of rising prices—is generally lower than the rate of inflation as measured above. The reason for the difference is that many people can lessen the impact of inflation on their standard of living by purchasing fewer goods or services that have risen in price and, instead, buying more goods or services that have not risen in price or have risen less.

How people substitute one good for another when prices change generally depends on the change in the relative prices of the goods (whether one item is becoming more or less expensive relative to another) rather than on the absolute price levels of the two goods (whether one item is more or less expensive than another). The importance of changes in relative prices in consumer decisionmaking means that people do not necessarily shift to lower-priced goods. If the price difference between two items narrows, consumers will tend to buy more of the more expensive one. A common example involves hamburger and steak. If the prices of both items rise, consumers will shift their spending toward the one whose price rises by a smaller percentage: If the price of hamburger increases more than the price of steak does, people will purchase more steak. Similarly, consumers will generally buy more fresh vegetables and fewer canned ones when the price difference between the two narrows.

To be sure, increases in the general price level that exceed increases in income and wealth lower consumers' standard of living. But the resulting decline in their standard of living is usually smaller than it would be if substitution were not possible. Thus, measures of inflation that do not account for such substitution overstate growth in the cost of living—a problem known as substitution bias.

The Consumer Price Index and Some of Its Limitations

The CPI is not a true cost-of-living index because it cannot include all of the factors that affect the cost of people's standard of living, such as personal safety or water quality. But BLS's goal in computing the CPI is to estimate the growth in the cost of living by measuring the change in the cost of a "market basket" of goods and services that represents average consumer spending.[2] The market basket is based on data from BLS's Consumer Expenditure Survey, in which thousands of families report what they buy. BLS divides those purchases into 211 categories—such as breakfast cereal, rent on a primary residence, dresses, and wireless telephone services—and assigns a percentage weight to each category based on its share of consumer spending in a base period. To measure price changes, BLS chooses about 80,000 specific items (several hundred for each of the 211 expenditure categories) and checks their prices every month at selected stores and other establishments in 38 geographic regions.

2. See Bureau of Labor Statistics, *BLS Handbook of Methods* (June 2007), Chapter 17, p. 2, www.bls.gov/opub/hom/pdf/homch17.pdf (436 KB). For more information about the CPI, see Congressional Budget Office, *Explaining the Consumer Price Index* (June 2007), www.cbo.gov/publication/18772; and Bureau of Labor Statistics, "Consumer Price Index: Frequently Asked Questions" (October 19, 2011), www.bls.gov/cpi/cpifaq.htm.

On the basis of those price data, BLS constructs approximately 8,000 item-area indexes—indexes for specific goods and services in specific places, such as breakfast cereal in Chicago—and then uses them to compute various versions of the CPI.[3] All of those versions are based on the same set of item-area indexes; they differ mainly in trying to represent spending patterns for different subpopulations and in the formulas used to combine the item-area indexes into an overall estimate of price changes for the entire economy.

Two versions of the CPI are currently used to index federal programs: the consumer price index for all urban consumers (CPI-U) and the consumer price index for urban wage earners and clerical workers (CPI-W). The CPI-U is based on the spending patterns of a representative sample of people who live in urban or metropolitan areas, as do about 87 percent of U.S. residents. The CPI-W focuses on a subset of the CPI-U sample: households that include clerical workers, sales workers, laborers, or certain other types of nonprofessional employees. The the CPI-W sample represents about 32 percent of U.S. residents.

The two versions of the CPI produce similar estimates of inflation. Over the past 20 years, inflation as measured by both the CPI-W and the CPI-U has averaged 2.45 percent a year. CBO expects that the two measures will continue to grow at about the same rate as each other.

The methodology currently used to calculate the CPI-U and CPI-W suffers from at least two drawbacks—substitution bias and small-sample bias. Both of those drawbacks cause traditional versions of the CPI to grow more quickly than the chained CPI-U, an improved measure of overall inflation developed by BLS that is discussed below. Substitution bias has been recognized by economists for many years; small-sample bias has also been known for some time, but until recently, it has received little attention.[4]

Substitution Bias

Every two years, BLS uses new data from the Consumer Expenditure Survey to update the share of consumer spending devoted to each of the 211 categories in the market basket. As a result, at any given time, the CPI is based on spending patterns from two to four years earlier. For example, the monthly values of the CPI computed in 2010 and 2011 were based on spending data reported in the Consumer Expenditure Survey in 2007 and 2008. For the monthly values beginning in January 2012, BLS used new data to update the market basket to reflect purchases made in 2009 and 2010.

Because the CPI is based on spending patterns from a point in the past, it does not fully incorporate the effects of consumers' substitution between various goods and services when their relative prices change. Therefore, the CPI grows faster than the cost of living does. That substitution bias would exist whether the market basket was from one month ago or five years ago. However, greater periods of time between updates to the basket tend to magnify the size of the substitution bias and to cause an even larger gap between the increase in the CPI and growth in the cost of living.

BLS's current procedures for calculating the CPI account for some degree of substitution *within* most basic categories of goods and services in the market basket—such as when some consumers who previously bought large eggs switch to medium-sized eggs when the latter go on sale.[5] Current procedures for calculating the CPI do not, however, take into account shifts that occur *between* one

3. Price data are actually collected for 87 geographic regions, but they are combined into 38 regions when the item-area indexes are created.

4. One estimate suggests that small-sample bias is responsible for roughly two-thirds of the difference between the traditional and chained CPIs and that substitution bias is responsible for the other third. That estimate is highly uncertain, however, in part because the analysis used only a few years of data, and in one of those years the data were of lower quality than in the others. See Ralph Bradley, *Analytical Bias Reduction for Small Samples in the U.S. Consumer Price Index* (Bureau of Labor Statistics, Office of Survey Methods Research, September 2005), www.bls.gov/ore/abstract/st/st050290.htm. Also see Robert McClelland and Marshall Reinsdorf, *Small Sample Bias in Geometric Means and Seasoned CPI Component Indexes*, Working Paper 324 (Bureau of Labor Statistics, August 1999), www.bls.gov/osmr/abstract/ec/ec990050.htm.

5. BLS does not use those procedures for some types of goods and services included in the CPI—such as rents, certain utilities, and medical services—because consumers cannot easily substitute one good for another within those categories. Those procedures were initially examined to correct for a problem known as formula bias; see Kenneth V. Dalton, John S. Greenlees, and Kenneth J. Stewart, "Incorporating a Geometric Mean Formula Into the CPI," *Monthly Labor Review*, vol. 121, no. 10 (October 1998), pp. 3–7, www.bls.gov/opub/mlr/1998/10/art1abs.htm; and Robert McClelland, "Evaluating Formula Bias in Various Indexes Using Simulations" (draft, Bureau of Labor Statistics, 1996), www.bls.gov/osmr/abstract/ec/ec960110.htm.

category and another. For instance, if the price of apples rises by 50 percent and the price of bananas goes up by only 10 percent, consumers will tend to buy fewer apples and more bananas. Because apples and bananas are separate categories in the CPI market basket, the index does not account for the effects of such substitution. As a result, it overstates the amount by which consumers' well-being declines when prices rise and understates the benefit of reductions in prices.

Small-Sample Bias

The traditional CPI also suffers from a statistical bias that occurs because the index is calculated using prices for only a small portion of the items in the economy. BLS produces an inflation index for an item in a specific region—such as cheese in the Kansas City area—by averaging the growth rates of a sample of prices for that item in that locale. BLS then computes the geometric average of the change in those prices.[6] When the sample of prices is large, the geometric average of the price changes in that sample can be expected to be very close to—but slightly higher than—the geometric average of all price changes for that item in that region. When the sample size is smaller, that upward bias is larger.[7]

Although there can be thousands of prices for items in each geographic area, BLS creates the item-area indexes using, on average, prices of only about 10 examples of an item. Such a small sample creates a measurable upward bias in those indexes. Because the traditional CPI is calculated as an arithmetic average of those indexes (and the arithmetic average is unbiased), any bias contained in the item-area indexes carries through to the overall CPI.

Small-sample bias in the traditional CPI could be reduced by increasing the sample of prices collected or by attempting to estimate and adjust for the effect. Increasing the size of the sample, however, would require additional spending for data collection. Initial research has been conducted into statistical methods that could possibly adjust for small-sample bias directly, but those methods have never been implemented for the item-area indexes.[8]

An Alternative Measure: The Chained CPI-U

BLS has developed—and has been using for more than a decade—another approach to measuring price increases that avoids both substitution bias and small-sample bias. Since August 2002, BLS has published an alternative index, the chained CPI-U, which attempts to account for the effects of substitution on changes in the cost of living.[9] The chained CPI-U provides a more accurate estimate of changes in the cost of living from one month to the next by using market baskets from both months, thus "chaining" the two months together.[10]

The chained CPI-U is also largely free of small-sample bias because of the way in which it is computed. Both the traditional CPI and the chained CPI-U are based on the same item-area indexes, which are calculated using a geometric average. To combine those indexes into an overall estimate of price growth in the United States, however, BLS uses a geometric-average formula for the chained CPI-U, as opposed to an arithmetic-average formula for the traditional CPI. The use of a geometric-average formula to combine the item-area indexes effectively makes the number of elements in the geometric average much larger, which essentially eliminates small-sample bias.

6. Whereas an arithmetic average is obtained by adding a set of values and then dividing the sum by the number of values in the set (n), a geometric average is obtained by multiplying the values and then taking the nth root of the product. For example, the geometric average of two numbers is the square root of the product of the two numbers. Thus, the arithmetic average of ½ and 2 is 1.25, but the geometric average is 1.

7. The small-sample bias of the geometric mean is systematically positive because of the properties of the mathematical functions used in calculating that mean.

8. See Ralph Bradley, *Analytical Bias Reduction for Small Samples in the U.S. Consumer Price Index* (Bureau of Labor Statistics, Office of Survey Methods Research, September 2005), www.bls.gov/ore/abstract/st/st050290.htm.

9. Although BLS began publishing the chained CPI-U in 2002, it has produced monthly values for the index back to December 1999. For more information about the chained CPI-U, see Bureau of Labor Statistics, "Frequently Asked Questions About the Chained Consumer Price Index for All Urban Consumers (C-CPI-U)" (April 6, 2005), www.bls.gov/cpi/cpisupqa.htm; and Julie M. Whittaker, *The Chained Consumer Price Index: What Is It and Would It Be Appropriate for Cost-of-Living Adjustments?* Report for Congress RL32293 (Congressional Research Service, April 5, 2013).

10. Another chained measure of prices is the price index for personal consumption expenditures, which the Bureau of Economic Analysis constructs as part of the national income and product accounts.

Estimates of Differences Between Traditional and Chained Indexes

The chained CPI-U results in lower estimates of inflation than the traditional CPI does. CBO expects that annual inflation as measured by the chained CPI-U will be about 0.25 percentage points lower, on average, than annual inflation as measured by the traditional CPI. That estimate is based in part on the observed past differences between the chained CPI-U and the traditional CPI-U and CPI-W. Although the traditional CPI-U and CPI-W have produced very similar average estimates of inflation over long periods, the CPI-W tends to be more volatile over short periods because it is based on a smaller sample. Thus, in the future, CBO expects inflation as measured by the CPI-U to be the same, on average, as inflation as measured by the CPI-W even though such inflation estimates differed by 0.05 percentage points during the period in which the chained CPI-U is available for comparison. Because of that long-term similarity, CBO has relied primarily on differences between the traditional CPI-U and the chained CPI-U to forecast future changes in both the traditional CPI-U and CPI-W relative to changes in the chained CPI-U.

From 2001 through 2011, the annual increase in the chained CPI-U was 0.24 percentage points lower, on average, than the increase in the traditional CPI-U.[11] Within that average, the difference between the two indexes has varied over time (see Figure 1). The difference tended to be larger early in the 2000s and smaller late in that decade, although it varied substantially from year to year even within those shorter periods. That difference has generally been smaller when overall inflation has been lower—perhaps reflecting fewer increases in the relative prices of goods and services for which consumers spend a great deal and less interest by consumers in substituting between goods and services when price increases are mostly smaller. In addition, the gap between the traditional and the chained CPI-U has generally been smaller when prices for energy have been declining and larger when those prices have been rising rapidly.

The difference between annual increases in the core CPI—which excludes food and energy prices—and its chain-weighted counterpart has been somewhat less volatile than the difference between increases in the overall versions of the traditional and chained CPI-U and has shown less of a trend over time. However, the average difference for those core measures over the 2001–2011 period was very close to the average difference for the overall indexes: about 0.25 percentage points.

Revisions to the Chained Index

A drawback of the chained CPI-U is that it requires new data each month on changes in consumers' spending patterns from the Consumer Expenditure Survey. Those data do not become available for some time, so BLS releases preliminary estimates of the chained CPI-U and revises them over the following two years.

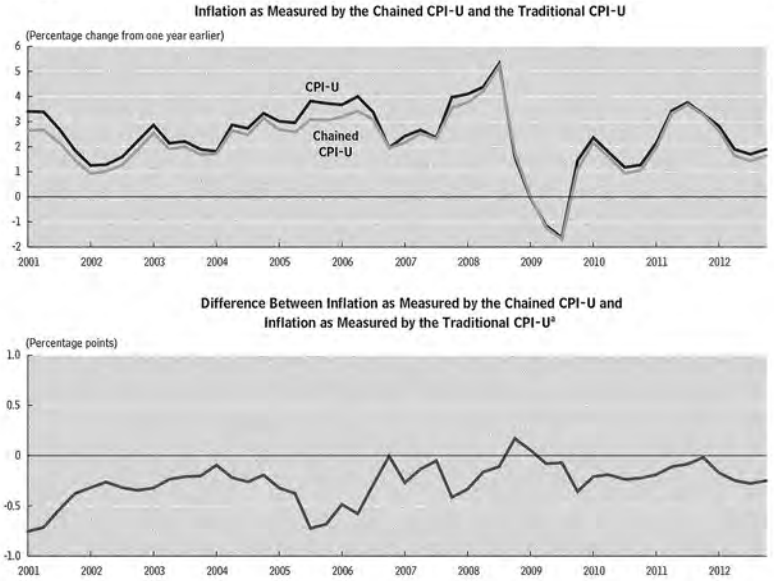
Specifically, for each month, BLS releases estimates of the chained CPI-U at three points in time. The *initial* estimate is published a few weeks after the end of the month for which price changes are being measured, at the same time as the traditional CPI. Because of the time required to collect and process the spending data, that estimate is based on data about consumers' spending patterns that are at least two years old. *Interim* estimates of the chained CPI-U are published each February for all months in the previous year, and *final* values for that year are released the following February. For example, an initial estimate of the chained CPI-U for January 2011 was released in February 2011; interim estimates for January 2011 through December 2011 were released in February 2012; and final values for all months in 2011 were published in February 2013. By contrast, the values of the traditional CPI that are currently used to index federal programs are not revised.[12]

11. Although data for the chained CPI-U go back to December 1999, some anomalous weighting issues involving the traditional CPI occurred in 2000 that make comparing the two indexes before 2001 problematic. For details, see Owen J. Shoemaker, *Analysis of Divergence Between Chained CPI-U and Regular CPI-U for the All_US-All_Items Indexes (2000-2002)* (Bureau of Labor Statistics, 2004), www.bls.gov/osmr/abstract/st/st040050.htm. In addition, although data for the chained CPI-U are available through March 2013, final values for that index are available only through 2011, as discussed below. (The 2012 values for that index used in Figure 1 are interim values.)

12. BLS also publishes estimates of the CPI that are adjusted to remove the effects of seasonal influences (such as the fact that although oranges are available year-round, they are much more expensive in the summer, when they are out of season). The seasonally adjusted values of the CPI are revised, but those values are not used to index federal programs.

Figure 1.

Comparison of the Chained CPI-U and the Traditional CPI-U



Source: Congressional Budget Office based on data from the Bureau of Labor Statistics.

Notes: Data are quarterly and are plotted through the fourth quarter of calendar year 2012. The 2012 values of the chained CPI-U used to estimate inflation are interim values.

CPI-U = consumer price index for all urban consumers.

a. In this panel, negative numbers indicate that inflation as measured by the chained CPI-U was lower than inflation as measured by the traditional CPI-U.

Using the Chained CPI-U to Index Social Security, Other Federal Programs, and the Tax Code

The purpose of indexing Social Security and other federal benefits for inflation is to prevent the purchasing power of those benefits from eroding over time as prices rise. Similarly, the purpose of indexing parameters of the tax code is to tax similar amounts of real (inflation-adjusted) income at roughly the same rates over time.

Cost-of-living adjustments for Social Security are based on changes in the CPI-W. A person's initial Social Security benefits are determined primarily by that individual's lifetime earnings and the past growth of wages nationwide.[13] Benefits increase annually by a COLA (except when the CPI-W declines). The adjustment is applied to December benefits, which are sent to recipients in January, and reflects growth in the CPI-W from the third quarter of the previous year to the third quarter of the current year.[14] (Data for September, the final month of the third quarter, become available in October.) For example, the 1.7 percent COLA that applied to benefits paid in January 2013 was based on the increase in the CPI-W between the third quarters of 2011 and 2012.

Growth in the CPI affects spending for numerous other federal programs as well. For example, COLAs for federal employees' pension benefits are based on the CPI-W, and the federal poverty guidelines—income thresholds that are used to determine eligibility for many programs aimed at lower-income people—are indexed to the CPI-U.

Parameters of the tax code that are indexed for inflation include the amounts of various exemptions and deductions; the income thresholds that divide the rate brackets for the individual income tax and the alternative minimum tax; the maximum size of tax-deductible contributions to retirement accounts; and the phaseout thresholds for various exemptions, deductions, and credits. If those values were not indexed, average tax rates would gradually rise as the effects of inflation boosted people's income, pushing them into higher tax brackets and reducing their eligibility for various exemptions, deductions, and credits.[15] All of those parameters are indexed by adjusting them for the growth in the average monthly CPI-U between a base year (which runs from September through August) and the most recent September-to-August period.[16]

An alternative to current law would be to index federal programs and the tax system to the chained CPI-U rather than the traditional CPI-U or the CPI-W. In programs that use components of the CPI for indexing (such as the CPI for medical care), the chained versions of those components could be used. Because the chained CPI-U generally grows more slowly than the traditional CPI does, such a change would reduce federal outlays and increase federal revenues.

For Social Security, that policy change would not alter the size of people's benefits when they are first eligible, either now or in the future, but it would reduce their benefits in subsequent years because of the reduction in the average COLA. The impact would be greater the longer people received benefits (that is, the more reduced COLAs they experienced). For example, after a year, the Social Security benefits paid to a 63-year-old who had claimed initial retirement benefits at age 62 would be about 0.25 percent lower, on average, if the chained CPI-U was used for indexing instead of the CPI-W, CBO estimates. After 10 years of COLAs, the effect for a 73-year-old would be 2.5 percent, on average; after 30 years of COLAs, the effect for a 93-year-old would be 7.2 percent, on average.[17] The impact would be especially large for some

13. For details, see Congressional Budget Office, *Social Security Policy Options* (July 2010), pp. 2–3, www.cbo.gov/publication/21547. Prior to eligibility, initial benefits are indexed to the average level of earnings in the economy rather than to the CPI. However, between the time someone becomes eligible for benefits (in the case of a retired worker, at age 62) and the time those benefits are claimed, initial benefit amounts are indexed to the CPI-W.

14. If the resulting adjustment is negative, no COLA is given. The next COLA occurs when the CPI-W for the third quarter of the calendar year exceeds the CPI-W for the third quarter of the last year in which an adjustment occurred. For details, see Social Security Administration, "Latest Cost-of-Living Adjustment" (October 16, 2012), www.ssa.gov/oact/cola/latestCOLA.html.

15. Even with indexing, average tax rates tend to increase over time as the real growth of income (growth above and beyond the effects of inflation) pushes taxpayers into higher tax brackets.

16. September-to-August averages are used instead of calendar year averages because they allow enough time to incorporate the new dollar amounts for indexed parameters into tax forms for the coming year.

17. The effect after 30 years is slightly less than three times as large as the effect after 10 years because in later years, the lower COLA applies to benefits that have already been reduced.

disabled beneficiaries; they generally become eligible for Social Security benefits before age 62 and thus can receive COLAs for a longer period.

To protect certain people from those reductions in benefits relative to current law, lawmakers might choose to continue to base COLAs on the traditional CPI for beneficiaries whose income or benefits are less than specified amounts or who have received benefits for a long period. Alternatively, lawmakers could compensate those beneficiaries in some other way for a reduction in COLAs. For example, the President's budget request for 2014 proposes raising Social Security benefits for certain groups and excludes some programs (such as Supplemental Security Income and the Supplemental Nutrition Assistance Program) from changing to the chained CPI-U for indexing.

Budgetary Effects

CBO and the staff of the Joint Committee on Taxation estimate that switching to the chained CPI-U on a governmentwide basis starting in calendar year 2014 would reduce the deficit by a total of $340 billion over the next 10 years (see Table 1). Such a change would decrease federal spending on mandatory programs (direct spending) by $216 billion and increase federal revenues by $124 billion over the fiscal year 2014–2023 period.

A little more than half of the reduction in spending would be for Social Security. According to CBO's analysis, using the chained CPI-U for annual COLAs would reduce outlays for Social Security (relative to CBO's current-law baseline) by $1.6 billion in 2014. Those savings would grow each year, reaching $24.8 billion in 2023, and would total $127 billion over the 2014–2023 period. CBO projects that Social Security recipients would face an average benefit reduction of 0.25 percent in 2014 (about $3 per person per month) and approximately 2 percent in 2023 (roughly $30 per person per month). That estimated average reduction in 2023 reflects larger percentage cuts (of up to 2.5 percent) for people who are already receiving benefits today or will become eligible for them shortly (and who thus would have experienced smaller COLAs for nearly a decade by 2023) and smaller cuts for people who will become eligible for benefits later (and thus would have experienced smaller COLAs for a shorter period of time in 2023). By 2033, outlays for Social Security would be 3 percent lower than they would be under current law, or 6.0 percent of gross domestic product (GDP) rather than 6.2 percent.[18] As a result, the gap between Social Security's outlays and tax revenues in that year would shrink by about one-sixth, to 1.0 percent of GDP.

Switching to the chained CPI-U governmentwide would also lower benefits in other programs that apply automatic COLAs, including civil service and military retirement, Supplemental Security Income, and veterans' programs. In addition, the change would reduce federal spending for Medicaid, Medicare, higher education assistance, and nutrition programs, among other mandatory programs. In the case of certain means-tested programs, such as Medicaid and nutrition assistance, those reductions would occur in part because using the chained CPI-U to make annual adjustments to the federal poverty guidelines would decrease eligibility for those programs.

The impact of using the chained CPI-U would vary among participants in the affected programs. Where the index was used to inflate a benefit or payment level, such as with Social Security, all program participants would receive a lower benefit than they would under current law. Where the chained CPI-U was used to inflate a threshold, such as the federal poverty guidelines, there would be a large effect on participants who lost eligibility for certain benefits but no effect on other program participants.

In the case of Medicare, for example, switching to the chained CPI-U would affect both payment rates and thresholds for means-tested elements of the program. CBO estimates that such a policy would reduce net Medicare spending per beneficiary by an average of roughly $3 per month in 2023. Of that amount, about $2 per beneficiary, on average, would reflect reductions in payments to providers and plans for services furnished to beneficiaries; those reductions would affect payments for services furnished to most beneficiaries. The remaining reduction of roughly $1 per beneficiary, on average, would stem from two factors: First, roughly half a million beneficiaries would see their premiums for Parts B and D of Medicare increase by up to $125 per month because they would become subject to higher premiums on the basis of their income. Second, Medicare spending would be reduced by an average of about $300 a month for

18. CBO's most recent long-term projections of Social Security outlays under current law are described in Congressional Budget Office, *The 2012 Long-Term Projections for Social Security: Additional Information* (October 2012), www.cbo.gov/publication/43648.

Table 1.

Estimated Budgetary Effects of Using the Chained CPI-U for Mandatory Programs and the Tax Code Starting in 2014

(Changes from CBO's February 2013 baseline, by fiscal year, in billions of dollars)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total, 2014-2018	Total, 2014-2023
Changes in Outlays for Direct Spending Programs												
Social Security	-1.6	-3.7	-6.0	-8.5	-11.2	-13.8	-16.5	-19.2	-22.0	-24.8	-31.0	-127.2
Other Benefit Programs With COLAs[a]	-0.5	-1.2	-2.0	-2.6	-3.1	-4.0	-4.8	-5.5	-6.6	-7.0	-9.5	-37.5
SNAP Interaction With COLA Programs[b]	*	0.1	0.1	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.7	2.8
Health Programs[c]	-0.2	-0.5	-1.0	-1.4	-2.1	-2.7	-3.8	-4.6	-5.5	-6.7	-5.2	-28.5
Refundable Tax Credits	0	-0.3	-0.6	-1.3	-1.8	-1.7	-2.4	-2.8	-3.3	-3.7	-4.1	-17.9
Other Federal Spending[d]	*	-0.2	-0.4	-0.6	-0.8	-0.9	-1.0	-1.1	-1.2	-1.3	-2.1	-7.8
Total Change in Direct Spending	-2.2	-5.9	-10.0	-14.3	-18.7	-22.9	-28.1	-32.8	-38.2	-43.0	-51.2	-216.0
Changes in Revenues												
Total Change in Revenues[e]	1.2	2.6	5.5	7.8	9.4	13.0	15.8	19.2	22.7	26.3	26.5	123.7
Net Decrease (-) in the Deficit												
Total Change in the Deficit	-3.4	-8.5	-15.4	-22.1	-28.1	-35.9	-44.0	-52.0	-60.8	-69.3	-77.7	-339.8
On-budget	-1.9	-4.8	-9.4	-13.6	-17.0	-22.1	-27.4	-32.7	-38.6	-43.9	-46.7	-211.5
Off-budget[f]	-1.6	-3.7	-6.0	-8.5	-11.1	-13.8	-16.5	-19.4	-22.3	-25.4	-31.0	-128.3

Sources: Congressional Budget Office; staff of the Joint Committee on Taxation. This estimate was first published in Congressional Budget Office, *Preliminary Estimate of the Budgetary Effects of Using the Chained CPI for Mandatory Programs and the Tax Code Starting in 2014* (March 1, 2013), www.cbo.gov/publication/43965.

Notes: These estimates reflect an assumption that the policy change is enacted by October 1, 2013. The estimates are subject to change, depending on legislative language.

Numbers may not add up to totals because of rounding.

CPI-U = consumer price index for all urban consumers; COLA = cost-of-living adjustment; SNAP = Supplemental Nutrition Assistance Program; * = between -$50 million and $50 million.

a. Includes civil service retirement, military retirement, Supplemental Security Income, veterans' pensions and compensation, and other retirement programs whose COLAs are linked directly to COLAs for Social Security or civil service retirement.

b. The policy change would reduce payments from other federal programs to people who also receive benefits from SNAP. Because SNAP benefits are based on a formula that considers such income, a decrease in those payments would lead to an increase in SNAP benefits.

c. Consists primarily of changes to various payments and collections in Medicare and Medicaid and changes in outlays associated with subsidies for health insurance purchased through exchanges and other health insurance provisions established under the Affordable Care Act. Includes the effects on health programs of using the chained CPI-U to update the federal poverty guidelines.

d. Includes changes to various benefits and levels in other federal programs, such as Pell grants and student loans, SNAP, and child nutrition programs. Also includes the effects on nonhealth programs of using the chained CPI-U to update the federal poverty guidelines.

e. Includes changes to revenues from indexing parameters of the tax code and changes in the revenue portion of refundable tax credits for health insurance purchased through exchanges, as well as other effects on revenues of the Affordable Care Act's provisions related to insurance coverage.

f. Off-budget changes reflect changes to outlays for Social Security benefits and changes to Social Security revenues.

approximately 100,000 beneficiaries who would qualify for the Part D low-income subsidy program (LIS) under current law, because those beneficiaries would receive less generous or no LIS subsidies for Part D premiums or cost sharing under the policy.

Approaches for Dealing With the Delay in Determining the Final Value of the Chained CPI-U

Switching to the chained CPI-U in government programs and the tax code would be complicated by the fact that it can take up to two years to release the final value of that index for a given month. That delay could be handled in various ways for different programs and tax provisions. For simplicity, this discussion focuses on Social Security.[19]

One approach to surmounting the delay in determining the final value of the chained CPI-U would be to base Social Security COLAs on the difference between the initial releases of the chained CPI-U from one year to the next, with no further adjustments as those initial estimates are revised. The initial value of the chained CPI-U is released at the same time as the CPI-W and CPI-U, so such a switch would be straightforward technically: In the formula for computing COLAs, the CPI-W could be replaced with the initial release of the chained CPI-U, and no additional changes would be needed. In that case, as under current law, all beneficiaries would receive the same annual cost-of-living adjustment.

However, under that approach, COLAs would not incorporate revisions to past releases of the chained CPI-U—so errors in the initial estimates of the chained CPI-U would lead to permanently lower or higher benefits for a cohort of beneficiaries (people who become entitled to benefits in the same year) than the benefits that would correspond to the best estimates of inflation. As an illustration, retired workers who turn 62 in 2015 will receive their first cost-of-living adjustment in 2016. If the chained CPI-U was adopted using this approach, that adjustment would equal the growth in the initial value of the chained CPI-U between 2014 and 2015. The second COLA for that cohort, which would affect 2017 benefits, would equal the growth in the initial value of the chained CPI-U between 2015 and 2016, and so on. Therefore, the total increase in the benefits for those workers since they began receiving COLAs would equal the difference between the *initial* 2014 value of the chained CPI-U and the most recent initial value. That difference would not be the best estimate of overall price growth over that period, however; the best estimate would be the difference between the *final* 2014 value of the chained CPI-U (which will become available in 2016) and the most recent initial value. If the initial 2014 estimate was lower than the final estimate, benefits would always be higher than they would have been without that error. Conversely, if the initial estimate was higher than the final estimate, benefits would be permanently lower.

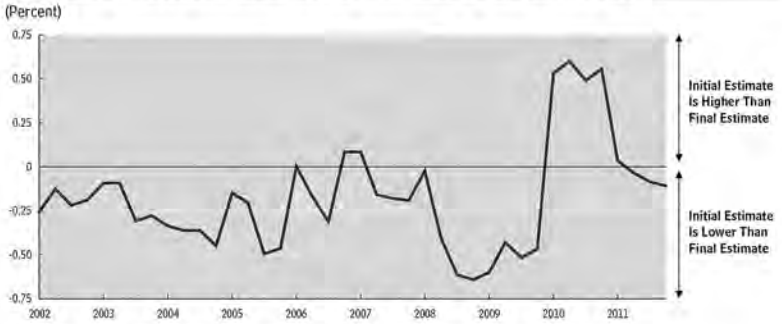
An alternative, more complex, approach to using the chained CPI-U for Social Security would link the COLA for each cohort of beneficiaries to the most recent estimate of total inflation since that cohort became entitled to benefits. Specifically, the annual COLA for a cohort would be calculated so that the cumulative COLAs that cohort would receive since becoming entitled to benefits would equal the difference between the value of the chained CPI-U from the year before entitlement—which, after two years of entitlement, would be the final value—and the latest initial value of the chained CPI-U.

For beneficiaries who had been receiving benefits for several years, that calculation would yield COLAs that would be, perhaps surprisingly, the same as under the first approach: the difference between the initial releases of the chained CPI-U. Consider a simplified example in which the chained CPI-U is revised only once rather than twice. Suppose that the final value of the chained CPI-U for year 1 is 100, that the initial value for year 2 is 101, and that the following year that initial value is revised to 102. The COLA based on the change from year 1 to year 2 will be 1 percent, which is about 1 percentage point lower than the final change in the chained CPI-U (102/100). Now suppose the initial value for year 3 is 105. The COLA between year 2 and year 3 that will make cumulative COLAs equal to the most recent estimate of cumulative inflation since year 1 will be about 4 percent, because that will make cumulative COLAs equal to about 5 percent (1 percent plus 4 percent) and cumulative inflation is also 5 percent (105/100). However, that COLA of 4 percent also equals the difference between the initial

19. For details about this and other challenges in implementing changes to COLAs for civil service and military retirement benefits and to indexing parameters of the tax code, see Congressional Budget Office, "Indexing with the Chained CPI-U for Tax Provisions and Federal Programs" (technical appendix to *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code*, February 24, 2010), www.cbo.gov/sites/default/files/cbofiles/ftpdocs/112xx/doc11256/webappendix.pdf (76 KB).

Figure 2.

Difference Between Initial and Final Estimates of the Chained CPI-U



Source: Congressional Budget Office based on data from the Bureau of Labor Statistics.

Notes: Data are quarterly and are plotted through the fourth quarter of calendar year 2011.

CPI-U = consumer price index for all urban consumers.

releases of the chained CPI-U (105/101). Essentially, a COLA that looks erroneously high given the change in the CPI-U between years 2 and 3 (a 4 percent COLA, compared with the best current estimate of inflation between those years of only about 3 percent [105/102]) offsets the erroneously low COLA that occurred on the basis of the initial estimate of the change in the chained CPI-U from year 1 to year 2.

Newer beneficiaries, however, would receive different COLAs under the alternative approach than under the first approach, because they would not have been subject to erroneous COLAs in previous years. In the simplified example, beneficiaries who begin to receive benefits in year 2 receive a 3 percent COLA from year 2 to year 3 because that corresponds to the most recent estimate of cumulative inflation since that cohort became eligible for benefits (105/102). As a result, under this approach, new cohorts of beneficiaries would receive different COLAs than other cohorts. (For details of how this approach could be applied, see the appendix.)

The magnitudes of the average error in initial values of the chained CPI-U (that is, the average difference between the initial and final values) and of the deviations around that average are important considerations in choosing between the two approaches. Under the first approach, if the initial index value was always lower than the final value *by the same amount*, benefits would not be affected by those errors, because the errors would cancel out when the differences between the initial values of the index were calculated. However, *unusual* errors in the initial values of the index would affect benefit amounts for each subsequent year because those errors would not cancel out over time. Thus, benefits under the first approach would be affected by deviations from the average error. In contrast, under the alternative approach, unusual errors in the index would be corrected in a subsequent year. Therefore, lifetime benefits would not be affected by deviations from the average error under that approach, but they would be affected by the average error. For instance, if the initial index value was always lower than the final value by the same amount, lifetime benefits would be lower by the same percentage.

Initial values of the chained CPI-U have generally been slightly lower than final values (see Figure 2). For example, from 2002 through 2005, the initial quarterly values were lower than the final values by 0.09 percent to 0.49 percent. In recent years, that gap has widened: Initial values have been lower than final values by as much as 0.64 percent, or in some cases have exceeded final values

by up to 0.60 percent. As a result, under the first approach, benefit payments would have differed from those that would have occurred if the final values of the chained CPI-U had been known right away. On average over the 2002–2011 period, the initial values for the third quarter of the calendar year—the quarter whose values are used to index Social Security benefits and civil service and military retirement benefits—were 0.26 percent lower than the final values. As a result, under the alternative approach, benefit payments would have been 0.26 percent lower, on average, than if the final values of the chained CPI-U had been used. The alternative approach would have led to different benefit payments for different cohorts, because it would have corrected errors in each cohort's early COLAs that differed from the average error.

When the chained CPI-U was first published, in 2002, BLS had little historical data available on which to base the methodology it used to estimate the initial and interim values, so it began with a simple model. If better estimating methods are adopted in the future, the initial and interim values of the index will still differ from the final value, but the differences may be notably smaller than in the past.

Measures of Inflation for Specific Populations

The consumer price index reflects prices paid for the goods and services purchased by an average household, not by any specific individual or by the average person in certain age groups, income groups, or other categories. Therefore, most people experience price changes that are either higher or lower than reported in the CPI. Computing changes in the cost of living separately for each person would not be feasible, but different indexes could be calculated for subgroups of the population or for different policy purposes. For example, the purchasing patterns of disabled Social Security beneficiaries presumably differ, on average, from those of elderly Social Security beneficiaries, which provides a rationale for indexing Disability Insurance benefits differently from Old-Age and Survivor's Insurance benefits. In addition, beneficiaries of federal income support programs presumably buy different combinations of goods and services, on average, than other consumers do. Nevertheless, there is some evidence that the average change in prices for the types of goods purchased by low-income people does not differ substantially from the average change in prices overall.[20]

The possibility that the cost of living may grow at a different rate for the elderly than for the rest of the population is of particular concern in choosing a price index for Social Security COLAs because Social Security benefits are the main source of income for many older people. BLS computes an unofficial index that reflects the purchasing patterns of older people, called the experimental CPI for Americans 62 years of age and older (CPI-E). Since 1982 (the earliest date for which that index has been computed), annual inflation as measured by the CPI-E has been 0.2 percentage points higher, on average, than inflation as measured by the traditional CPI-U (see Figure 3) or the CPI-W. However, since December 2007, when the most recent recession began, inflation as measured by the CPI-E has generally been lower than inflation as measured by the CPI-U or CPI-W.

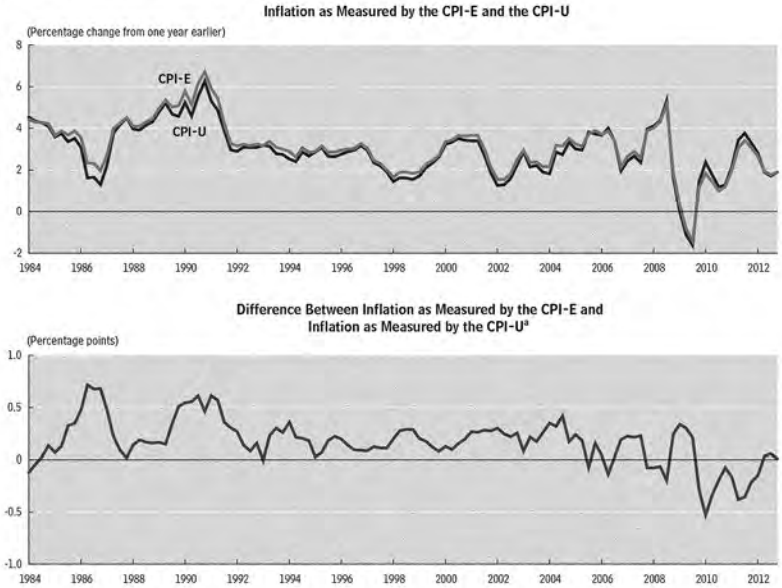
The longer-term difference between the growth rates of the CPI-E and CPI-U mainly reflects the fact that a larger percentage of spending by the elderly is for items whose prices rise especially quickly. In particular, compared with the overall population, the elderly devote a much larger percentage of their spending to medical care. That difference in spending patterns alone accounts for about half of the long-run difference between the CPI-E and the CPI-U. (The CPI covers all health care spending by individuals, including for insurance premiums, but excludes health care paid for by governments or employers. In addition to inflation, changes in the quality and quantity of care contribute to changes in total health care costs; such changes are not reflected in the CPI on a monthly basis, but only when the market basket of goods in the index is updated and only to the extent that changes in the quality of care are accurately measured.)

The other half of the longer-term difference between the growth rates of the CPI-E and CPI-U occurs primarily because other goods and services that receive greater emphasis in the CPI-E have prices that tend to rise at an above-average rate—most notably, housing. The effect of the greater emphasis on housing, however, has reversed in recent years. Over the past five years, the CPI for housing—which accounts for 45 percent of the CPI-E but a smaller percentage of the CPI-U—has risen less than the overall CPI has. That situation may be at least partly

20. See Thesia I. Garner, David S. Johnson, and Mary F. Kokoski, "An Experimental Consumer Price Index for the Poor," *Monthly Labor Review*, vol. 119, no. 9 (September 1996), pp. 32–42, www.bls.gov/mlr/1996/09/art5abs.htm.

Figure 3.

Comparison of the CPI-E and the CPI-U



Source: Congressional Budget Office based on data from the Bureau of Labor Statistics.

Notes: Data are quarterly and are plotted through the fourth quarter of calendar year 2012.

CPI-E = experimental consumer price index for Americans 62 years of age and older; CPI-U = consumer price index for all urban consumers.

a. In this panel, positive numbers indicate that inflation as measured by the CPI-E was higher than inflation as measured by the traditional CPI-U.

attributable to the collapse in housing prices that largely resulted from overbuilding during the previous economic boom. Housing prices have started to rise again, however, and CBO expects that increase to continue in the coming decade, so it anticipates that the CPI-E will outpace the CPI-U in the future.

If policymakers believe that the CPI-E is an appropriate measure of inflation for the elderly, they could use it to index programs that serve that population. A chained version of the CPI-E could also be developed to better account for economic substitution by older consumers, but doing so would require collecting significantly more data about the purchasing patterns of the elderly.

It is unclear, however, whether the cost of living actually grows at a faster rate for the elderly than for younger people, despite the fact that changes in health care prices play a disproportionate role in their cost of living. Determining the impact of rising health care prices on the cost of someone's standard of living is problematic because it is difficult to measure the prices that individuals actually pay and to accurately account for changes in the quality of health care.[21] Both treatment costs and the value of improved treatments often increase rapidly. Thus, more uncertainty exists about measures of price growth for health care than for other goods and services. Many analysts think that BLS underestimates the rate of improvement in the quality of health care, and some research suggests that such improvement may make the true increase in the price of health care more than 1 percentage point a year smaller, on average, than the increase in that price measured in the CPI.[22] If that is the case, then all versions of the CPI overstate growth in the cost of living, with the overstatement being especially large for the CPI-E because of the large weight on health care in that index. However, if health care increases in both price and quality, the previous lower-quality care may become less accessible, reducing patients' options for making lower-cost substitutions.

The CPI-E differs from the CPI-U only by using different percentage weights for the 211 categories of goods and services in the CPI market basket. For the CPI-E, BLS calculates those weights on the basis of the spending patterns of people ages 62 and older as observed in the Consumer Expenditure Survey, whereas for the CPI-U, BLS calculates expenditure weights on the basis of the spending patterns of all urban consumers in the survey. Both indexes use the same underlying price data from the more than 8,000 item-area indexes. That may be problematic because *within* each item-area index, elderly consumers probably have different purchasing patterns than all urban consumers. To address such differences in purchasing patterns, new indexes could be constructed that would also reflect the differences in different populations' purchasing patterns within each item-area index. If the prices of goods that elderly consumers buy within a category rise particularly rapidly—for example, if they consume more medical care with rapidly increasing prices than the general population does—then those new indexes would reflect that extra growth. However, if the prices of goods that elderly consumers buy within a category do not rise particularly rapidly, then those indexes would not differ appreciably from the current indexes.

21. When the price of a good or service changes, it can be difficult to determine what portion of the price growth is attributable to underlying improvements in the quality of the good or service and what portion is attributable to inflation—especially in the case of electronic goods and medical services. Most analysts think that this difficulty leads to an upward bias in the CPI, which is known as quality bias. Such bias is present in all forms of the CPI and is not limited to the CPI-E.

22. See Robert J. Gordon, *The Boskin Commission Report: A Retrospective One Decade Later*, Working Paper 12311 (National Bureau of Economic Research, June 2006), pp. 24–25, http://papers.nber.org/papers/w12311.

Appendix: Cohort-Specific Approaches to Indexing Social Security With the Chained CPI-U

For Social Security retirees, annual cost-of-living adjustments (COLAs) could be based on the growth in the chained consumer price index for all urban consumers (CPI-U) since the third quarter of the year in which they turned 61. With that method, not every cohort of beneficiaries (all of the people born in a given year) would receive the same COLA, but the differences would be small (generally about 0.1 percentage point). That approach would have the advantage of not adjusting new recipients' benefits for errors in past years' COLAs, because those new recipients would not have benefited or suffered from past errors in preliminary values of the chained CPI-U. The most straightforward way to implement cohort-specific COLAs would be to switch from the present system, in which someone's benefit is based on the previous year's benefit and the COLA, to a computation in which the person's benefit equals a base-year benefit (the primary insurance amount in the first year of eligibility for Social Security benefits) adjusted for total estimated growth in the chained CPI-U between the base year and the current year.

Under the present system, price indexation through age 60 is done implicitly by indexing benefits to Social Security's national average wage index, which is based on the average of all wages over a calendar year. Because the wage index is a nominal value, it can be considered to incorporate both real (inflation-adjusted) wage growth and price growth—including price growth from the year in which the beneficiary turns 59 to the year in which he or she turns 60. The COLA is then applied to benefits for the December of the year in which the beneficiary turns 62. That COLA equals the price growth between the third quarter of the year in which the person turns 61 and the third quarter of the year in which he or she turns 62.

Benefit amounts are reduced for people who claim benefits before the normal retirement age and are raised for those who claim benefits after that age. But the age of claiming does not affect the initial computation or the application of COLAs, which apply regardless of when people claim benefits.

The chained CPI-U could be used to determine cohort-specific COLAs by setting benefits in a given year (the "benefit year") equal to initial benefits adjusted for growth in the chained CPI-U between the year in which the beneficiary turned 61 and the year before the benefit year. More formally, benefits in year y would equal initial benefits times the ratio of the chained CPI-U in year y-1 to the chained CPI-U in the year in which the beneficiary turned 61. The computation would always use the most recent data available. Specifically, the numerator would always be the initial value of the chained CPI-U. In the first year in which a COLA was applied, the denominator would be the interim value of the chained CPI-U; thereafter, it would be the final value.

For example, if someone turned 62 in 2013, no COLA would be applied to benefits paid in that year; benefits would simply be the primary insurance amount (adjusted for the age of claiming). Then, for benefits paid in 2014,

$$\text{benefit}_{2014} = \text{benefit}_{2013} \times \frac{\text{initial index}_{2013}}{\text{interim index}_{2012}} \qquad (1)$$

For benefits paid in 2015,

$$\text{benefit}_{2015} = \text{benefit}_{2013} \times \frac{\text{initial index}_{2013}}{\text{final index}_{2012}} \qquad (2)$$

And in later years,

$$\text{benefit}_{y} = \text{benefit}_{2013} \times \frac{\text{initial index}_{y-1}}{\text{final index}_{2012}} \quad (3)$$

Using historical data for the chained CPI-U and third-quarter-to-third-quarter inflation rates illustrates how the above formulas would have applied to a beneficiary who turned 62 in 2005 with a primary insurance amount of $1,000. That person would have received the following monthly benefits (with each value rounded to the nearest 10 cents):

$$\text{benefit}_{2005} = \$1{,}000.00 \quad (4)$$

$$\text{benefit}_{2006} = \text{benefit}_{2005} \times \frac{\text{initial index}_{2005}}{\text{interim index}_{2006}} = \$1{,}000.00 \times \frac{113.945}{110.596} = \$1{,}030.30 \quad (5)$$

That adjustment is the same as applying the initial 2005 inflation estimate of 3.03 percent.

Benefits in 2007 would have been

$$\text{benefit}_{2007} = \text{benefit}_{2005} \times \frac{\text{initial index}_{2006}}{\text{final index}_{2004}} = \$1{,}000.00 \times \frac{117.725}{110.790} = \$1{,}062.60 \quad (6)$$

Applying the initial 2006 inflation estimate of 3.08 percent to the 2006 benefit of $1,030.30 would have produced a 2007 benefit of $1,062.00. The actual 2007 benefit would be 60 cents higher, reflecting the upward revision to 2005 inflation (from an initial estimate of 3.03 percent to an interim estimate of 3.09 percent).

The revisions made to the initial values of the chained CPI-U for 2005 to 2008 would have trimmed about 0.2 percent to 0.6 percent from each year's benefit amount relative to the benefits that would have been paid if the initial values had equaled the final values.

About This Document

This testimony updates *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code*, a report written by Noah Meyerson that the Congressional Budget Office (CBO) released in February 2010. In keeping with CBO's mandate to provide objective, impartial analysis, this testimony contains no recommendations.

David Brauer, Sheila Dacey, Robert McClelland, Kevin Perese, and Emily Stern of CBO contributed significantly to the analysis on which this testimony is based. Robert Arnold, Joyce Manchester, and Sam Papenfuss supervised that work.

Christian Howlett edited the testimony, and Jeanine Rees prepared it for publication. The testimony is available on CBO's website (www.cbo.gov).

Chairman JOHNSON. Thank you, sir.
Mr. Lorenzen, you are recognized for five minutes.

STATEMENT OF ED LORENZEN, EXECUTIVE DIRECTOR, THE MOMENT OF TRUTH PROJECT, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Mr. LORENZEN. Mr. Chairman, Ranking Member Becerra, Members of the Subcommittee, it is an honor to be before you and an unusual experience to be on this side of the table.

I am Executive Director of The Moment of Truth Project, which was established to continue the work of the National Commission on Fiscal Responsibility and Reform, also known as the Bowles-Simpson Commission. I worked on the staff of the Fiscal Commission.

On a personal note, I would like to briefly note that I have had significant personal experience with the value of the Social Security program having received survivor's benefits as a child after the death of my father, and more recently, having had to manage my family's finances for a period based on Social Security benefits.

Neither of those experiences have convinced me that providing COLAs that are greater than the rate of inflation is the desirable policy, rather, that we should try to find a way to make the Social Security system fiscally strong by making progressive changes in the benefits in a way that strengthens poverty protections for the programs.

The CPI offers a rare opportunity to achieve both significant savings spread across the entire budgets and by making a technical improvement to existing policies.

Brief background. The issue of overstatement of inflation in the CPI gained prominence in 1995 when then Federal Reserve Chairman Alan Greenspan mentioned the issue and his belief in testimony before Congress.

Even before Chairman Greenspan's comments, the Congressional Budget Office had done a report noting there was a growing discussion and debate among economists identifying a bias in CPI.

In response to Chairman Greenspan's comments, the Senate Finance Committee, chaired by then Senator Pat Moynihan, appointed the Baskin Commission, which did a review of CPI and estimated the bias of between 0.7 and 2.0 percent.

While there was controversy over many of the specific elements and disagreements of the specific findings, the general consensus was the findings were broadly accepted and confirmed by subsequent analysis by the Federal Reserve Board and others.

In response to that discussion, the Bureau of Labor Statistics did a thorough review of the methodology and made changes where it felt there were improvements that could be made, including introduction of the geometric mean to deal with lower substitution bias and other changes.

Those changes reduced the bias by 0.35 percent, and were implemented with very little notice or controversy, very similar to what switching to the Chained CPI would do.

The changes that BLS were able to do administratively did not address the issue of upper level substitution bias, which is what Chained CPI is intended to do, as described before.

On the Fiscal Commission, when we started meeting with various groups for suggestions about ideas for deficit reduction, switching to the Chained CPI for all parts of the budget was one

of the common themes of suggestions from groups across the ideological perspective, and in the Commission meetings, it was an area of early discussion for potential consensus among members.

There was definite agreement that it should only be done as a technical correction and therefore should be applied to all parts of the budget equally. Interestingly, it was a Democratic member of the Commission who first raised the idea of Chained CPI for Social Security, and a Republican member who raised it on the issue of revenues, both did so on the basis that it should be done for accuracy.

The final Commission report did include a switch to Chained CPI, and had some low income protections. It was one of the few elements that every member of the Commission who voted for the plan did support.

Since the Commission report has come out, there have been additional recommendations for improvements for low income protections, which should be considered.

Switching to the Chained CPI has broad support from the Congress, across the spectrum, which I have detailed in my testimony, and has been included in every major bipartisan proposal.

The budgetary effects have just been described. I would just note that while most of the focus has been on the impact it would have on Social Security, Social Security represents slightly more than a third of the savings while the remaining two-thirds of savings would come from revenues and changes in other Government programs.

Switching to Chained CPI would also close approximately one-fifth of the Social Security funding gap and help avoid the Trust Fund exhaustion, and therefore, avoid the automatic reduction in benefits that would occur with Trust Fund exhaustion.

It is important to remember that under Chained CPI, nominal benefits would continue to increase. We estimate they would increase by approximately 60 percent over 20 years under Chained CPI, instead of a 68 percent increase under the current measure.

Also, interestingly, real benefits for an 85 year old will be higher in the future than a similar retiree today.

If you were to compare a worker who retired at age 65 and is 85 today and took a worker who retired today at age 65 and received benefits subject to Chained CPI, that future retiree would still have a higher benefit in real inflation or adjusted terms by about eight percent higher.

On the distributional effects, both the Tax Policy Center and the Social Security Administration have found that switching to Chained CPI is roughly distribution neutral. However, that does not mean we should not have concerns about the distributional effects.

However, those should be addressed in the context ideally of a comprehensive plan where it makes comprehensive reforms of the Social Security program and tax system to make the Tax Code and Social Security system more progressive, but absent that, there are many proposals where you could make much more targeted, much more effective improvements to provide benefits for lower income beneficiaries who have been assisted by the higher Chained CPI

which provides a very blunt and fully targeted way to provide assistance to those populations.

Chairman JOHNSON. The gentleman's time has expired.

Mr. LORENZEN. Very briefly, moving to the CPI–E would be a very controversial step. There are many questions and concerns about the methodology of CPI–E.

I would just conclude by saying that any changes in deficit reduction are going to require tough choices, but moving to Chained CPI is not a change in policy, but rather a more accurate way to implement the current policy and any adverse effects of implementing current policy more accurately should be addressed by more targeted and effective policies.

[The prepared statement of Mr. Lorenzen follows:]

Testimony of Ed Lorenzen
Executive Director, The Moment of Truth Project
Senior Advisor, Committee for a Responsible Federal Budget
Before the Subcommittee on Social Security
Committee on Ways and Means
U.S. House of Representatives
April 18, 2013

Introduction

Mr. Chairman, Ranking Member Becerra, and members of the subcommittee, I appreciate the invitation to appear before you today to discuss the merits of switching to the chained Consumer Price Index (C-CPI-U) for provisions in the federal budget that are indexed to inflation.

I am the Executive Director of the Moment of Truth Project, a project of the Committee for a Responsible Federal Budget established to build on and continue the work of the National Commission on Fiscal Responsibility and Reform (also known as the Simpson-Bowles Commission) and which is co-chaired by Fiscal Commission Co-chairs Erskine Bowles and Alan Simpson. I was a staff member on the Fiscal Commission and was involved in development of all policies in the final report, including the proposal to switch to the chained CPI and the broader Social Security reform recommendations. I have been involved in issues related to fiscal policy and Social Security in a number of capacities as a Congressional staff member and in the non-profit sector for over twenty years.

On a personal note, I have significant experience with the Social Security program, which shaped my views both about the tremendous importance of preserving a strong Social Security system and the need to address some of the shortcomings of the program. As a child, I received Social Security survivor's benefits along with my sister after the death of our father. Those benefits were critical in helping my mother make ends meet, provide for my sister and I during some tough financial times our family experienced throughout my childhood, and help pay for my education. More recently, I had the responsibility for managing my parent's finances after my mother was gravely injured in an automobile accident, with my stepfather's Social Security retirement benefit and my mother's Social Security disability benefit providing their only sources of income. Because of their intermittent work histories and other factors, my stepfather's relatively modest Social Security benefit and my mother's very small disability benefit were inadequate to meet expenses in most months.

But neither my experience as a child illustrating the value of the Social Security program nor the shortcomings of the current system I witnessed with my parents as an adult has convinced me that providing cost-of-living adjustments that are greater than inflation is a desirable or justified policy. Rather, it has informed my view about the importance of acting soon to enact policies to make Social Security financially sound for future beneficiaries in a progressive manner that improves benefits and strengthens poverty protections for those who are not sufficiently protected by the current program. I believe that the Social Security reforms included in the Fiscal Commission report, with some tweaks to the benefit formula and minimum benefit provision we have developed based on additional analysis, would achieve both of those goals.

While many of the policy options under consideration in recent budget negotiations require various tradeoffs and tough policy choices to put our debt on a sustainable path, the switch to the chained CPI requires neither. In fact, it offers a rare opportunity to achieve significant savings spread across the entire budget by making a technical improvement to existing policies.

Background

The issue of bias in the Consumer Price Index (CPI) first gained prominence in 1995 after then Federal Reserve Board Chairman Alan Greenspan stated in testimony before the House Budget committee that he believed the existing measure of CPI overstated inflation by 0.5 to 1.5 percent. Chairman Greenspan's remarks called attention to a growing debate among economists and others that had been developing for several years. A report issued by the Congressional Budget Office (CBO) in October 1994 found increased evidence of upward bias in CPI and cited estimates of bias between 0.2 to 1.5 percentage points a year greater, with CBO estimating the bias at somewhere between 0.2 and 0.8 percentage points of GDP based on the empirical evidence at the time.[1]

In response to the increased attention on the issue of bias in the CPI following Chairman Greenspan's comments, the Senate Finance Committee convened a bipartisan blue ribbon commission to study the issue called the "Advisory Commission to Study the Consumer Price Index" and appointed economist Michael Boskin as its chair. The Boskin Commission issued a report identifying several sources of bias in the CPI and suggesting a range for the potential overstatement of between 0.7 percent and 2.0 percent.[2] While some of the specific findings and the overall estimate of bias estimated by the Boskin Commission were subject to criticism, the overall conclusion that shortcomings in the methodology for calculating CPI overstated inflation was supported by subsequent research from staff economists of the Federal Reserve and broadly accepted by most economists.

Following the release of the Boskin Commission report, the Bureau of Labor Statistics (BLS) made a number of changes in the methodology for calculating CPI to address the sources of bias identified by the Commission and others. In 1999, the BLS adopted a geometric mean to account for improvements to what is known as "lower level substitution bias," when individuals substitute within item categories as relative prices change. BLS has made other changes such as the use of hedonic quality adjustments, which have also resulted in a slight reduction in the growth rate of CPI.

Implementation of the geometric mean has reduced the annual growth rate of the CPI by approximately 0.3 percentage points, with other changes reducing CPI further. The cumulative impact of these changes on the reported CPI is approximately 0.35 percentage points, which is slightly greater than the impact of switching to the chained CPI. Yet these changes implemented by the BLS were automatically applied to the indexation of government programs and the tax code with little notice or controversy.

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[1] Congressional Budget Office, "Is the Growth of the CPI a Biased Measure of Changes in the Cost of Living?" (October 1994). http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/48xx/doc4839/doc48.pdf

[2] The Advisory Commission To Study The Consumer Price Index, "Toward A More Accurate Measure Of The Cost Of Living" (December 4, 1996). http://www.ssa.gov/history/reports/boskinrpt.html

However, the changes made to date by the BLS have not accounted for consumer substitution taking place between categories – known as "upper level substitution bias" – which the chained CPI would address. This kind of substitution bias occurs because the regular measure of CPI assumes consumers will buy the same basket of goods regardless of relative prices, not realizing that consumers can often soften the blow of increased relative prices by consuming more of a relatively cheaper good. For example, if consumers respond to the price increase for Granny Smith apples by buying more Red Delicious apples instead (lower level substitution bias – changes within categories), this is accounted for in the current CPI. Though, the formula does not account for changes between categories (upper level substitution bias) if consumers respond to the higher price of Granny Smith apples by buying less apples altogether and purchasing more oranges instead.

Upper level substitution bias is an artifact of BLS's reliance on a fixed "market basket" of goods, based on old purchasing habits. Instead, this could be fixed by using a market basket based on the newest purchasing habits, except that this would actually cause the opposite problem where substitution biases cause the CPI to understate inflation.

As a result, in 2002 the BLS created a new measure of inflation called the chained CPI (also known as the superlative CPI or the C-CPI-U) to account for consumer substitution between categories. The chained CPI addresses the upper level substitution bias by using a superlative index that updates expenditure weights and formulas in order to address consumer response to substitution between categories. As the CBO explains, the chained CPI "attempts to fully account for the effects of economic substitution on changes in the cost of living… [It] provides an unbiased estimate of changes in the cost of living from one month to the next by using market baskets from both months, thus 'chaining' the two months together."[3]

This measure has been refined and improved since it was initially published. On average, the chained CPI has been 0.25 to 0.3 percentage points lower per year than the standard CPI measures. Though this difference is small on average, it compounds over time. Depending on which index you use, prices have either increased by 34 percent (CPI-U and CPI-W) or 29 percent (chained CPI) between 2000 and 2011.

However, unlike the methodological changes in the calculation of CPI-U and CPI-W that are automatically reflected in the published measures used for indexing programs under current law, using the more accurate chained CPI for indexation instead of the CPI-U or CPI-W requires a statutory change in law.

Fiscal Commission Proposal

When the staff of the Fiscal Commission began assembling deficit reduction options and meeting with organizations and individuals from across the spectrum to solicit suggestions for deficit reduction, switching to the chained CPI was one of the common themes that emerged as an option with strong substantive and political merit.

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[3] Congressional Budget Office, "Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code" (February 24, 2010). http://www.cbo.gov/ftpdocs/112xx/doc11256/CPI_brief.pdf

Switching to the chained CPI was an early area of general consensus as Commission members began to discuss specific policy options. It was suggested as an option to reduce the Social Security shortfall by one of the Democratic Members of the mandatory spending working groups, and had previously been included in bipartisan tax reform legislation introduced by Republican Commission member Senator Judd Gregg. Commission members emphasized the importance of making this change as a technical improvement to more accurately index programs for inflation and believed that, in order to be credible, the change must be applied to all provisions in the budget (both the spending and revenue sides) that are indexed to inflation.

In the fall of 2010, the Fiscal Commission issued its final report, "The Moment of Truth," which was supported by eleven of the eighteen Commission members and included over sixty specific recommendations, including a recommendation to adopt the chained CPI as a more accurate measure for all CPI-linked provisions in the budget.[4]

While every member of the Commission who supported the final report had to accept one or more items they opposed in the context of the entire plan, the chained CPI was one of the few major provisions in the plan that was supported by all of those who endorsed the final plan and even a few who opposed it. For instance, Andy Stern, who opposed the Commission's plan, included the chained CPI in the alternative proposal he put forward.[5]

Since the report was issued, additional suggestions have been put forward for benefit enhancements and low income protections beyond the twenty year bump up in the original Commission recommendation. These include indexing the Supplemental Security Income (SSI) disregard and asset limits that deserve serious consideration. However, the rationale for using the most accurate measure of inflation to index provisions in the federal budget remains as strong today as it did when the Commission report was issued.

Broad Support for Chained CPI

Switching to the chained CPI enjoys broad support from experts across the political and ideological spectrum who agree that it is the best available measure for overall changes in the cost of living. Support ranges from Austan Goolsbee, who served as Chair of the Council of Economic Advisors under President Obama, to Michael Boskin, who held the same position under the President George H.W. Bush; experts at the Heritage Foundation, the Center of American Progress, the Center on Budget and Policy Priorities, American Enterprise Institute, Progressive Policy Institute; the National Research Council's Committee on National Statistics; and the editorial boards of the Washington Post and USA Today.

Every serious bipartisan budget plan – from the Fiscal Commission, the Bipartisan Policy Center's Debt Reduction Task Force ("Domenici-Rivlin"), the bipartisan Senate "Gang of Six" and numerous other Congressional leaders in both parties to the Obama-Boehner negotiations – has

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[4] National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (December 1, 2010). http://www.momentoftruthproject.org/sites/default/files/TheMomentofTruth12_1_2010.pdf

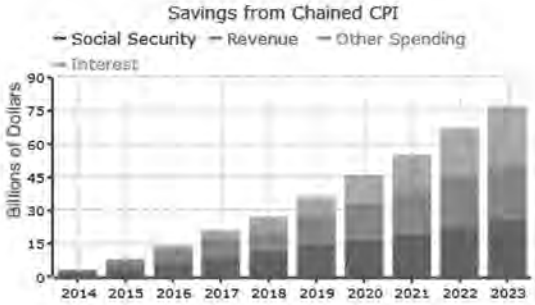
[5] Andy Stern, "21st Century Plan for America's Leadership," (December 2010). http://crfb.org/blogs/stern-releases-plan-lower-budget-deficitand-investment-deficit

included savings from switching to the chained CPI to more accurately index provisions in the budget.

Budgetary effects

In addition to improving technical accuracy, switching to the chained CPI would substantially help to reduce future deficits. While most of the discussion regarding the proposals to switch to the chained CPI have focused on the impact it would have on Social Security lead to the impression that it singles out Social Security for savings, the impact of the policy would actually be spread much more broadly and applied to all provisions in the budget currently indexed to changes in the cost of living based on CPI. In fact, Social Security would only make up one third of the savings from switching to the chained CPI over the next decade. Another third of the savings would come from new revenue and the remaining third from other spending programs and interest savings.

According to the CBO, switching to the chained CPI would reduce deficits by $340 billion over the next decade if implemented for 2014, relative to current law which projects continued overpayments and under collection. Adopting the chained CPI for Social Security cost-of-living adjustments (COLAs) alone would save $127 billion through 2023, over the same period. Using it for COLAs in other federal retirement programs would save another $38 billion, and there would be an additional $51 billion in deficit reduction from other areas of the budget. On the tax side, moving to the chained CPI would cause tax bracket thresholds and other parameters to grow more slowly and raise an extra $124 billion over the ten-year period relative to current law.



Source: Committee for a Responsible Federal Budget

Using a superlative measure of inflation has the added benefit of providing a more accurate understanding of changes in real variables in the economy. As the Boskin Commission report stated, "Even if no federal program on either the outlay or revenue side of the budget were indexed, it would still be desirable to improve the quality of measures of the cost of living from the standpoint of providing citizens a better and more accurate estimate of what was actually going on

in the economy."[6] However, the magnitude of our fiscal challenges and the substantial fiscal impact of achieving this correction make this change particularly timely.

In addition to the $340 billion in deficit reduction, implementing the chained CPI would contribute to reducing the long-term funding shortfall in Social Security. Switching to the chained CPI for COLAs would close more than one fifth of Social Security's 75-year shortfall. This would be a significant down payment toward bringing that program into long-term balance, preventing the across-the-board cut in all benefits projected by the Social Security Trustees under current law and ensuring its existence for our grandchildren.

While this policy would provide much needed deficit reduction, it should not be considered a change in tax or spending policy. Cost of living adjustments for retirement benefits and indexation of other government programs and provisions in the tax code are intended to ensure these provisions keep pace with inflation. Rather than serving to raise taxes and cut benefits, switching to the chained CPI would simply be fulfilling the policy of properly adjusting provisions in the budget to reflect for cost of living changes.

Impact on Benefits

Importantly, under chained CPI, nominal benefits for Social Security and other retirement programs will continue to grow year after year. No one will see the dollar value of their benefits go down – instead they will continue to go up at a modestly slower pace. The Committee for a Responsible Federal Budget estimates that an individual's Social Security benefits will rise by approximately 60 percent over 20 years under chained CPI, compared to just under 68 percent under the current CPI-W measure.

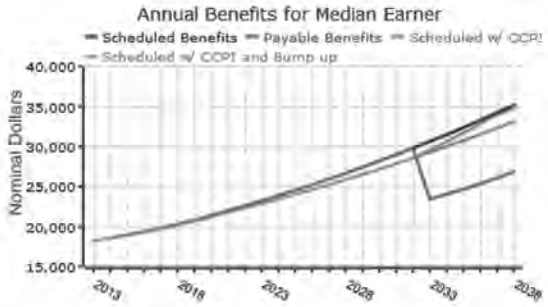
Most of the criticism of switching to the chained CPI focuses on the reduction in benefit levels relative to "scheduled benefits." Under this measure, the chained CPI reduces benefits 20 years from now by between five to six percent. But the scheduled benefits analysis ignores the projected exhaustion of the Social Security trust fund by 2033. At that point, revenues will only be able to cover 75 percent of promised benefits by assuming that general revenue funds are shifted to cover the funding shortfall and to ensure that Social Security pays full benefits despite the legal requirement that outlays for benefits be limited to dedicated revenues and the longstanding social insurance principle behind the Social Security system.

By contrast, "payable benefits" take into account trust fund insolvency and the automatic benefit reduction that would be required under current law. Considering that the trust fund is projected to be exhausted in 2033, at which point beneficiaries would receive a nearly one-quarter benefit cut, benefits under the chained CPI would be about 25 percent higher than under the payable benefit scenario in 2033.

In addition, real benefits for an 85 year old will be higher in the future than they are for a similar retiree today. When the real benefits for an 85-year old in 2013 are compared to a similar

[6] The Advisory Commission To Study The Consumer Price Index, "Toward A More Accurate Measure Of The Cost Of Living" (December 4, 1996). http://www.ssa.gov/history/reports/boskinrpt.html

beneficiary in 2033 (assuming both retire at age 65 and accounting for the switch to the chained CPI), real benefits for the latter beneficiary would be higher because the growth in initial benefits, which essentially grows with wage inflation, outweighs the slower growth of the chained CPI. Specifically, benefits for the 85-year old in 2033 would be 8 percent higher than the present-day 85-year old.



Source: Social Security Administration

Distributional Effects of Chained CPI

One concern that has been raised about proposals to switching to the chained CPI is the distributional impact and the effect on lower-income Social Security beneficiaries. The non-partisan Tax Policy Center and the Social Security Administration have both estimated that using the chained CPI would be roughly distributionally neutral for both the tax code and Social Security.

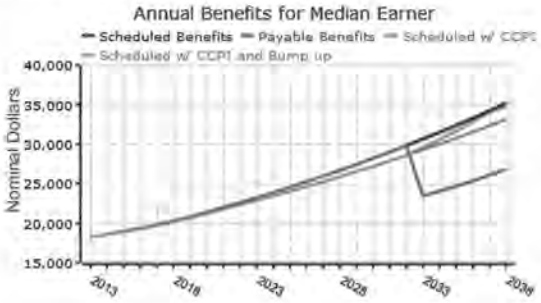
Because the COLA offers the same percent increase for all beneficiaries, the effect of switching to a more accurate, but modest measure of inflation would therefore be roughly the same for everyone. Of course, in reality there would be some slight differences due to a number of factors, including how long individuals receive benefits from the program. However, these deviations would actually be marginally progressive rather than regressive. According to the Social Security Administration's shared earnings quintile, switching to the chained CPI would reduce average benefits in 2050 by about three percent relative to the current CPI for those in the bottom three quintiles, and four percent for those in the top two quintiles. It should be noted that other methods of modeling income – such as the household benefit quintile, individual income quintile, and the average indexed monthly earnings (AIME) quintile – can slightly skew the distributional impact of the chained CPI.

Still, distributional neutrality does not mean we do not need to be concerned with low-income individuals and the very old. For all its flaws, the current CPI formula offers accidental protection to beneficiaries whose initial benefit levels under the current formula are inadequate and those most at risk of outliving their savings – even though it does so in a very blunt and untargeted way. Instead

of this approach, a better way to protect those groups would be through specific policy changes targeted to those populations.

Ideally, these concerns would be addressed in the context of a comprehensive plan which includes other policies to improve progressivity of the Social Security system and tax code and other provisions to benefit low income and vulnerable populations. For example, in addition to switching to chained CPI, the Fiscal Commission proposal included a tax reform proposal which eliminated or significantly scaled back many tax breaks and preferences that disproportionately benefit higher income taxpayers along with Social Security reforms which raised the taxable maximum and made the benefit formula more progressive. As a result, the net impact of the Fiscal Commission recommendations was highly progressive for both revenues and Social Security benefits. The Domenici-Rivlin plan put forward by the Bipartisan Policy Center Debt Reduction Task Force, which also recommended switching to the chained CPI as part of a comprehensive deficit reduction plan, produced similar results.

Looking specifically at proposals to switch to the chained CPI in isolation, any undesirable effects of the chained CPI on certain vulnerable populations can be addressed through small policy changes targeted to those populations rather than continuing to provide higher than justified inflation adjustments for all individuals regardless of income at a cost $340 billion over ten years. For example, the Fiscal Commission recommended instituting a flat dollar benefit bump-up equal to five percent of the average benefit. Calculating the bump up based on the average benefit rather than as a percentage of an individual's benefit level would target assistance to those who need it the most by providing a greater percentage increase in benefit levels to beneficiaries with benefits below the average level, as illustrated by the chart below.



Source: Social Security Administration

Other policies such as enhancing SSI benefits or increasing the refundability of certain credits on the tax side could be included in a package to offset the impact of the change on lower income individuals. Moreover, policymakers could further look at enhancements to food stamps or other low-income programs to offset the impact on means-tested programs.

Overall, there is no reason to maintain an average tax windfall of $450 for those in the top quintile as a result of using an inaccurate measure of inflation in the tax code just to prevent a $25 tax increase for those in the bottom quintile. Likewise, there is little reason to provide higher than warranted increases in benefits for all Social Security beneficiaries just to protect lower-income beneficiaries when those concerns could be addressed by much more targeted policies and at lower overall costs.

Chained CPI and Social Security

One of the primary arguments raised against using the chained CPI to index Social Security benefits is that it is inappropriate because it does not reflect the spending patterns of seniors, particularly the higher than average spending on health care by seniors. As a result there have been suggestions that the experimental CPI for the elderly, or CPI-E, an experimental index developed by BLS, would be a more appropriate measure to calculate Social Security COLAs.

In contrast to the broad consensus among economists that the current CPI measure overstates inflation, there is much less agreement about whether the correct cost of living index for the elderly is, in fact, higher than it is for younger Americans. A recent CBO report stated that "it is unclear whether the cost of living actually grows at a faster rate for the elderly than for younger people."[7]

With respect to the criticism that using the chained CPI to index Social Security does not account for higher spending by seniors devoted to health care, studies have suggested that the BLS may overstate the effect of health costs on inflation. This would offset the impact that higher average spending on health care by seniors would have on inflation. In addition, while total spending on health care for seniors as a group is higher than other age cohorts, most of the higher spending is concentrated in a relatively small portion of seniors.[8] Instead of providing higher cost of living adjustments for all seniors to account for higher health care costs for a small percentage of seniors, the better policy would be to provide catastrophic coverage for seniors with high health care costs through out of pocket limits in the Medicare program as the Fiscal Commission and others recommended.

The CPI-E has several flaws that are likely to overstate inflation. In addition to the limitations of the current measure, the CPI-E fails to account for the totality of the differences, beyond healthcare, between the spending patterns of the elderly and of the general population, such as senior discounts or outlet and mail-order shopping. The higher weight given to health expenditures in CPI-E would also exacerbate the potential overstatement of health inflation in the CPI.

Furthermore, it is not clear that the way CPI measures the costs of homeownership – by imputing the rental value of the home – is a very accurate measure of cost of living given that 80 percent of seniors are homeowners rather than renters (compared to 60 percent of the population under age 65)

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[7] Congressional Budget Office, "Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code" (February 24, 2010). http://www.cbo.gov/ftpdocs/112xx/doc11256/CPI_brief.pdf

[8] Robert J. Gordon, "The Boskin Commission Report: A Retrospective One Decade Later," Northwestern University and National Bureau of Economic Research (2006).
http://faculty-web.at.northwestern.edu/economics/gordon/P376_JPM_Final_060313.pdf

and 70 percent of them have fully paid off their mortgage (compared to 17 percent of the population under age 65). In other words, more than half of seniors have no mortgage or rental costs even as the CPI-E – almost half of which is made up by housing – assumes they have growing rental costs.

The BLS itself stresses the limitations of the CPI-E because of shortcomings in the methodology, warning that "any conclusions drawn from the data should be interpreted with caution" and says it is not likely to be appropriate as an index to use for Social Security COLAs.[9] A report by the National Research Council's Committee on National Statistics echoes this by saying, "In the absence of an index that can capture these differences, we see no rationale for basing social security COLAs on the type of indexes constructed in the BLS studies."[10]

It is true that using a more accurate measure of inflation to index Social Security may exacerbate some of the shortcomings of the current Social Security system, which may provide too few resources to very-low income individuals, particularly as they get older and outlive their retirement savings. However, those shortcomings can and should be addressed through targeted policy changes, such as those previously mentioned, designed to help those populations instead of providing higher than justified COLAs to all beneficiaries.

Implementation of Switching to the Chained CPI

One shortcoming of the chained CPI is that it requires data which is not fully available for two years, and so the BLS publishes the chained CPI in initial and interim forms before publishing in final form with a time lag. However, as the BLS has grown more experienced with calculating the chained CPI, the errors associated with its initial estimate have and will continue to decrease. More importantly, the CBO and others have identified ways to ensure COLAs remain accurate over time, by calculating COLAs using a combination of the current initial chained CPI and a correction for past errors.
In this way, any errors from using the chained CPI would be small, and would disappear by the time the final index was released. This differs from the problems associated with the overstatement of the current CPI, which compound rather than correct over time.

Conclusion

Addressing our fiscal challenges will require many tough choices and policies, but adopting the chained CPI represents neither. Eliminating the unjustified increases in spending and reduced revenues from the current inaccurate measure of inflation should be a priority for any comprehensive deficit reduction plan. The chained CPI represents a more accurate and effective way to maintain purchasing power in spending programs and to index various parts of the tax code.

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[9] Kenneth Stewart, "The experimental consumer price index for elderly Americans (CPI-E): 1982–2007," Bureau of Labor Statistics (April 2008). http://www.bls.gov/opub/mlr/2008/04/art2full.pdf

[10] National Research Council, *At What Price?: Conceptualizing and Measuring Cost-of-Living and Price Indexes*. By Panel on Conceptual, Measurement, and Other Statistical Issues in Developing Cost-of-Living Indexes, Committee on National Statistics, National Research Council

Any policy that affects either Social Security and other benefit programs or government revenues will be controversial, but if a technical change with broad support among experts like switching to the chained CPI to more accurately index provisions to inflation cannot win bipartisan support in Congress, then prospects for putting our debt on a sustainable, downward path as a share of the economy are grim.

Chairman JOHNSON. Thank you, sir.

Ms. Altman, you are recognized.

STATEMENT OF NANCY ALTMAN, CO–CHAIR, STRENGTHEN SOCIAL SECURITY COALITION

Ms. ALTMAN. Thank you. As you know, every January, Social Security benefits are automatically adjusted for inflation. Some refer to these adjustments as increases, but they are not.

They are intended to allow those on fixed incomes to remain in place, to simply tread water, without accurate and timely inflation adjustments, retirees, people with serious and permanent disabilities, and others will see their Social Security erode as they age.

That is no small matter. Half of retirees have total incomes, that is incomes from all sources, of less than $17,000. Most of that comes from Social Security. One out of three seniors relies on Social Security for virtually all of their income. Nearly one out of two seniors age 80 or over does. For women and people of color, the reliance is even greater.

The intent of the adjustment is to allow beneficiaries to tread water, but they are not, they are sinking. The current inflation index under measures the inflation they experience.

The Index is designed for workers and the general public, but seniors and people with disabilities spend more on health care where prices rise faster and less on clothing, recreation and other items where prices tend to rise slower.

Chained weighting an Index that already under measures their inflation simply will sink beneficiaries faster.

By shielding some from the harshest impacts of the Chained CPI, the Simpson-Bowles, Rivlin-Domenici, and Administration proposals all implicitly concede that it is less accurate for this population.

People do not need to be shielded from a more accurate adjustment.

These protections cannot solve what is a poorly targeted benefit cut. The Chained CPI cuts the benefits of every single one of today's 57 million beneficiaries, but people already on fixed incomes have little or no ability to make up the loss.

In addition, the cost grows with each succeeding year, like a snowball rolling down a hill, hitting hardest the oldest of the old, the poor and the near poor.

Members must confront many divisive issues, but Social Security is not one of them. Poll after poll reveals that Democrats, Independents, Republicans, Union households, tea parties, the young, the old, and virtually every other demographic overwhelmingly agree about Social Security.

They agree that Social Security should not be addressed as part of a deficit deal to reduce the deficit, and they are right. Cutting Social Security does not reduce by even a penny the Federal Government's total debt burden. Cutting it does not buy the Government a single extra day of borrowing authority.

Let me repeat because many people find this surprising. Cutting Social Security does not reduce at all the Federal Government's debt subject to the debt limit.

Including Social Security in a deficit package gives the appearance that policy makers are raiding Social Security's contributions and diverting them to unauthorized purposes.

You can easily avoid this improper appearance by addressing Social Security as it should be addressed, on its own, and in the sunshine.

That is how it was done in 1977 and 1983, when Social Security's projected shortfall was much more immediate in 1983, it was six months versus 20 years today, and much larger, over eight percent of taxable payroll in 1977 versus less than three percent today.

Social Security is too complicated and too important to address any other way, but to do that, policy makers have to be prepared to follow the will of the people.

This body must open the door to more than just a narrow group of budget experts, an open process focused solely on Social Security will not lead to the Chained CPI. Instead, it will lead, I am confident, to a stronger foundation of economic security for America's workers and their families.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Altman follows:]

STATEMENT OF NANCY J. ALTMAN
CO-DIRECTOR, SOCIAL SECURITY WORKS
CO-CHAIR, THE STRENGTHEN SOCIAL SECURITY COALITION

HEARING ON
THE PRESIDENT'S AND OTHER BIPARTISAN ENTITLTMENT REFORM PROPOSALS

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON SOCIAL SECURITY

APRIL 18, 2013

Chairman Johnson, Ranking Member Becerra, and Members of the Subcommittee:

As co-director of Social Security Works, I co-chair the Strengthen Social Security Coalition, a broad-based coalition of over 320 national and state organizations representing 50 million Americans, including seniors, workers, women, people with disabilities, children, young adults, veterans, people of low income, people of color, communities of faith, and others. I also chair the Board of Directors of the Pension Rights Center, and serve on the Board of the National Academy of Social Insurance.

I have worked in the area of retirement income for over 35 years, both inside and outside of government. In the private sector, I have worked as a pension lawyer with Covington and Burling, and have taught courses on retirement income at Harvard University. In 1982, I had the privilege to serve as the top assistant to Alan Greenspan in his capacity as the Chairman of the so-called Greenspan commission, whose recommendations formed the basis for the Social Security Amendments of 1983. Prior to that, I was fortunate to serve as a legislative assistant to Senator John C. Danforth (R-MO.).

I appreciate the opportunity to testify before this subcommittee and to present this written statement on the important subject of how best to automatically adjust Social Security benefits to ensure that they retain their purchasing power over time.

The Purpose Behind Automatic Inflation Adjustments of Social Security Benefits

Social Security benefits are adjusted automatically every January to prevent their erosion if and when there has been inflation. Some describe these adjustments as 'increases," but they are not. They are intended to prevent erosion in the purchasing power of Social Security's modest benefits, which average just $13,900 for all beneficiaries.

President Richard Nixon, who championed these automatic adjustments, explained their importance when he signed them into law on July 1, 1972:

> "One important feature of this legislation which I greet with special favor is the automatic increase provision which will allow social security benefits to keep pace with the cost of living. This provision is one which I have long urged, and I am pleased that the Congress has at last fulfilled a request which I have been making since the first months of my Administration. This action constitutes a major break-through for older Americans, for it says at last that inflation-proof social security benefits are theirs as a matter of right, and not as something which must be temporarily won over and over again from each succeeding Congress."

As President Nixon recognized, this basic benefit protection is an extremely important feature of our Social Security system. Indeed, full inflation protection is virtually nonexistent for those seniors fortunate to have employer-sponsored pension plans. Once workers retire, they no longer have salaries or wages which are capable of increasing with the increasing productivity of the nation. Rather they must rely on Social Security, and, if they are fortunate, employer-sponsored pension plans, and savings.

The Importance of Automatically Adjusting Social Security Benefits

A worker who earns $40,000 and retires in 2015 at age 66 will receive a Social Security benefit that replaces 39.8 percent of those earnings. That retired worker will receive no gain as the nation becomes wealthier and more productive. Rather, that income is, in colloquial terms, "fixed." It is very valuable, because unlike savings, one cannot outlive it. It is paid for life. If it weren't adjusted for inflation though, it would become less and less valuable as one aged.

This is no small matter. The vast majority of seniors rely on Social Security for most of their incomes. For more than six out of ten seniors, Social Security accounts for half or more of their total income. For one out of three, Social Security represents 90 percent or more of their total incomes.

The reliance is even greater as people age and exhaust other sources of support. For those aged 80 and over, three out of four rely on Social Security for half or more of their income. For almost one out of two (45 percent), Social Security is 90 percent or more. For widowed, divorced, or never-married women and for people of color, the percentages are even higher at those ages.

Because those on fixed incomes do not enjoy productivity gains, they on average have considerably lower incomes than the general population. Half of retirees aged 65 and older have total incomes -- from all sources -- of just $16,749 or less. Most assets of seniors are not protected against inflation and are not guaranteed for life. If Social Security were not adjusted to take account of inflation, their Social Security benefits, which already fail to experience productivity gains, would slowly but inexorably erode over time in real terms as they aged. These earned benefits would lose value at the same time that they exhausted other assets and that health care costs were increasing.

To ensure that the value of these vital but modest benefits does not erode as people age, it is crucial that the automatic adjustment be as accurate as possible, and does not under-measure inflation. At the time of the enactment of automatic adjustments, in 1972, the Bureau of Labor Statistics produced only one measure of inflation – which today is referred to as the Consumer Price Index for Urban Wage Earners and Clerical Workers or CPI-W. Ironically, the index is limited to workers, not retirees, but was the only, and so best, measure available.

In recognition, though, that seniors have very different expenditures than those of workers or the general population, the Older Americans Act of 1987, which President Ronald Reagan signed into law on November 30, 1987, included a provision directing the Secretary of Labor to develop, through the Bureau of Labor Statistics, a consumer price index for older Americans. In response to the legislative directive, the Bureau of Labor Statistics created and continues to produce the Consumer Price Index for the Elderly, referred to by the shorthand, CPI-E.[1]

[1] In calculating the CPI-E, the Bureau of Labor Statistics takes the work it does in constructing the CPI-U and narrows it to capture the subset of those aged 62 and over. To have a completely accurate CPI-E, it would need to also conduct a survey of expenditures and point of purchase tailored specifically to those aged 62 and older, because seniors often buy different goods

The CPI-E has historically reported higher rates of inflation than the consumer price indices measuring the inflation experienced by workers or the general population. This is unsurprising. On average, seniors spend a higher percentage of their incomes on health care than workers or the general population, and health care costs have grown, and are projected to continue to grow, at a faster rate than other goods and services. On average, seniors spend a lower percentage of their incomes on apparel, transportation, and recreation than workers or the general population, and those goods and services have not experienced as rapid inflation.

For those same reasons, the current measure of inflation used to automatically adjust Social Security benefits under-measures the inflation experienced, on average, by Social Security beneficiaries.

A Consnmer Price Index Which Under-Measnres Inflation Will Be Even Less Accurate if It Is "Chained"

In common-sense terms, one's standard of living is maintained if one can continue to purchase the same goods and services that one has been able to afford in the past. If one can no longer afford those goods and services, but must substitute less-preferred goods and services or reduce one's consumption in other ways, one's standard of living has declined. That common-sense understanding was the approach the Bureau of Labor Statistics employed historically. It measured a fixed basket of goods and services determined by surveying purchasing patterns of the population for whom inflation was being measured.

Starting in 1999, the Bureau of Labor Statistics changed its method of calculating its CPI indices to adjust for the possibility of substitution of less expensive goods within each of its 211 categories of goods and services within its 30 geographical areas.[2] Starting in August, 2002, it began to publish the Chained Consumer Price Index for All Urban Consumers (C-CPI-U or chained CPI), which adjusts for substitutions among the 211 categories, but the index is not used by the government in any official capacity.

One can argue whether having an index account for substitution in response to lower prices, producing a lower calculation of inflation, is more or less accurate, as a general matter. However, adjusting for substitution with respect to an index which already under-measures inflation will simply make the measure even less accurate, because the under-measurement will be larger.

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in different quantities and shop at different stores in different frequency than the general population. Consequently, the Bureau has labeled the CPI-E "experimental." If those surveys were done, the differential in inflation between what seniors experience and what workers and the general population experience could be even greater.

[2] The changes may or may not have been the result of inappropriate political pressure to change the measure so that inflation would appear to be lower. The then-Director of the Bureau of Labor Statistics, Katharine G. Abraham, wrote, in a paper presented at a meeting of the American Statistical Association on August 6, 1996,

> "Back in the early winter of 1995, Federal Reserve Board Chairman Alan Greenspan testified before the Congress that he thought the CPI substantially overstated the rate of growth in the cost of living. His testimony generated a considerable amount of discussion. Soon afterwards, Speaker of the House Newt Gingrich, at a town meeting in Kennesaw, Georgia, was asked about the CPI and responded by saying, 'We have a handful of bureaucrats who, all professional economists agree, have an error in their calculations. If they can't get it right in the next 30 days or so, we zero them out, we transfer the responsibility to either the Federal Reserve or the Treasury and tell them to get it right.'"

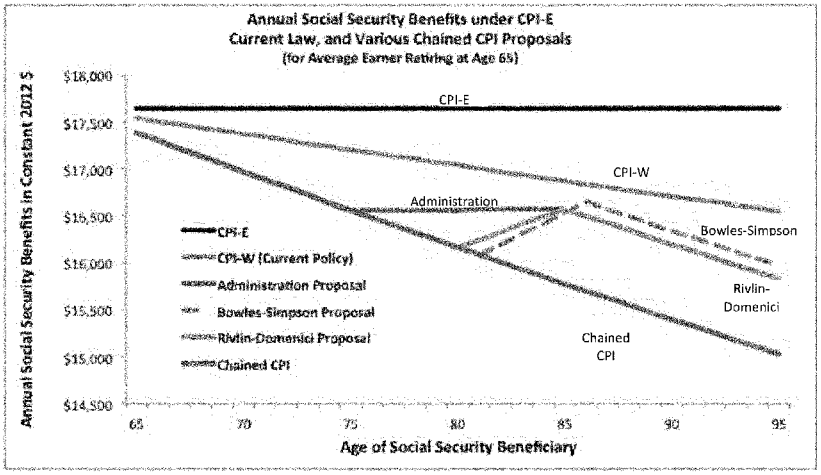
Abraham, Katharine G., Bureau of Labor Statistics, "Statistics Under the Spotlight: Improving the Consumer Price Index: Statement," Paper presented at a meeting of the American Statistical Association, Chicago, Illinois, August 6, 1996. at ftp://ftp.bls.gov/pub/special.requests/cpi/cpibri.txt (last viewed, April 12, 2013).

That is why 250 leading PhD economists and more than 50 experts with PhD degrees in related fields issued a statement on November 20, 2012, opposing the use of the chained CPI for Social Security. In that statement, they concluded emphatically that "there is no empirical basis" for claiming that the chained CPI is a more accurate measure of the inflation experienced by Social Security beneficiaries.

The Chained CPI for Social Security is a Poorly Targeted Benefit Cut

Chain-weighting an index that already under-measures the inflation experienced by Social Security beneficiaries would result in a faster erosion of their Social Security benefits. Implicitly recognizing that the proposal to shift to the chained CPI for Social Security and other programs that serve the elderly and those with serious and permanent disabilities is nothing more than a benefit cut masquerading as a technical adjustment, three leading proposals to shift to the chained CPI – the proposal of former Senator Alan Simpson and Erskine Bowles, the proposal of the Debt Reduction Task Force chaired by former Senator Pete Domenici and Alice Rivlin, and the proposal contained in the Administration's budget -- all call for measures to ameliorate, to a small extent, the impact of the chained CPI, as the graph below shows.[3] These proposals are poorly targeted cuts.

Those currently on fixed incomes have little or no ability to adjust to declines in what already are very modest incomes. As mentioned above, half of retirees aged 65 and older have total incomes, from all sources, of just $16,749 or less. For that reason, many members have stated their opposition to cutting benefits of those 55 and over. Moreover, as the graph also reveals, the largest cuts fall on the oldest old, because the cut compounds over time. The increasingly large cut occurs as other resources are exhausted and health costs are increasing, on average.



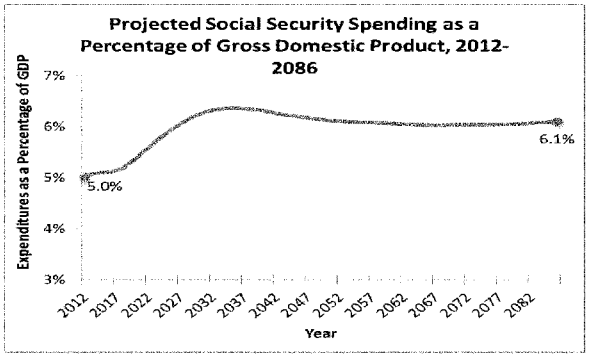
[3] Social Security Works created the graph from calculations based on estimates of the Social Security Office of the Actuary, Social Security Administration. "Average Earner" is a worker with career average earnings of $40,728.

In addition, the benefit cut in the form of the chained CPI creates a substantial burden on the poorest in society. For that reason, the Administration budget proposes to exempt means-tested programs from the switch to the chained CPI, but this still leaves many poor and near poor unprotected. The Supplemental Security Income program ("SSI") is a program for the aged, blind, and disabled who have extremely limited income and assets. If an individual receives Social Security, because he or she worked a sufficient number of quarters to qualify, the SSI benefit is reduced dollar for dollar after disregarding the first $20. There are 2.8 million people who receive income from both Social Security and SSI – the so-called dual eligibles – so part of their income will still be subject to the benefit cut. Moreover, because the SSI income and asset limits are so meager, there are 9.4 million poor or near poor who receive only Social Security, and so would be subject to the cut imposed by the chained CPI.[4]

If Congress is intent on cutting Social Security's benefits, there are numerous ways to do so. They all have disadvantages, but have distributional impacts different from the chained CPI. For example, they may not affect current beneficiaries, the oldest old, or the most vulnerable and disadvantaged. Nevertheless, as the following sections explain, cutting Social Security's modest benefits at all is unwise policy, unnecessary, and in violation of the will of the American people.

Social Security is Fully Affordable, Cutting It Does Not Reduce, By Even a Penny, the Total Federal Debt Subject to Limit, and Should Not Be Part of Any Grand-Bargain Deficit Deal

One problem with talking about "entitlements" is that Social Security, Medicare, and Medicaid are three very different programs, with different structures, goals, and challenges. According to the Congressional Budget Office, if the nation's health care costs, private as well as public, were to continue to grow at historical rates, the nation would be spending 99 percent of its Gross Domestic Product on health care in 75 years. Medicare and Medicaid are simply symptoms of that larger problem. That kind of growth is obviously unsustainable.



In marked contrast, the most recent Social Security Trustees Report projects that in 75 years, Social Security will account for just 6.1 percent of the nation's Gross Domestic Product, as the graph to the left illustrates.[5]

[4] Near poor is defined as within 125 percent of the federal poverty level, which for single households is $13,485 for individuals aged 65 and older, or $14,628 for individuals under age 65.

[5] Social Security Works created the graph based on projections found in "Table VI.F4 - OASDI and HI Annual Income, Cost, and Balance as a Percentage of GDP, Calendar Years 2012-90," *2012 Trustees Report Supplementary Single-Year Tables*, May 2013.

Social Security is unquestionably affordable. The United States is the wealthiest nation in the world. We spend considerably less on our Social Security system, as a percentage of our Gross Domestic Product, than the majority of other industrialized countries spend on the old-age, survivors and disability portions of their Social Security programs. We will continue to spend less, even when the baby-boom generation fully retires, than many other nations spend on their counterpart programs today.[6]

Consistent with this lower cost, the life insurance, disability insurance, and old age annuities provided through our Social Security system are less adequate than the benefits provided in most industrialized nations, as well.[7] Indeed, Social Security's benefits are modest by virtually any standard, yet vitally important to the vast majority of American workers and their families.

Social Security is more efficient, secure, universal and fair than its private sector counterparts. Its administrative costs comprise less than one penny out of every dollar spent, a much higher efficiency than that experienced by private sector retirement plans. With the termination and freezing of traditional pension plans and the documented serious shortcomings of 401(k) plans, Social Security is likely to be an increasingly important source of retirement income for the vast majority of Americans in the future. Analysts project a looming retirement income crisis, where most seniors will be unable to maintain their standards of living until death.[8] As people aged 65 and older grow to a projected 20.2 percent of our population in 2050, the nation is projected to allocate only 6.1 percent of GDP to the provision of the basic necessities through our Social Security system. Congress could easily alleviate the pending retirement income crisis by increasing Social Security. Cutting Social Security will exacerbate the looming crisis.

Whatever is done, though, it should not be done as part of a deficit reduction package.

Social Security Should Not Be Included in Deficit-Reduction Legislation

As the members of this Subcommittee know, the federal government will reach the limit on federal debt, or debt limit, in a matter of months. Those arguing for the inclusion of Social Security in comprehensive deficit legislation often seek to justify their position by asserting that "everything" should be "on the table." But that facile phrase fails to recognize that cutting Social Security does not reduce the United States' debt subject to that limit. This sharply differs from cuts to agricultural subsidies, defense, or other expenditures from the government's general fund.

If a program paid for from general-fund revenue were cut by $100 billion and nothing else changed, the federal government's borrowing needs would go down by $100 billion. As a consequence, the federal debt subject to the debt limit would also go down (or more realistically, given the current large deficits, would go up less than it would have, without the cut). If the savings from that hypothetical cut were

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[6] Organization for Economic Cooperation and Development (OECD), "Country profile: United States," *Pensions at a Glance 2011: Retirement-Income Systems in OECD and G20 Countries*, March 2011.

[7] Our Social Security replaces a smaller share of a median worker's career earnings than 29 of the 34 members of Organization for Economic Cooperation and Development. See Center on Budget and Policy Priorities (CBPP), "Social Security: We're Number…30!" May 11, 2011. http://www.offthechartsblog.org/social-security-we%E2%80%99re-number%E2%80%A6-30/

[8] See, e.g., Center for Retirement Research (CRR), *The National Retirement Risk Index: An Update*, October 2012. http://crr.bc.edu/wp-content/uploads/2012/11/IB_12-20.pdf

offset dollar-for-dollar by a cut in income taxes or an increase in other expenditures funded from general revenues, the federal debt subject to limit would be unchanged.

In stark contrast, if Social Security benefits were cut by $100 billion, the federal debt subject to limit or total debt would remain unchanged. If the $100 billion savings from cutting Social Security benefits were offset dollar-for-dollar by a cut in income taxes or an increase in general-revenue spending, the total federal debt would increase!

For those who are used to thinking about Social Security as just another spending program and about Social Security contributions as just another tax, the relationship between Social Security and the federal debt may be counterintuitive. To grasp that relationship, it is important to see that Social Security is a defined benefit pension plan with its own separate income, outgo, and reserve fund.

The following thought experiment may help. Imagine a private pension plan whose assets are invested solely in Treasury obligations. Imagine further that the plan sponsor, Company XYZ, cuts the benefits the plan provides, but does not decrease the plan's funding in any way. In that case, the plan would have more income in relation to its expenses than it had before plan benefits were cut. The plan accordingly would use that additional income to purchase additional Treasury obligations (or to pay plan costs, if that were necessary). The plan's increased income would have no effect on the federal deficit or debt. The federal government would have exactly the same general-fund income and outgo, and so, the same borrowing needs, irrespective of the cuts to the pension plan benefits. Consequently, the Department of Treasury would issue debt instruments totaling the exact same value, irrespective of the actions of the pension plan.

In the exact same way, if Social Security's plan sponsor, the federal government, cuts the benefits Social Security provides but does not decrease the level of contributions employers and employees are required to make under FICA, Social Security's income would increase in relation to its expenses, and Social Security, accordingly, would purchase additional Treasury obligations. Social Security's additional income and its purchase of additional Treasury bonds would have no effect on the federal deficit or debt. The federal government would have exactly the same general-fund income and outgo, and so, the same borrowing needs, irrespective of the cuts to Social Security. Consequently, the Department of Treasury would issue debt instruments totaling the exact same value, irrespective of the changes to Social Security.

Cutting Social Security's benefits, like cutting the benefits of a private pension plan, does not reduce by even a penny the total value of debt instruments issued by Treasury. The only way to reduce the amount of federal debt Treasury issues is to reduce the expenditures of the government's general operating fund or increase its income.

Including Social Security within Deficit Legislation – Irrespective of the Rationale -- Risks the Appearance of Improperly Raiding Social Security

Including Social Security in a comprehensive deficit package, even with language that the savings are accruing to the program, is highly likely to create deep suspicion, and perhaps even anger, among the American people. The suspicion and anger that would ensue from including Social Security in deficit reduction legislation – no matter the rationale for its inclusion -- is foreseeable and understandable.

Social Security is a defined-benefit pension plan. For sound reasons, the law requires that private employers who sponsor pension plans keep plan income and assets segregated from the company's general operating fund. For the same sound policy reasons, the law requires that Social Security's income and assets be kept segregated from the general operating fund of its plan sponsor, the federal government.

By law, Social Security's income can only be used for benefits and associated administrative costs. That requirement is not just the operation of law; it represents the solemn, long-standing, fiduciary responsibility of the government, as the plan sponsor.

Historically, Congress has been extremely diligent and careful in executing its fiduciary responsibility with respect to Social Security's income and assets. Congress has always required Social Security's trustees to invest all surpluses in the safest, most conservative investment possible -- interest-bearing debt instruments backed by the full faith and credit of the United States. Congress has also required those trustees to report annually, no matter the circumstances, even during World War II and other times of war, on those contributions and those surpluses which are in reserve, available whenever the monies are needed to pay scheduled benefits. Currently Social Security has an accumulated reserve of $2.7 trillion.

Diverting Social Security's dedicated income and assets from their intended purpose is legally and morally wrong. Not surprisingly, numerous polls indicate that the American people do not want their Social Security contributions diverted to governmental purposes other than Social Security. Yet, polling and focus group data from a number of sources, including our own, reveal that too many Americans are convinced that their Social Security contributions have been stolen. Too many others are uncertain or worried that Congress will steal Social Security's income and assets to use for other unauthorized purposes.

The reason for this widely held anxiety is easy to understand. The American people are constantly bombarded with irresponsible rhetoric about Social Security. For example, some policymakers casually refer to the interest-bearing United States Treasury bonds purchased by Social Security as "just IOUs." These policymakers fail to acknowledge that the expression could be used for all Treasury obligations backed "just" by the full faith and credit of the United States. Similarly, some elected officials have warned ominously that Social Security's reserves have already been spent, again not acknowledging that whenever a corporation or governmental entity issues bonds, it does so to raise needed funds, which it plans to spend; investors understand and expect that the funds will be spent and repaid out of future revenue. Even more reprehensibly, the chairman of the Federal Reserve Board has argued for cutting Social Security by quoting Willie Sutton, a notorious bank robber, who, when asked why he robbed banks, replied, "because that's where the money is." The quip presents an unintended but revealing picture – bank robbers and politicians, all eager to grab the money that hardworking Americans trustingly hand over every payday to what they believe is a safe institution.

All of this casual, irresponsible rhetoric is a serious disservice to the American people and explains why so many Americans believe that their contributions have been stolen. To avoid even the appearance of impropriety, deliberations over Social Security's future solvency should be kept completely separate from broad deficit-reduction efforts. To include Social Security in deficit legislation, even with the explanation that the inclusion has nothing to do with deficit reduction, risks reinforcing the widespread belief that Congress is improperly commingling Social Security's dedicated monies with the government's general operating fund.

The foreseeable suspicion and anger on the part of the American people can easily be avoided by addressing Social Security in legislation devoted to it alone, at a time after the current deficit debate is concluded, so that Social Security deliberations are totally divorced from general budget discussions. This approach will avoid the appearance of wrong-doing. It is likely to produce better policy outcomes, as well.

Congress Should Address Social Security Separate From and After Deficit Deliberations

In addition to the advantage of avoiding even the appearance of wrong-doing, prudence suggests waiting until after the deficit deliberations are concluded to take up the issue of Social Security. Social Security is too complicated and too important to the American people to be addressed as part of other complicated legislation, when full attention will necessarily be diverted, and when there is no compelling or urgent reason to do so. There is no need for haste in addressing Social Security. The most recent Trustees' Report projects that Social Security can pay all old age and survivors benefits on time and in full until 2035, and, if income is reallocated between the DI and OASI trust funds, as is generally done when the projections of the two fund diverge substantially, then the Report projects that all cash benefits can be paid in full and on time until 2033. While Social Security's projected deficit should be eliminated in a timely manner, waiting until after the current debate over deficits and the debt ceiling is both timely and prudent, given the program's complexity and importance.

Social Security, which has been carefully crafted over its 77 year history, provides vital economic security to virtually every American -- not only to the more than 56 million beneficiaries who receive monthly benefits but also to the more than 165 million workers who contribute and who, together with their families, are insured against the loss of wages in the event of disability, death, or old age. Current beneficiaries include millions of widows, widowers, seniors, children who have lost parents, and people with disabilities, as well as their children and spouses. Our brave soldiers wounded in Iraq and Afghanistan receive Social Security benefits, as do their spouses and children. So do the families of soldiers who have given their lives in defense of the nation. Indeed, about one in five Social Security beneficiaries is a veteran.

Because Americans in the last few years have lost trillions of dollars in home equity and retirement savings, it is more important than ever that proposed changes to Social Security be addressed deliberately, thoughtfully, and in the sunshine. The importance of Social Security to virtually the entire population demands that proposals for change receive thorough consideration, with public participation by representative groups, so that the implications of all changes are closely examined and clearly understood. Any kind of expedited procedure or omnibus vehicle would be a disservice to the American people.

In Addressing Social Security, Congress Should Follow the Will of the People

The question of whether Social Security's benefits should be increased, decreased or remain the same is not a question of affordability. We are undeniably wealthy enough as a nation to afford a Social Security system with much higher benefits. Rather the level and structure of Social Security benefits is a question of how as a nation we choose to use our collective wealth. That is the essence of a political question. When the American people are overwhelmingly united, that is the view that should prevail.

There is much polarization in the country today, but Social Security is a program about which the American people are united. Poll after poll indicates that the American people by overwhelming percentages support Social Security and do not want it to be part of deficit discussions. They overwhelmingly believe that Social Security's benefits, if anything, are too low, and want its projected shortfall, manageable in size and decades away, closed by increasing its revenue, ideally progressively. They do not want benefits cut, and they do not want the retirement age increased – an approach which is mathematically indistinguishable from an across-the board cut in benefits for retirees, even with respect to workers who work until age 70 or beyond.[9]

According to polling we have conducted, as well as polls of other organizations, these are the views held by Democrats, Independents, Republicans, union households, tea partiers, the young, the old, and every other age and demographic.

What most Americans support -- eliminating Social Security's manageable shortfall solely through increased revenue -- is the best policy solution, as well. Fortuitously, the best politics with respect to Social Security is also the best policy.

Conclusion

For the reasons explained in this statement, the chained CPI is a poorly targeted benefit cut. The overwhelming majority of Americans oppose all benefit cuts – as they should. Social Security is fully affordable. Its manageable shortfall, manageable in size and still decades away, can and should be eliminated by increasing Social Security's dedicated revenue. Whether Congress and the President choose that approach or not, Social Security should be kept out of a comprehensive deficit package. For better policymaking and to avoid the appearance of impropriety, Social Security should be addressed in its own legislative vehicle under regular order with full hearings, open mark-ups and debate. The American people want and deserve no less.

[9] For an explanation of the mathematical indistinguishability, see Trudy Lieberman, "What a Higher Retirement Age Really Means," Columbia Journalism Review (September 13, 2012), available at http://www.cjr.org/united_states_project/what_a_higher_retirement_age_r.php?page=all&print=true

Chairman JOHNSON. Thank you.

Mr. Blahous, welcome again. Good to see you. Please proceed.

STATEMENT OF CHARLES P. BLAHOUS, III, TRUSTEE, SOCIAL SECURITY AND MEDICARE BOARD OF TRUSTEES

Mr. BLAHOUS. Thank you, Mr. Chairman, Mr. Ranking Member, all the Members of the Subcommittee. It is an honor as always to appear before you.

As has been mentioned, I am here to discuss proposals to apply the Chained CPI to calculation of Social Security COLAs.

In my written testimony, I have provided some background information about how the COLAs are currently calculated, along with some basic information about the current state of program finances.

Because my speaking time is limited, what I would like to do is gloss over most of that background information and really just focus on three major points.

The first point, admittedly, at the risk of stating the obvious, is that whether Chained CPI should be used for Social Security COLAs is primarily a function of whether you as lawmakers are persuaded that it is technically meritorious as a measure of general price inflation.

Obviously, if you were not so persuaded, it would not make sense to apply it to Social Security.

If you were persuaded, I would argue that it should be applied to Social Security along with everything else, including the Federal Income Tax Code, including other Federal programs. I would not recommend specifically singling out Social Security for the change nor would I recommend specifically exempting it.

The second point has to do with the state of program finances and the impact that the Chained CPI would have upon them.

Basically, the current Social Security system faces a substantial financial shortfall that consists of significant excess of scheduled benefits over projected taxes.

One way or the other, we are going to need legislation to correct that.

Our best estimates are that if Chained CPI were adopted, it would reduce that shortfall by between 16 and 20 percent, depending on the measure that is employed to measure it. That would be a significant financial step in the right direction, although one could argue it is modest in the context of the overall financing shortfall.

A very important factor to bear in mind is that with each passing year, the shortfall has been growing larger, and because of that, changes to Chained CPI that improve the financing situation would actually get us back a little bit less than to where we were two years ago. It would make up not fully for the last two years of deterioration in program finances.

We would still have a very long way to go. I would regard CPI reform as sort of a broader Government-wide technical reform on how inflation is measured. I would not regard it as Social Security reform or entitlement reform or tax reform. The basic work of comprehensive solvency reform would still be ahead of us.

The final recommendation I have, and this is a subjective one, but I believe in it very strongly, which is regardless of what the Subcommittee concludes with respect to the technical merits of Chained CPI, I would recommend that we continue to base Social Security COLAs on measures of general price inflation affecting America as a whole and population as a whole.

Occasionally, you read commentary from people suggesting that we should have sort of a senior specific inflation index and use that for Social Security COLAs. I would strongly recommend against

doing that. That approach, I think, would suffer from a number of disqualifying problems.

One is you have to remember a lot of Social Security recipients are not elderly. A lot are dependent children. You have the disabled, 19 percent are disabled, and their dependents.

Clearly, it would be inappropriate to use an inflation index for the elderly to index benefits for children or young disabled.

If you went down the road of trying to have specific inflation indices for specific sub-populations in Social Security, we could create real problems and real chaos in a hurry.

We would have a situation where different components of the Social Security population would be getting different COLAs, that can be very divisive. You have to also remember that people move from one group to the other, when the disabled reach retirement age, they convert from disability to retirement benefits.

It would not take very long for people to notice that there are other disparities in inflation experienced by other sub-populations, geographic differences, things like that.

I would strongly caution against going down the road of trying to divvy up the Social Security recipient population into sub-populations.

I would recommend sticking with the long-standing use of CPI which is measure for general price inflation affecting the population as a whole.

In conclusion, Mr. Chairman, I would just say again I think the main point is whether it should be applied for Social Security COLAs is really a function of the technical merits of the Chained CPI as a measure of general price inflation.

It would have a positive, modest effect on program finances, and we would still have in front of us the major work of Social Security financing reforms.

Thank you.

[The prepared statement of Mr. Blahous, III follows:]

Statement of Charles P. Blahous

Public Trustee for Social Security[1]

Before the Subcommittee on Social Security

of the U.S. House of Representatives Committee on Ways and Means

April 18, 2013

Thank you, Mr. Chairman, Mr. Ranking Member and all of the members of the subcommittee. It is an honor to appear before you today to discuss proposals to use the chained Consumer Price Index (C-CPI) to determine Social Security Cost-of-Living-Adjustments (COLAs) as well as to index other federal programs.

How Social Security COLAs are Calculated under Current Law

Discussions of the possible use of C-CPI are relevant to Social Security because, as with other federal programs, certain aspects of Social Security benefit growth are tied to measures of price inflation. Specifically, Social Security benefits of those who have already begun to receive them are adjusted for general price inflation via an annual COLA. The COLA is currently calculated on the basis of reported change in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), a measure of price inflation maintained by the Bureau of Labor Statistics (BLS).[2] The text of the Social Security Act specifies that the COLA for the next calendar year is calculated based on how much the CPI has risen from September 30 of the previous year to September 30 of the current year. It has become typical for the Social Security Administration to announce these annual COLA adjustments in mid-October.

The annual COLA adjustment, based on the CPI-W, is but one of several forms of indexation of Social Security payments and revenues. For the purpose of calculating participants' initial benefits, both the individual's own wage history as well as the benefit formula itself are indexed to growth in the national average wage index (AWI). The amount of a worker's wages annually subject to the Social Security payroll tax is also indexed to the AWI. These other forms of Social Security indexation would be unaffected by a change in the measurement of CPI.

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[1] I am also a research fellow with the Hoover Institution and a senior research fellow with the Mercatus Center.

[2] Many other federal programs are indexed to another measure of price inflation, CPI-U, which had not yet been introduced when Social Security COLAs were first established.

Using Chained CPI to Measure General Price Inflation

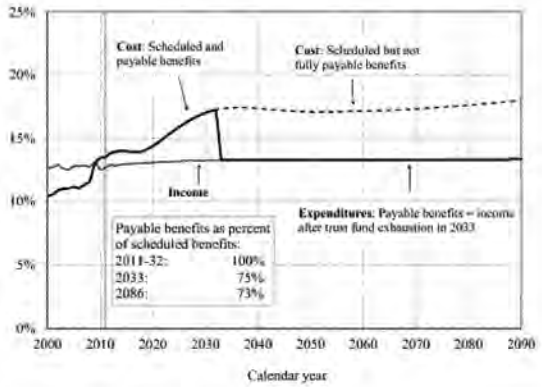
Many economists have concluded that the CPI-W systematically overstates actual price inflation because it fails to account for changes in consumption patterns that arise as the prices of different goods and services rise by different amounts. A fully accurate measure of inflation must take into account changes in purchasing patterns, rather than assuming that an individual's purchases from different categories remain unchanged regardless of whether some items' prices grow more rapidly than others. Many economists regard C-CPI as a more accurate measure of general inflation because it accounts for such changes in buying patterns whereas CPI-W does not.

Clearly, whether C-CPI is a preferable measure for indexing annual Social Security COLAs is primarily a function of whether policy makers are persuaded that it represents a technical improvement in how general inflation is measured. Other witnesses at this hearing are in a better position to discuss the extent to which C-CPI represents a technical improvement over CPI-W. If C-CPI is technically meritorious, it would be fairest to apply the measure to all federal programs indexed to general price inflation including Social Security, as well as to the federal tax code. Social Security should neither be singled out among federal programs for application of the change, nor should it be selectively exempted. The rest of my testimony will be focused on describing the change's effects on Social Security operations in the event that lawmakers are persuaded of C-CPI's technical merits.

Current Social Security Financial Projections

Social Security faces a substantial and growing financing shortfall consisting of a significant excess of scheduled benefits over incoming revenues. The latest trustees' report estimated the actuarial deficit in Social Security's combined trust funds at 2.67 percent of its tax base, which consists of worker wages subject to the payroll tax. This is the highest deficit recorded since the last major Social Security reforms in 1983. Social Security's financing shortfall embodies an enormous public policy challenge as well as a significant threat to the financial security of millions of program participants.

Figure 1: Social Security Costs and Income as a Percentage of Taxable Payroll

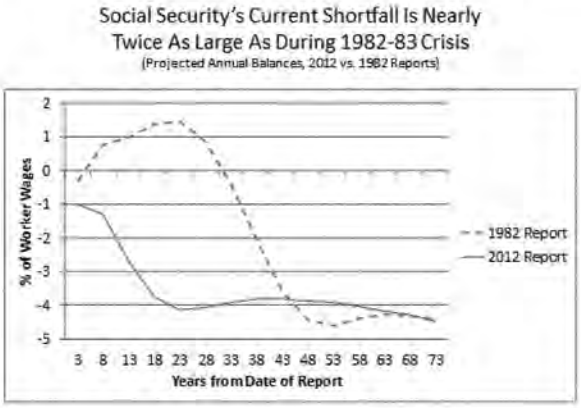


(Source: 2012 Social Security Trustees' Report)

Social Security's shortfall arises because expenditures are growing substantially faster than the program's base of tax income. A leading cause of this cost growth is an increase in the numbers of beneficiaries relative to taxpaying workers, a phenomenon driven both by increasing longevity and changes in fertility rates. Various aspects of program law also play critical roles in driving cost growth, including the indexation of initial benefit formulas to the AWI (which tends to grow faster than price inflation), and statutory eligibility ages that permit individuals today to claim retirement benefits at younger ages than permissible at Social Security's inception despite living generally longer lives.

It is significant that Social Security's projected financing shortfall is already much larger than the one addressed in the landmark 1983 program amendments. Averting insolvency in 1983 required several extremely controversial measures, including a six-month delay in COLAs, the first-time exposure of benefits to income taxation, bringing newly hired federal workers (and their payroll taxes) into the system, a full retirement age increase, and an acceleration of a previously-enacted payroll tax increase, among others. Social Security's currently-estimated shortfall is already much larger even in relative terms, such that a long-term financing solution enacted today would require tax increases and benefit restraints nearly twice as severe as those necessitated in 1983.

Figure 2: Comparison of 1982 and 2012 Social Security Projections



(Source: 1982 and 2012 Social Security Trustees' Reports)

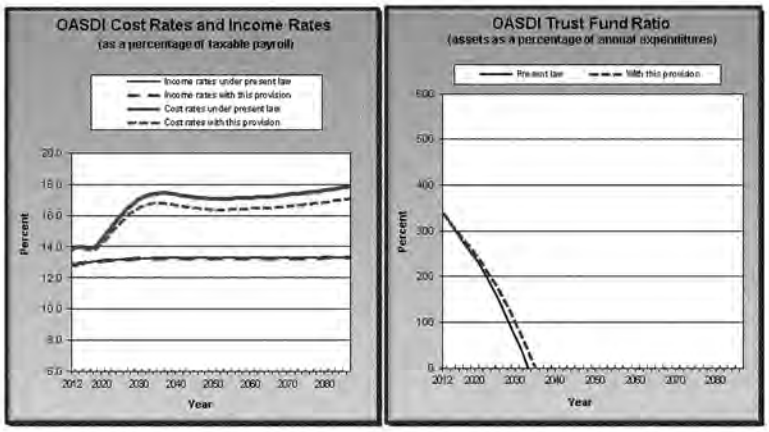
With each passing year of further legislative delay, Social Security's shortfall becomes more difficult to resolve, especially when factoring in lawmakers' historical desire to avoid sudden reductions in benefits for those already receiving them. Among the near-term consequences of a continued failure to enact financing reforms is that depletion of Social Security's disability trust fund would force sudden disability payment reductions of roughly 21% by 2016.

Projected Effects of CPI Reform upon Social Security Finances

The projected effects of using C-CPI to index Social Security COLAs would be positive for program finances, though small relative to Social Security's total financing shortfall. Accomplishing lasting Social Security financing reforms will require far more substantial action to align the program's basic benefit formula and eligibility rules with future tax schedules. CPI reform may be technically meritorious as a broader government-wide correction in the measurement of inflation, but it does not constitute Social Security reform or entitlement reform any more than it constitutes comprehensive tax reform.

The most recent available actuarial estimates of the long-term effect of basing Social Security COLAs on C-CPI are that it would improve the program's actuarial balance by approximately 0.54% of taxable payroll and annual program operations over the long term by approximately 0.73% of taxable payroll. This would eliminate either 20% or 16% of the long-term shortfall depending on the measure employed.[3] The currently-projected decline in trust fund assets would decelerate only slightly.

Figure 3: Projected Effects of C-CPI on Social Security Finances

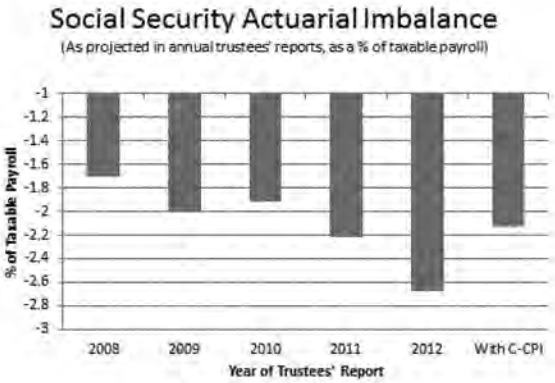


(Source: Social Security Administration Office of the Chief Actuary)

Though this would represent an improvement in program finances, by itself it would not even make up for their deterioration in just the last few years. The remaining actuarial imbalance of 2.13% of taxable payroll would still be larger than the shortfall estimated as recently as 2010. The shortfall would also remain much larger than the one confronted in the crisis year of 1983. With or without CPI reform, repairing Social Security's financial outlook will remain an urgent public policy challenge.

[3] Net savings would be substantially less if combined with other benefit enhancements that some have proposed be coupled with CPI reform.

Figure 4: Social Security Financing Shortfalls, with C-CPI vs. Recent Reports



(Sources: 2012 Social Security Trustees' Report, SSA Office of the Chief Actuary)

Intergenerational Equity Considerations

In addition to modestly improving program finances, CPI reform would also create a slight improvement in program equity across generations. One current policy challenge is that the interaction between Social Security financing methods and demographic trends causes worsening treatment of younger generations, threatening the continued efficacy of Social Security as a future bulwark against old-age poverty.

It is estimated that scheduled benefits for current and past participants in Social Security exceed the total taxes they will have contributed by approximately $22.2 trillion in present value. A great deal of this excess is because the earliest Social Security beneficiaries received far more in benefits than they contributed in taxes. If current benefit schedules remain unchanged, those now entering the system will on balance lose approximately 4.2% of their career taxable wage income to Social Security, assuming that they receive all currently-scheduled benefits. Even future workers of modest income would be subject to these net income losses. A medium-wage two-earner couple now entering the workforce can currently expect to receive only 82 cents of each Social Security tax dollar back as benefits unless something is done to significantly slow the growth of program costs in the upcoming decades.

A substantial portion of these income losses are virtually inevitable under nearly any realistic policy scenario, as lawmakers have historically been reluctant to reduce benefits for those in or near retirement. These losses facing younger generations would be exacerbated, however, if they are taxed to pay annual COLAs to current participants that exceed actual price inflation.

Alternative Proposals for Calculating Social Security COLAs

Some have suggested that an alternative method of indexing for inflation be used for Social Security COLAs, such as one developed specifically to model the purchasing patterns of seniors. I believe that this approach faces a number of disqualifying problems. The first and most obvious problem is that no such technically accurate measure currently exists. The BLS currently maintains an experimental measure known as the CPI-E, but it suffers from a number of widely-acknowledged flaws. For one, like the CPI-W it is not a chained measure and thus does not account for relevant changes in purchasing patterns. For another, it is more greatly affected by expenditures on health services, a sector in which a significant portion of cost growth is driven by advances in technology and quality rather than by actual price inflation. The Congressional Budget Office has recently cited research finding that CPI-E might overstate health price inflation by more than 1 percent per year.

However, even if a technically improved senior-specific inflation index could be developed, I do not believe it would be appropriate for use in calculating Social Security COLAs. The clear intention in adding COLAs to Social Security was to adjust for general price inflation rather than that affecting seniors specifically, as evidenced by the fact that the section of the Social Security Act establishing the COLA applies the same calculation to the benefits of older retirees and younger disability recipients alike.

Social Security provides various types of benefits, many of them to individuals who are not elderly. 19% of all benefits are paid to disabled workers and their dependents; 11% to survivors of deceased workers. Within the disability benefit program, 7% of payments are for children. Individual Social Security beneficiaries sometimes move from one category to another. For example, a worker receiving disability benefits converts to old-age benefits upon reaching the full retirement age.

The use of a special senior-specific CPI to calculate Social Security COLAs could potentially have confusing and divisive consequences. It would be inappropriate to calculate benefits for children or young disabled adults using an inflation index developed only for the elderly. However, it also risks chaos for Social Security to employ different inflation indices for different

recipient groups, with each individual's COLA calculation changing as they move from one beneficiary category to another. Adopting separate inflation indices in Social Security for seniors in comparison with children and the disabled invites other potential subdivisions as well, for example if it is later discovered that price inflation in a particular year is markedly different in different geographic regions. I recommend against lawmakers going down the road of employing subpopulation-specific inflation measures, and instead continuing the use of a single measure of general price inflation.

Broader Concerns about Distributional Effects, Benefit Adequacy and Tax Burdens

Some have expressed concern about the use of C-CPI on the grounds that slower growth of Social Security COLAs could result in inadequate benefits, especially for those who live to particularly advanced ages. I share the concern about benefit adequacy for vulnerable groups, and have long advocated comprehensive Social Security reforms that would buttress benefits and protections against poverty for low-income populations. In the context of enacting a comprehensive financing solution, I recommend that lawmakers consider a number of such potential changes, including proposals for enhanced benefits for those at very advanced ages, while carefully considering interactions between Social Security and the Supplemental Security Income (SSI) program.

Having said that, I believe it would be a mistake to enact such benefit enhancements outside of the context of a credible and comprehensive Social Security solvency solution. To date, lawmakers have not yet proved willing to assess payroll taxes sufficient to finance now-scheduled Social Security benefits (regardless of whether COLAs are calculated with CPI-W or C-CPI), let alone with additional benefit enhancements. As long as Social Security finances remain on a course toward insolvency, scheduling increased benefits represents a hollow promise that does not add meaningfully to the income security of the beneficiary population.

In conclusion, I believe that whether C-CPI should be used for Social Security COLAs is primarily a function of whether lawmakers are persuaded that it represents an improved measure of general price inflation. If so, it should be applied to Social Security COLAs as with other federal programs, neither selectively targeting nor exempting any. Such a change, however, does not embody Social Security reform or entitlement reform; it would create a slight improvement in Social Security finances but not enough even to offset their worsening over the last two years Though it may be technically meritorious, it is in no sense a substitute for significant Social Security financing reforms, the need for which grows more urgent with each passing year.

Chairman JOHNSON. Thank you, sir.

As is customary, for each round of questions, I am going to limit my time to five minutes and ask my colleagues to also limit their questioning time to five minutes as well.

Commissioner Groshen, it seems like we have an acronym for everything here in Washington. Maybe we could think of a new one today.

For those not so well versed in the inside the Beltway jargon, what exactly is the "CPI," and is it best called an "inflation estimator," and how does your staff go about determining it?

Ms. GROSHEN. As I said, we think of it as a way to estimate the changes over time in the cost to consumer of maintaining their standard of living.

It really focuses on what it is that consumers buy and weights it by the experience of consumers. It is an attempt to measure a cost of living index, and in that way, the Chained CPI is different from the CPI that we had before, because it allows for substitutions.

When people can substitute for goods, they experience less of a decline in their standard of living than when they cannot substitute among goods, and therefore, the cost to restore them to their previous standard of living is lower.

It also corrects another technical problem called "the small sample bias" that I can tell you more about if you are interested.

Chairman JOHNSON. How is Chained CPI different? What does it mean to call a CPI "chained?"

Ms. GROSHEN. One of the benefits of having it be chained is that you can compare the current level of the Index to an original level very simply. That is where the term "chained" comes from. Again, a somewhat technical explanation.

It is really on the difference between the current one that you have to do a more complicated set of algebra to be able to get the total difference over time.

Chairman JOHNSON. Do we have to go back to college?

[Laughter.]

Ms. GROSHEN. No, you might need to use your calculator. That is all.

Chairman JOHNSON. Why is Chained CPI considered the most accurate measure of inflation?

Ms. GROSHEN. It is considered more accurate because it allows for this substitution, where consumers substitute. It does not act as if consumers are more constrained than they actually are.

Chairman JOHNSON. Dr. Blahous, you are well versed in Social Security history, and have been here many times. Was not the original reason for the COLA to ensure benefits keep pace with inflation? If the current measure is not accurate, do we not need to switch to a more accurate one?

Mr. BLAHOUS. I would argue yes, and that was the original intent. The COLAs were basically created in the 1972 Social Security Amendments, which have kind of a history. There were some mistakes that were made in the 1972 Amendments, and also the way it is done today really reflects the state of knowledge at the time.

Basically they made an effort to adjust benefits for inflation both for people already receiving them and for initial retirees. They made some technical errors in the application of new retirees, and that is what the whole 1977 Amendment set of changes was about, the notch babies, and that whole story.

They made some mistakes. The reason we are using CPI–W today for Social Security is not so much because people regard it as the most accurate measure of inflation, it was just the only one that was around at the time. Even CPI–U was not around at the time of the 1972 Amendments.

Over time, the interpretation has been that CPI–W is the one that has to be applied to Social Security COLAs based on the old wording of the law.

Ms. ALTMAN. Mr. Chairman, if I can add to that.

Chairman JOHNSON. No, ma'am. I am not asking you the question. Thank you. My time has practically expired. I am going to stop now. Mr. Becerra, you are recognized.

Mr. BECERRA. Thank you, Mr. Chairman. I think it is appropriate to talk about this Chained CPI. I think it is a very appropriate name for this change in the way you calculate seniors' benefits.

It really does drag down the ability of those who rely on Social Security to know their Social Security will be there for them the way they expect it, they will be chained down.

On the issue, Commissioner Groshen, of the accuracy of the Chained CPI or the CPI, you also do a calculation called "CPI–E," which is a calculation of the cost of living for the elderly. You take a sample of elderly Americans throughout the country. It is a smaller sample. You do not apply it but you keep a study that samples elderly Americans when it comes to what their cost of living is.

In that CPI–E, which calculates cost of living for elderly, do you notice a difference between the CPI–E and the currently used CPI?

Ms. GROSHEN. Yes, we do. The difference between the two measures, the CPI–E and the CPI–U, are the weights, the consumption weights, differences between the elderly and the non-elderly.

Mr. BECERRA. What are the actual results? I know I am going to run out of time. Which ends up providing a higher benefit amount to an elderly person, the currently used CPI–U or the CPI–E which takes into account the survey of elderly folks?

Ms. GROSHEN. During the period from December 1982 to December 2012, the average annualized change for the CPI–W was 2.8 percent, and for the CPI–E, it was 3.1 percent. It was three-tenths of a percent higher for the CPI–E.

Mr. BECERRA. The CPI–E, which is a calculation of the cost of living for elderly that you do showed that the elderly have a cost of living that is higher than the average consumer that you use to calculate the regular Consumer Price Index.

Now we have the Chained CPI, which would be below the currently used CPI down here. When people ask is this a more accurate measure of what the costs of a senior are, there is a good chance that senior is going to lose way more than what he or she is currently receiving, which may already be inaccurate given that seniors probably tend to use health care more than the average consumer you use to measure your CPI.

I suspect—I am guessing Mr. Kling and Mr. Lorenzen are probably the youngest folks here. I suspect they have not had to worry about colonoscopies yet. They probably, being male, do not worry about mammograms as much.

Once you are a senior, that colonoscopy is something you have to regularly do. If you are a female, you probably have to worry about mammograms quite a bit.

If you are young and healthy, you do not have to worry about that. You might decide if you are running out of money, you will not buy the steak, you will buy the chicken because it is less expensive.

I doubt you are going to have a choice when it comes to a colonoscopy of getting a colonoscopy or a cheaper colonoscopy somewhere else, or taking your heart medication or buying a cheaper heart medication.

It is a less flexible calculation for seniors when it comes to their ability to substitute one product or one service for another because for them—we would love to have as many choices in health care, for example, as possible, but they are not always there.

Ms. Altman, does the change to a Chained CPI, as modest as it may sound when we speak of it in terms of accountants and .0 this and .0 that, does it have an actual impact on the resources that most seniors or disabled or survivors of our deceased American workers have?

Ms. ALTMAN. Absolutely. As I say, it has a snowballing effect. It compounds over time. The older you get, the larger the cut. We have calculated that for an average work, retires at age 65, fortunate enough to live 30 years, even these bump up's in these various proposals, would still lose a cumulative amount of about $15,000. That is someone who during their working years was only earning $40,000.

Mr. BECERRA. It is a hit. Let me just conclude by saying I thank you all for your testimony. We have to continue to examine these things.

I think Mr. Blahous said it correctly, we have to here in Congress decide what we do, and I would simply finally add that knowing that Social Security has never added a single penny to our deficits.

I would hope that we confine our discussions about working on strengthening Social Security to Social Security, not within the context of budget deficits that Social Security never caused.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you. Mr. Renacci, you are recognized for five minutes.

Mr. RENACCI. Thank you, Mr. Chairman. I want to thank all the witnesses today for being here. When I saw this chart in the beginning, it is interesting, because you try to learn some things.

Mr. Kling, I want to ask if this statement is true. Since 2010, Social Security has been paying more in benefits than it receives in revenue and that the cash flow deficit for the ten year period ending 2023 is projected to reach $1.3 trillion according to the CBO?

Mr. KLING. Yes, it is correct. The Congressional Budget Office generally focuses on the budget of the Government as a whole. On that basis, the dedicated revenue from Social Security taxes was less than outlays for Social Security benefits last year, and will be throughout the next decade under current law, contributing to the unified Federal budget deficit and increasing Federal debt held by the public.

Looking at just the Social Security program, the total inflow including payroll tax revenue and interest payments on the Trust Fund balances from the Treasury will exceed the outflow from the

combined Old Age Survivors and Disability Insurance Trust Funds for the next several years.

That situation will reverse and the outflow will exceed the inflow starting in 2017, CBO projects. That combination of Trust Funds includes the Disability Insurance Trust Fund that will be exhausted in 2016.

Mr. RENACCI. Between now and 2023, we will reach $1.3 trillion? That is a true statement?

Mr. KLING. Yes.

Mr. RENACCI. Thank you. Mr. Lorenzen, I think this comes down to accurate measure. You were ending your testimony about this is all about coming up with an accurate measure of inflation.

You did not get a chance to finish. I would like to hear the rest of what you were going to say.

Mr. LORENZEN. What I was saying is the policy within the Social Security program, within the Tax Code and many other programs is to ensure that the value of those benefits or those provisions in the Tax Code keep pace with inflation.

As long as that is the policy, we should try to implement that policy in the most accurate way and make sure those programs are indexed to the most accurate measure of inflation as possible.

In some cases, providing a higher than justified increase in inflation masks other shortcoming's in the programs or provides benefits across the board that benefit certain populations more so and provide a more accurate measure that may have other undesirable consequences, but those should be addressed by policies that are intended to do that.

We should not be having a policy to index programs to greater than inflation that provides a higher adjustment for everyone in order to help some.

For example, it makes no sense to have an indexing of the Tax Code that provides a $450 windfall to someone at the top quintile of the Tax Code in order to protect a $25 tax benefit for someone at the bottom quintile.

You would be far better to accurately index inflation for everyone, and then if we are concerned, as I am about the person at the bottom quintile, find another change to the Tax Code to address that.

I think we can do that in Social Security and other programs, index the programs to achieve the policy goal of keeping pace with inflation for all of them and then finding ways to help and assist those for whom that change in inflation exposes other shortcoming's.

Mr. RENACCI. What do you believe is the most accurate measurement?

Mr. LORENZEN. I do believe the Chained CPI that has been developed over years is the most accurate measure based on what I have read from experts.

Mr. RENACCI. Thank you. Commissioner Groshen, why is CPI–E referred to as experimental? Is it ready for prime time?

Ms. GROSHEN. The short answer is no, it is not ready for prime time, which is why we all it experimental. The problems with it are it is based on a small sample size, but even more than that, it is

based on using the same stores and the same prices and the same set of goods as for the general population.

For the BLS to stand behind it as an official statistic, we would need to do the research involved to really design the program to measure the cost of living for the elderly in a statistically sound way.

Mr. RENACCI. Mr. Lorenzen, do you have any comments about the flaws in the CPI–E?

Mr. LORENZEN. I would add a couple of flaws. I think health care is one area of different expenditures, but there are other differences in spending patterns among seniors that are not reflected in CPI–E, including mail order and senior discounts.

There are also questions about how it accounts for housing is accurate, that seniors are much more likely to own their own home and have paid off mortgages, whereas CPI and CPI–E both assume inflation based on imputed rent.

On the issue of health care, I would say two things. First, as was noted, it is not clear how much the measures are accurate in measuring health inflation, that it is very difficult to do so accurately, and some suggestions that measures overstated health care inflation.

I would add the bulk—the increase in health care costs for seniors is in a small population. Instead of again having a higher inflation adjustment based off the higher health expenditures for the smallest population, we can address that through something like an out-of-pocket limit and other reforms of the Medicare program instead of providing a higher adjustment for everyone.

Mr. RENACCI. Thank you. I yield back.

Chairman JOHNSON. Thank you. The gentleman's time has expired.

Ms. Schwartz, you are recognized for five minutes.

Ms. SCHWARTZ. Thank you, I appreciate the testimony. I do also have to start with where I think our premise has to begin.

I will echo some of the comments made by the Ranking Member, that we should begin by understanding that Social Security is different and is funded differently, has its own Trust Fund, in fact, in the wisdom of Congress, they actually anticipated the baby boomers, unlike in Medicare, for example, and that was important. Those are dollars in Social Security going forward.

We have made a commitment, Social Security to seniors and to their families, and we ought to start with the premise of absolutely sustaining it and making sure it's there for our current seniors and our future seniors.

The discussion about how to modify the CPI, Consumer Price Index, for Social Security, it feels really different. How it affects seniors, as I think was pointed out in the panel, the idea of changing it and already we know it is not going to work for all seniors.

Therefore, how many seniors are we then going to modify it for because we are worried about older seniors, the biggest group that is growing, over 85. The poorest seniors, which is a lot of them also, and our sickest seniors.

If you are starting to say okay, it does not work for percent or that percent, we begin to say is this a wise thing to do. That is really the question before us, should we even be applying a change

in the Chained CPI or even considering it for seniors and for Social Security?

That is a big deal. In Pennsylvania, it is a big deal. We have almost two million seniors. As you know, seniors are aging.

As already pointed out, they have very different uses of the economy than you might compare to a 25 or 35 or 45 year old. They are living on fixed incomes, more and more of them are relying on Social Security as the one piece they know is going to come to them.

Small changes in an inflationary factor, I think it becomes increasingly important as we are seeing changed in retirement benefits for many Americans, to sort of move from defined benefits to defined contributions, it may be even more important as we go forward for future seniors.

Again, you point out that most seniors—I thought the number was $14,000, average income, you said $17,000. It is still not very much.

I wanted to really ask the question about how this would apply to the poorest and sickest seniors. The question was raised about seniors had a different position in terms of health care than younger Americans.

I know when I talk to a group of seniors, and I bet if I say it to everybody in this room, how many of you take a medication. Forget the ones that are really serious, how many of you who are over 65 take a medication. They laughed.

I said, "does anyone take one?" They all laughed at me. One. How about two, how about three, how about four. Which one are you not going to take if you do not get a little more of an increase.

It is a little different than am I going to buy steak or chicken. It is really a question of am I going to buy chicken at all. Am I going to buy vegetables. Am I going to take one medication versus another.

That is serious business. It has implications for higher costs for families, who often have to help out their seniors/relatives, or higher costs to taxpayers because they show up in emergency rooms.

The implication in relationship to health care costs, which seems to be very, very important and different for seniors, as well as some of the issues some others would like to raise about housing.

These are seniors who live on a fixed income. It is not easy for them to shift costs to somewhere else, as some do. I will get a job. I will get a second job. I will find a higher paying job. I will not buy a new car this year.

This is really not what most 85 year old's or 80 year old's or even 75 year old's are really thinking about.

We really have to understand that may be very different than a change we might make or might not make in how we index increases.

What we hear as Members of Congress all the time is the increases, and they are small, that they get in Social Security, often go to the increases in Medicare, cost sharing. They get pretty upset about it.

It is not even an increase question, about whether they can afford increases in their heating bill because they have already used it all up for health care.

I really wanted to ask Ms. Altman if you could just speak more specifically to how many seniors would have to—I think Mr. Lorenzen talked about this—be ameliorated. The harm to seniors would have to be ameliorated in terms of our sickest seniors, our poorest seniors, our oldest seniors.

Ms. ALTMAN. We have actually looked at that very carefully. It is really more than half. If you are talking about the poorest of the poor, you are talking about 9.4 million seniors who are not getting SSI but just Social Security, but are poor or near poor.

As you say, the population is aging. More and more are getting older.

If it is an accurate Index, you do not have to ameliorate. People talk about shielding veterans, two out of five Social Security beneficiaries are veterans.

There are lots of groups that I think the American people would see as deserving and not worthy of having a cut.

Chairman JOHNSON. The gentlelady's time has expired.

Ms. SCHWARTZ. Thank you very much.

Chairman JOHNSON. Mr. Kelly, you are recognized.

Mr. KELLY. Thank you, Chairman. Thank you all for being here.

There is an old adage where I come from, if you do not know where you are going, any road will get you there. In this case, we do know where we are going. We know if we do not take a look into the future, if we do not get this fixed—I understand charts and I understand income has nothing to do with solvency. A lot of people make a lot of money and still go broke every year.

It is not a matter of how much you make, it is how much you save. It is about keeping your spending under control.

Listen, I am/ 64. You think I am not concerned about what is happening? I am absolutely concerned with what is happening. By the same token, there is something about early detection. If you get it early enough, you can usually get it fixed and get it done at much less cost.

I am trying to figure out why even have the hearing today if there is no problem. We have all kind of revenue. We do not have any problem looking into the future, why are we worrying about this? Why are we even having this conversation about the solvency and the long range stability of Social Security?

If I look at the figures, what are we talking about? We have all kind of money. All kind of money coming in. It is growing at a tremendous rate, 1.6%, 1.8%.

Here is the deal. If your heart is willing but your wallet is weak, I do not care how much you care about these folks, I care about them.

We made promises to people years ago that we cannot keep today and then we try to soft soap it and really, I wish policy were the driving force in this town and not politics.

I wish we could talk about the reality of how we are going to save this program as opposed to how we are going to spend it some way that makes us look good in the next election.

If we really care about Americans, I do not care about Republican, Democrat, Independent, Libertarian, whatever you are in this country, there is always that ability to speak about it openly and do it the right way, but do it honestly, please.

I want to save the program, too. Mr. Blahous, you have some interesting approaches. Running a business all my life, there are a lot of things that I made a mistake on early. My dad was a World War II pilot, and much like the Chairman, he was a bomber pilot. We had a Cessna franchise for a while.

The most important thing he told me is when we were flying somewhere. He would say, son, make sure that you chart that the right way and make sure you stay on course.

It is no big deal being off one degree. I grew up in a little town called Butler, about 25 miles from Pittsburgh. You can be off one degree flying from Butler to Pittsburgh and end up pretty close to Pittsburgh. If we were flying from Butler to Los Angeles, we would end up in Oregon.

There is a long range effect to this stuff. The equities that you talked about, if it is not a problem, we have all this income, if it is coming in and we cannot spend it fast enough and do not worry about it, why be concerned? Why all the interest?

If we do not do this, what is the ultimate effect? I like the approach you have to it. We are talking now about numbers that support what our hearts want to do.

Mr. BLAHOUS. I think even relative to many other experts, I am extremely concerned about the financial future of Social Security.

You made a reference to early detection. I fear the early detection light has been going off for a while and there has been a failure to act.

I fear we are actually getting to the point where it is going to be difficult to get this problem resolved.

In 1983, the program faced a very substantial financing crisis. It took a tremendous amount of bipartisan cooperation to resolve it. You actually had Republicans and Democrats joining together to overcome the very spirited opposition of the AARP and other seniors groups. It was a very difficult thing to do.

We had to delay COLAs by six months. They had to raise the retirement age. They exposed benefits to taxation for the first time. They had to bring all Federal employees into the system. They had to accelerate a previously enacted increase in the payroll taxes.

This was really politically painful stuff. The current long range shortfall in Social Security relative to that then, it is about twice as large now. The amount of political pain that all of you would have to endure in a long range solvency fix is about twice as much as it was in 1983.

If you did a 50/50 on benefits and taxes, conservatives would have to agree to twice as much in terms of tax increases and progressives twice as much in terms of benefit restraints as was done in 1983.

That is a very tall order. With each passing year, this becomes a bigger problem to solve. I am very worried about it. I am worried about the consequences if we do not enact repairs relatively soon.

Mr. KELLY. Mr. Renacci and I are both automobile dealers. In the old day, we had gauges that told us what the temperature was, what the oil pressure was, and they switched the lights. They would go red. It was called "idiot lights" because when the light was on, it was already too late. The engine was fired.

You say we have a blinking light right now. It may be blinking yellow but we better wake up and smell the coffee. We are at a dangerous, dangerous point.

I thank you for your testimony. Mr. Chairman, my time has expired.

Chairman JOHNSON. Thank you. Mr. Thompson, you are recognized for five.

Mr. THOMPSON. Thank you, Mr. Chairman. Thanks to all the witnesses for being here today.

I am glad you preceded me in the questioning because you raised an issue that I came into this Committee thinking about today. It is a little bit confusing as we deal with this.

I think we need to talk about Chained CPI and what it means and how it works. The idea that we are talking about it from the vantage that you brought up as part of the shortfall for Social Security, I find a little bit baffling.

I do not think it is a reform to Social Security. As I understand it, it is about 20 percent of the shortfall. That is a long way from what we need to be doing. It is even worse in this case because to get that 20 percent of the shortfall, you are cutting benefits to seniors and you are cutting benefits to veterans, and many times those veterans are the seniors that we are trying to help provide a secure retirement for.

When we talk about Chained CPI as part of the deficit issue, I think it really muddies the water. Social Security does not have anything to do with the debt, as I understand it. I do not believe Social Security has added a dime to our debt. I do not believe it can by law.

When you start co-mingling these topics, I do not know if it gets us to where we need to be. That is we certainly need to deal with our deficit. We need a long term plan to do it. When we start doing that, I think we need to look at what caused it.

You cannot have major tax cuts without paying for them. You cannot go to war without paying for it. You cannot provide prescription drug benefits without paying for it. Yet, we are not talking about anything like that.

We also need to make sure that Social Security is available for providing a secure retirement for many years to come.

As I mentioned, this does not do it. It is 20 percent. I do not know you factor that in. If you look at the 20 percent and you are getting that from the seniors themselves, that kind of raises havoc with the security of those seniors that you are trying to help.

I have a couple of specific questions. Ms. Altman, can you explain how Chained CPI cuts veterans' benefits?

Ms. ALTMAN. Sure. The veterans' benefits actually can get hit three or four times because as you know, there are a number of programs Government-wide that are indexed, the largest savings comes from Social Security.

As I said earlier, two out of five veterans receive Social Security. People who are disabled or die in Service in Iraq or Afghanistan qualify for Social Security benefits. Those benefits would be cut by the Chained CPI.

In addition, there are a number of veteran specific programs, veteran retirement programs and programs for disabled veterans.

Those also are indexed and those also would be cut by the Chained CPI.

Mr. THOMPSON. If you are a veteran who was wounded in a previous war and you get a certain disability payment as a result of that, you can expect to see your veterans' disability check reduced?

Ms. ALTMAN. That is right.

Mr. THOMPSON. If you are a veteran who was killed and your children are receiving benefits, the children of that veteran can expect to see a reduction in their benefits they receive from their dead mother or father?

Ms. ALTMAN. They will be cut twice. They also receive survivor benefits under Social Security.

Mr. THOMPSON. Mr. Blahous, do you still believe we ought to privatize Social Security?

Mr. BLAHOUS. As you know, I worked for President Bush and worked on his proposal to include personal accounts of Social Security. I actually think although at one time, it would have been prudent to try to save as much Social Security contributions as we could going forward in personal accounts, I think that time has passed.

I think it is too late to advance fund a significant portion of Social Security obligations.

I believe our solutions at this point are best confined to the traditional ones, trying to align benefits and taxes within the current structure.

Mr. THOMPSON. You do not believe we should privatize Social Security?

Mr. BLAHOUS. No.

Mr. THOMPSON. How do you think we should do the reform?

Mr. BLAHOUS. I will give you a two part answer. There is what I personally would design if I were dictator of the world, and there is what I would support.

The second ranges much wider than the first one. I would tend to focus primarily on reductions in the rate of the growth on the high income end basically by changing the benefit formula. There are some other changes I would make.

Mr. THOMPSON. Means test it?

Mr. BLAHOUS. No, I would not do a true means test. A means test basically means measuring income outside the Social Security system and withholding benefits based on that.

There is a benefit formula in the current law that is progressive. It is like a system of income tax brackets except you have benefit brackets. I would basically make those more progressive and hold down benefit growth on the higher income end.

Having said that, there have been proposals put forward that would do more of a mix of revenue changes and benefit changes like the Simpson-Bowles proposal.

Mr. THOMPSON. Raising the age, is that one?

Mr. BLAHOUS. Raising the age would be something I would consider as was in Simpson-Bowles. Simpson-Bowles included some increases in the tax base as well.

I frankly think a solution is important enough that I would go along with a variety of ways to do it.

Chairman JOHNSON. The gentleman's time has expired. There are a lot of ways to fix it and we need to and we will.

Mr. Griffin, you are recognized.

Mr. GRIFFIN. Thank you, Mr. Chairman. I want to start out by saying that I saw a representative from the White House here in the room. I want to say something I do not say much, which is I congratulate the President on acknowledging that we have a problem.

There are some people here I have heard from today that do not acknowledge that we have a problem, and the President has acknowledged that we have a problem.

We may disagree on what to do about it, but it was welcomed to see him at least putting something forward that starts the conversation on this.

I will say one of the big problems is the longer we wait, the closer we get to the edge of the cliff, the fewer options we have.

We have heard a reference to that here a minute ago. My mother is on Social Security. I pay into Social Security, despite what the Internet says. I hope to get Social Security benefits at some point, especially since I turned down my congressional pension.

I am counting on Social Security. I want to save it. I feel like I am in a land of glitter and unicorns here because you have people who are saying Social Security has a problem, it does not have enough money, but it does not add to the deficit or the debt. Complete and utter nonsense.

I am not going to be one of these guys that cites Factcheck.org, although they have commented on this. Sometimes they are right and sometimes they are wrong.

The bottom line is we have a yearly deficit. If Social Security only used the money it has coming in, we would have a problem. You can say it does not add to the deficit. You can say it does not add to the debt. You may be thinking of Social Security as a separate fund and it technically is, but it is one Government.

Mr. BECERRA. Will the gentleman yield?

Mr. GRIFFIN. The gentleman will not yield. If you take $100 in your personal account and separate it in ten separate accounts, you still have $100.

The bottom line is because of where we go to get the money to plus up Social Security, at the end of the day, we are borrowing money. Where is the money coming from if we are not borrowing it from somewhere?

This is just ridiculous. I agree with this gentleman, why are we here if there is not a problem. There is a problem and that is why we are here. It is that simple.

You can talk Washington speak, about moving money around, and it is not here, that is a bunch of nonsense to normal people. You are insulting people when you say we have enough money.

If you say we do not have enough money, then you have to admit it is adding to some deficit somewhere even if it is on another balance sheet.

These ideas of trust funds is Washington speak, we know they are routinely treated as one big pool of money. Either you are wasting my time, which I rushed over here from somewhere else, or we have a problem.

I think the President just acknowledged we have a problem. I am a veteran. I am still serving. I had to get up early this morning and run Army Reserves all the way down the Mall. Do not talk to me about veterans. My grandfather served in World War I. I served in Iraq.

I want to help veterans. Will they be better off if we have a debt crisis, folks? How are seniors going to be better if we have a debt crisis? Ask the Europeans. It is a bunch of nonsense.

I had a question, but I am out of time. If I hear somebody else say that we have plenty of money and this is not adding to the deficit or debt, I just cannot listen to it.

I thank President Obama for starting the conversation so we can fix this for the next generation of people, which includes me. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you. The President is aware. Mr. Doggett, you are recognized.

Mr. DOGGETT. Let me just affirm that Social Security is not adding to the debt to begin with. That does not mean that I am not concerned about the long term solvency of Social Security and that it will be there as strong for my grandchildren as it was for my parents.

Mr. Lorenzen, your group has worked with the recommendations of the Simpson-Bowles Commission. This is not the only recommendation that the Simpson-Bowles Commission made to ensure the long term solvency of Social Security, is it?

Mr. LORENZEN. No, it is not.

Mr. DOGGETT. In fact, one of the other recommendations of the Simpson-Bowles Commission was that the wage base, the taxable wage base would be slowly expanded, and did not that proposal—if the concern is for the solvency, the long term solvency of Social Security, did not that proposal do more to protect the long term solvency than adjusting the cost of living increase?

Mr. LORENZEN. It did somewhat more. It was a comprehensive plan that looked at all parts.

Mr. DOGGETT. I want to be open to all points of view. My main objection here, when the President's name is invoked, that once again, as has happened a number of other times in this Administration, he begins by saying he agrees with what the Republicans want, which is clearly a limitation on the growth of Social Security benefits, and then begs for something in return.

Of course, they have rejected any other revenues, including additional revenues to protect the solvency of Social Security, or closing corporate loopholes, or making the other changes that would allow us to address our budget shortfall, which is very real.

Commissioner, let me ask you, with reference to the Chained CPI, my understanding from your testimony is that even if the Republicans exerted total control on this and they could impose it this morning, we are not quite ready yet to do so. It is not, as you said, ready for prime time yet.

Ms. GROSHEN. What is not ready for prime time is the Chained CIP–E. The Chained CIP–U is ready.

Mr. DOGGETT. Could be ready.

Ms. GROSHEN. That is right. You would have to deal with the fact that it is revised twice, but there is a plan out there that would allow that to happen.

Mr DOGGETT. You have indicated that implementing that takes longer than the way we do the CPI now, that the data takes longer to collect and is not as available as quickly as the way we do it now.

Ms. GROSHEN. No. We publish an initial number and that could be used to adjust the cost of living, were that the choice of the policy makers.

The BLS makes no recommendation on how our official numbers should be used.

Mr. DOGGETT. I guess like so many other members, I receive so many expressions of concern for seniors during the two years that they received no cost of living increase of any kind and the notion that increases in the cost of food at the grocery store did not decline or stay steady during that time, they soared.

If we had in effect the cost of living increase that is being discussed today, the chained approach, how much less over the last decade or two would seniors have received? Would there have been other years in which they had no cost of living increase?

Ms. GROSHEN. We can do that calculation for you. I do not have that off the top of my head.

Mr. DOGGETT. It would not surprise you taking it say over the last two decades if they had two recent years in which they got no cost of living increase, if this new system had been in place, there would have been other years over that 20 years in which they also would have received no cost of living increase.

Ms. GROSHEN. Possibly.

Mr. DOGGETT. Ms. Altman, let me ask you also, looking forward with reference to veterans, and I appreciate the gentleman's service, I have a lot of veterans in the San Antonio/San Marcos/Austin area concerned about what impact this will have on them, just like seniors and individuals with disabilities.

What difference will it make over time to them in terms of dollars and cents? What is the estimate?

Ms. ALTMAN. Let me make clear that the American Legion and the Veterans of Foreign Wars are against the Chained CPI, both for Social Security and the veterans' programs.

They would have the figures on the overall calculation.

Mr. DOGGETT. You are saying both the VFW and the American Legion oppose this change?

Ms. ALTMAN. We can give you a list of veterans, Paralyzed Veterans of America, those are the most prominent groups. There are about fifteen veterans' groups that have come out against it. We can provide your staff with the letters they have sent.

Mr. DOGGETT. Thank you.

Ms. GROSHEN. Actually, I have an answer. The two years where there was no increase were 2009 and 2010. The Chained CPI–U would have given three-tenths of a percent increase rather than zero.

Mr. DOGGETT. Why is that?

Ms. GROSHEN. It is because—basically the substitution effect.

Mr. HORRIGAN. One of the issues is we had such a large increase in energy prices in 2008 and then the decline, the way the adjustment in Social Security works using the CPI–W is it is compared to the previous peak.

We had two years where the Index was not above the previous peak. However, with the Chained CPI, because of substitution, it started at a lower level and came back a little bit faster.

Just in terms of the comparison of the previous year, it hit that previous peak one year earlier with the way it is adjusted, in the official way it is adjusted.

Mr. DOGGETT. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you. Mr. Tiberi?

Mr. TIBERI. Mr. Chairman, thank you. Mr. Doggett, can we sign you up for that proposal now?

[Laughter.]

Mr. TIBERI. Mr. Chairman, Mr. Ranking Member, if I were watching on C–SPAN 25, on the Internet right now, I would be pretty darn confused. I have to tell you, I am so blessed. I have an 80 year old father, he is going to be 80 this year, who came to America in 1950. In 1950, there were 16.5 workers for every retiree on Social Security. There were not 10,000 people retiring a day.

Now there are less than three workers for every retiree. My dad had figured it out and my mom has figured it out, my mom and dad still live in the same house I grew up in in Columbus, Ohio—just got rid last year of their 18 year old car, not because they wanted to but because it broke down, and Social Security is still really, really important to them.

They look at their grandkids and they have again figured it out, partly because of organizations like yours, who are doing a great job of saying we have a problem, even though some honorable folks even up here believe there is not a problem.

Here is what helped them.

Mr. BECERRA. Will the gentleman yield?

Mr. TIBERI. After my five minutes, I will.

Mr. BECERRA. I never said there is not an issue or challenge for Social Security. I just said today using Social Security funds to pay for deficits that it did not cause is the problem.

Certainly, we all want to take care of Social Security long term.

Mr. TIBERI. The long term for me is very quickly approaching. When I get my Social Security statement now, it says if we do nothing, if I go online, I will get approximately 72 percent of the benefits that I am supposed to get.

When I came in 2000, Mr. Becerra, it did not say that. I used to talk about saving Social Security for my kids. Now it is for people of my generation. My mom and dad get that, not because they are concerned about me, but they are really concerned about their grandkids.

If it is going to impact me in my generation, God help my kids and their kids.

Sir, in your written testimony, which I thought was awesome, you talk about the difference between the President's proposal and the current law, and the difference it has in terms of impact on benefits over a year, over a period of 20 years.

Can you expand on that for us?

Mr. LORENZEN. I was speaking about the proposals on the Chained CPI.

Mr. TIBERI. Yes, generally.

Mr. LORENZEN. With Chained CPI in place, benefits will still be increasing in nominal terms, obviously.

Mr. TIBERI. Can you say that again? I could not quite hear you.

Mr. LORENZEN. I am sorry. Benefits will still be increasing in actual terms. They will be increasing slightly less than they are under scheduled law, but doing it more accurately.

However, the Trust Fund is projected to be exhausted in 2033, at which point there will be a 25 percent reduction for all beneficiaries. The Chained CPI would delay that exhaustion briefly and make the shortfall thereafter smaller, so benefits would be higher with Chained CPI because the Trust Fund has money to pay benefits, but also because the initial benefits are indexed to wages, that a future retiree is going to start with a greater benefit in real inflation adjusted terms than a previous retiree.

If you were to compare someone who retired in 1993 at age 55 with what their benefit is today and took a comparable worker who retired today at age 65, 20 years from now when they are 85, even if Chained CPI had been applied and there was not any bump up in benefits or any other adjustments to compensate for it, someone retiring today would still have a higher benefit in real inflation adjusted terms at age 85.

Mr. TIBERI. Thank you. Commissioner, one last quick question. To follow up on Mr. Doggett's point, if this is enacted, long term, this is not even enough, correct? We need to do more?

Ms. GROSHEN. I am sorry?

Mr. TIBERI. Because of demographics, in terms of Social Security.

Ms. GROSHEN. The BLS does not do calculations of that.

Mr. TIBERI. Mr. Blahous.

Mr. BLAHOUS. You have to do a lot more.

Mr. TIBERI. We have to do a lot more. Any suggestions on your part in terms of saving for my kids, saving Social Security for them, at the same time not hurting current seniors like my mom and dad?

Mr. BLAHOUS. I think we are in "all of the above" mode. We have to make changes to the eligibility age. I think we have to make changes to the benefit formula. I think we should slow the rate of benefit growth on the high income end just by making brute force changes in the benefit formula itself.

I think there are other changes we should make to improve the work incentives in the system that would basically have the effect of rewarding seniors for staying in the workforce longer.

Mr. TIBERI. The longer we wait, the more difficult a challenge it is?

Mr. BLAHOUS. Absolutely.

Mr. TIBERI. Thank you.

Chairman JOHNSON. We have to get it through the House and the Senate.

[Laughter.]

Chairman JOHNSON. May or may not happen. Mr. Becerra for half a minute.

Mr. BECERRA. Thank you, Mr. Chairman. I just want to make clear we are clear on something. We all say we want to preserve Social Security. This is about making sure for our kids and our grandkids, it is working as well as it has worked for our parents and grandparents.

To try to make it sound like Social Security is having the sky fall on it today when what the sky is falling on is the Federal budget which has exhausted its resources and over spent, not Social Security, to say that the Social Security Trust Fund that Americans have created through their tax contributions does not exist and the interest it earned, it is like telling any American how much money do you have in your pocket today, can you pay off your house and your car loan today with the money you have in your pocket without going into your savings account?

That is crazy. We have money in the savings account for Social Security. It is there because Americans contributed taxpayer money into that Fund.

To cut benefits, to discuss a budget deficit caused by unpaid for wars or tax cuts that went to very wealthy folks, that is just putting it on the backs of seniors.

I think a number of us are ready to engage in a conversation about what we do long term to make sure Social Security is viable for everyone.

To just cut seniors and veterans' benefits to deal with today's budget deficits caused by other things, that is what concerns many of us.

Thank you, Mr. Chairman, for the time.

Chairman JOHNSON. The President likes the idea. Thank you to our witnesses for their testimony. I also thank our members for being here.

We know we have to do something to protect Social Security long term, and we will do that. Come 2033, Social Security will not be able to pay full benefits. Americans deserve a Social Security program they and their children and grandchildren can count on.

As our hearing series moves forward, I look to our continued examination of bipartisan Social Security reforms. We need to do right by today's beneficiaries and workers. When there is bipartisan agreement, we can and should act, and we will.

I want to thank you all for being here today. The meeting stands adjourned.

[Whereupon, at 11:05 a.m., the Subcommittee was adjourned.]

[Public Submissions for the Record follows:]

AARP

STATEMENT FOR THE RECORD

SUBMITTED TO THE

HOUSE COMMITTEE ON WAYS & MEANS
SUBCOMMITTEE ON SOCIAL SECURITY

On

Chained Consumer Price Index

April 18, 2013

AARP
601 E Street, N.W.
WASHINGTON, D. C. 20049

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Introduction

As the largest nonprofit, nonpartisan organization representing the interests of Americans age 50 and older and their families, AARP greatly appreciates the opportunity to discuss in this testimony the important role Social Security plays, and will continue to play, in the lives of current and future generations of Americans and AARP's specific concerns regarding cuts to Social Security via the adoption of what is known as the chained consumer price index (CPI).

Social Security Benefits are Vital But Modest

Social Security is the only lifetime, inflation-protected, guaranteed source of retirement income that most Americans will have. It is the foundation of retirement security that keeps millions of older Americans out of poverty and allows them to live independently. But Social Security also provides some measure of economic security for families who face a loss of income because of the disability or the death of a wage earner The inflation protection provided through Social Security's annual COLAs is a critical component to the success of the program.

At the end of 2012, about 57 million people received benefits from Social Security. The majority of these beneficiaries were 36.7 million retired workers. Social Security beneficiaries, however, also included 8.8 million disabled workers, 4.4 million children, 4.3 million widows, widowers, and parents and 2.4 million spouses.[1] For many of these beneficiaries and their families, Social Security is the one source of income that stands between them and poverty – without it, more than 21 million additional men, women and children would be in poverty.[2]

Today, half of those 65 and older have annual incomes below $20,000, and many older Americans have experienced recent and significant losses in retirement savings, pensions, and home values. Every dollar of the average Social Security retirement benefit of a little over $15,000 is absolutely critical to the typical beneficiary. For older American households receiving benefits, Social Security is the principal source of income for nearly two-thirds, and roughly one third of these households depend on Social Security for nearly all of their income.[3] Reliance on Social Security as a source of guaranteed income only increases as people age.[4]

Social Security benefits are particularly important for women, who, on average, live longer and earn less than men. Women also spend more time out of the labor force or work part-time to care for children and other family members. Fifty two percent of all women aged 65 and older depend on Social Security benefits for 50 percent or more of their family income. Moreover, in 2011, older minorities relied on Social Security for a significant share of family income. Thirty-four percent of African Americans and 35 percent

[1] Data accessed from: http://www.ssa.gov/cgi-bin/currentpay.cgi
[2] Center on Budget and Policy Priorities, Social Security Keeps 21 Million Americans Out of Poverty: A State-by-State Analysis, available at http://www.cbpp.org/cms/?fa=view&id=3851.
[3] Social Security Administration, Income of the Population 55 or Older, 2010, available at Table 9.A1 http://www.ssa.gov/policy/docs/statcomps/income_pop55/2010/sect09.html.
[4] Social Security: Who's Counting on It, page 2, AARP Public Policy Institute

of Hispanics who are 65 and older depended on Social Security for 90 percent or more of their family income. Finally, the poor and near-poor also rely on Social Security for a significant share of their income; in 2011, more than half of the poor and almost 50 percent of the near-poor relied on Social Security for 90 percent of more of their family income.

And Social Security will likely be even more important to future generations. Due to stagnating income, escalating personal debt and rising costs for education and health care, workers today are less likely than their parents or grandparents to enjoy the living standards of their working years when they retire. If these trends continue, Social Security will be the main source of income for all but the wealthiest retirees in the future.

The Chained CPI is NOT More Accurate for Retirees or the Disabled

Social Security contains several programmatic features that pertain to inflation and are designed to ensure that retirees maintain some modicum of their pre-retirement standard of living. First, when calculating one's initial benefit, Social Security looks at an individual's entire earnings history and then translates prior wage levels into present-day dollars, otherwise known as wage indexing. According to Social Security, "such indexation ensures that a worker's future benefits reflect the general rise in the standard of living that occurred during his or her working lifetime."

Once a retiree begins collecting Social Security, their benefit is adjusted annually to account for price inflation. This is to ensure that a beneficiary maintains the purchasing power of the benefits he or she has earned and the beneficiary's standard of living does not erode over time. That annual inflation adjustment, known as a cost-of-living adjustment (COLA), gets added to the previous year's benefit amount, and becomes part of the base benefit on which next year's COLA is computed.

Despite claims to the contrary, the chained CPI is *NOT* a more accurate measure of inflation, *especially* for Social Security COLAs. In fact, it is even *less* accurate than the current formula.

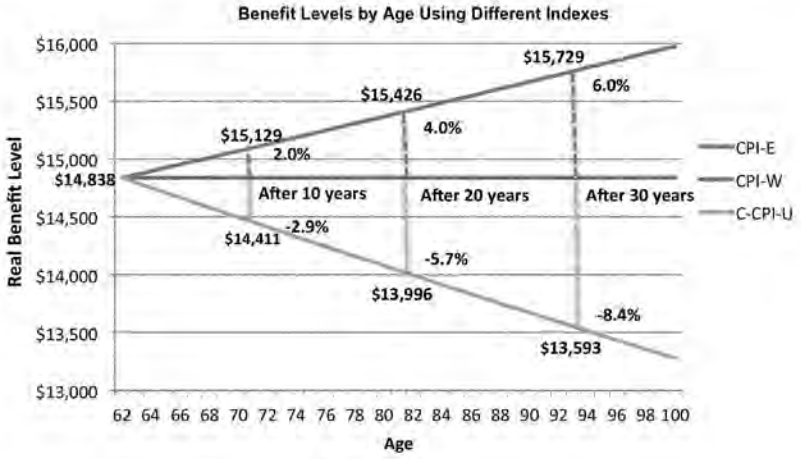
Currently, the COLA is calculated using the Consumer Price Index for Urban Wage Earners and Clerical workers, otherwise known as the CPI-W. By definition, this index reflects the purchasing patterns of those Americans who are still in the workforce. However, retirees and those out of the workforce due to disability have different spending patterns. Retirees and the disabled spend much more on medical care than working Americans. Moreover, health care costs have risen much faster than inflation in the prices for other goods and services. But because the current CPI-W formula is based on the spending patterns of *workers*, not *retirees*, current COLAs are based on an index that already underreports the real cost of inflation experienced by seniors. As such, the current COLA is already lower-than-warranted for seniors and those who cannot work due to disability.

Another flaw with the accuracy claim is that the chained CPI is premised on substitution behavior by consumers that, for several reasons, may not significantly occur among older or disabled Americans. First, these Americans typically live on less income than they did when employed, and thus most have already "traded down" or substituted

where possible to save money, such as purchasing generic instead of name-brand drugs. Second, older Americans tend to spend more of their income on expenses for which little or no substitution is available. Healthcare expenses (including drugs), housing, and utilities make up a substantial portion of an older or disabled person's spending. For expenses like these, the only option may be going without; no further substitutions are possible without significantly diminishing the ability of a retiree to maintain a decent standard of living. Reducing annual COLAs under the premise that older and disabled Americans can make these further substitutions will only undermine their ability to maintain their already modest standard of living – defeating the purpose of ensuring that the value of Social Security benefits are not eroded by inflation.

If accuracy is the goal, as some have argued to justify the adoption of chained CPI, then the first step should be to properly calculate the market basket of goods that are purchased by retirees and the disabled. The Bureau of Labor Statistics constructed an experimental index (the CPI-E) that better reflects the consumption patterns of people age 62 and over. Not surprisingly, this index shows that the rate of inflation for those 62 and over has been higher than the rate measured by the CPI-W in most years.

The inaccuracy of moving to a chained CPI, and its true impact on beneficiaries should therefore not simply be measured by the size of the cut relative to the CPI-W, but to the more accurate CPI-E. The Social Security Administration has estimated that the difference in growth between the CPI-E and the chained CPI could be as much as one half a percentage point each year. (See table below.)



Source: AARP Public Policy Institute

AARP believes that to the extent Congress is searching for a more accurate measure of inflation for annual COLAs, Congress should adopt a measure that accounts for the spending patterns of older Americans. The chained CPI fails this test and would further underreport the inflation experienced by retirees and the disabled and thus erode their standard of living.

The Chained CPI is a Significant Benefit Cut

Although many have attempted to characterize the chained CPI as a minor tweak, it is in fact a *significant benefit cut* that snowballs over time. The adoption of chained CPI would take approximately $340 billion dollars out of the pockets of current and near retirees, working families, veterans and the disabled, as well as the local economies in which they live, in the next 10 years alone. Specific to Social Security, the chained CPI cuts benefits by $127 billion over the next 10 years.

Initially, the 0.3 percent annual cut in Social Security COLAs exacted by a chained CPI may look small, but it compounds over time. The greatest impact of the COLA cut will be on those who receive benefits over a long period of time; the oldest retires and the long-term disabled. According to the National Women's Law Center, "(f)or an individual who receives a monthly benefit of $1,100 per month at age 65, the chained CPI would reduce benefits by $56 per month ($672 annually) at age 80," which is equivalent to losing one week's worth of food each month.[5] The chained CPI would cut one full month's income each year from a 92-year-old beneficiary's annual Social Security benefits.

AARP is greatly concerned that the oldest can least afford a COLA cut as reliance on Social Security as a source of guaranteed income only increases as people age. Americans in their 80s and 90s generally have less income, fewer financial assets, and are more dependent on Social Security than younger beneficiaries. They also face increasing out-of-pocket medical costs and are at greatest risk of poverty.

The impact of chained CPI would also disproportionately hurt women and the poor. Women tend to live longer than men and make up a larger share of the population as it ages. Because of their longer life expectancies, women would be subject to the compounding cuts of chained CPI for longer. Women also tend to have lower incomes, are more dependent on Social Security, and are more at risk of falling into poverty. The chained CPI will also cut living standards most deeply for the poorest households, who tend to rely on Social Security for all or most of their income.

Moreover, the chained CPI would cut the benefits of more than 3.2 million disabled veterans in this country and another 2 million military retirees. Under the chained CPI, permanently disabled veterans who started receiving disability benefits at age 30 would see their benefits cut by more than $1,400 a year at age 45, $2,300 a year at age 55 and $3,200 a year at age 65.

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[5] National Women's Law Center, Switching to the Chained CPI Means Painful Cuts to Social Security Benefits - Especially for Women 2 (Oct. 2012), available at http://www.nwlc.org/sites/default/files/pdfs/socialsecuritychainedcpiupdate.pdf.

Finally, low- to moderate-income households will also get a sizable tax increase thanks to the chained CPI by reducing the annual adjustment made to many parameters in the tax code. Over 10 years, chained CPI results in a $123 billion tax increase, the impact of which will be felt most by those of modest incomes. According to an analysis by the Joint Committee on Taxation, by 2021, taxpayers making between $10,000 and $20,000 would see a 14.5 percent increase in their federal taxes under a chained CPI.

President's Mitigation Efforts Fall Short

In recognition of the fact that chained CPI would significantly erode the standard of living for millions of retirees, the disabled, veterans and the poor, the President's FY2014 Budget attempts to shield certain "vulnerable" populations from chained CPI's harmful effects. The President proposes to provide a small 5 percent benefit bump-up phased in over 10 years from ages 76 to 85 and another bump from ages 95 to 104. He also proposes to mitigate for the very poor by exempting means-tested programs. The President's mitigation proposals fail because they don't protect everyone who needs protection and even fail to adequately protect the very old and the very poor in some cases.

The President's mitigation proposals do not exempt those who receive Social Security retirement benefits. Instead, these beneficiaries are to receive two "bumps" in their benefits after enduring decades of diminished COLAs. Vulnerable individuals would therefore see no help from the President's proposals unless and until they turn 76. According to the Social Security Administration's mortality tables, of the persons who reached age 62 and became eligible for Social Security retirement benefits, about three quarters would live long enough to *start* to receive the first benefit bump-up that begins at age 76, but only about half would survive through age 85, the end of the ten-year phase-in of the benefit enhancement. Only about 10% would still be alive at age 95 to begin the second 10-year benefit bump-up, and a negligible number of these beneficiaries would live out the second phase-in of the benefit enhancement, which finishes at age 104. Nor do the President's mitigation proposals exempt those on Social Security disability. They too would have to endure years of COLAs that do not keep up with the inflation they experience before receiving minimal bonuses.

Remarkably, the President's mitigation proposals do not exempt veterans, both retired and disabled. Many veterans depend on monthly benefits from retirement or disability compensation, both of which receive annual COLAs that would be reduced by a switch to the chained CPI. And veterans are often eligible for these benefits at younger ages than for Social Security and could experience the compounded cuts to benefits over many decades. It is also important to note that over 9 million veterans receive both Social Security and veteran's benefits and would be hit by the chained CPI twice.

As noted above, the President proposes to protect the vulnerable poor by exempting means tested programs. However, exempting means tested programs is not equivalent to exempting the poor. For instance, millions of low-income retirees depend almost solely on their Social Security benefits but do not qualify for means tested programs like Supplemental Security Income (SSI). These individuals would not be protected by the President's proposals. AARP is uncertain how many of these individuals might fall into

poverty as a result of the chained CPI. There are also low-income retirees who receive both SSI and Social Security. The Social Security portion of their income is not exempt from chained CPI. Finally, AARP notes there is nothing in the President's mitigation proposals to protect low- to moderate-income households from the sizable tax increase they will face as a result of chained CPI.

The American People Overwhelmingly Oppose Chained CPI

Older Americans truly understand that budgets matter and that we all need to live within our means. But they also understand that budgets impact real people – federal programs can make meaningful differences in peoples' lives and help ensure that older and disabled Americans can live independently and with dignity as they age. They also understand the difference between programs that have been contributed to and earned over the course of a lifetime of work and those that are not.

In March 2013, AARP commissioned a national survey that examined older voters' opinions on a proposal to adopt a chained CPI to reduce the deficit. AARP's survey also looked at how favorability would be affected towards Members of Congress who voted for such a proposal.

- The poll found older voters are nearly unanimous in their belief that Social Security benefits should not be reduced for today's seniors, with 87 percent saying the issue is "very important" to them (89 percent Democrat, 86 percent Republican, 88 percent Independent).
- Similarly lopsided margins of older voters believe that Social Security should be "off the table" in the current budget debate. Across party lines, a large majority of 50+ voters (84 percent) oppose reducing Social Security benefits in order to reduce the deficit (91 percent Democrat, 80 percent Republican, 78 percent Independent). In fact, 73 percent *strongly* oppose.
- 84 percent of older voters said that the future of the retirement security program should be considered separately and political affiliation made barely any difference.
- Of those surveyed, 70 percent said they oppose using a chained CPI for Social Security (75 percent Democrat, 63 percent Republican, 69 percent Independent).
- And 78 percent said they oppose using a chained CPI for retired and disabled veterans' benefits. (80 percent Democrat, 72 percent Republican, 79 percent Independent).
- In addition, 52 percent of those surveyed said they oppose using a chained CPI to adjust the tax code for inflation and 34 percent said they support that idea (13 percent said they didn't know and 1 percent declined to answer).

The older voters surveyed, who were split almost equally among Democrats, Republicans and independents, also sounded a strong note for Capitol Hill lawmakers who might support a switch to the chained CPI.

- Two-thirds (66 percent) said they would have less favorable feelings toward their representative in Congress for voting in support of chained CPI (69 percent Democrat, 60 percent Republican, 67 percent Independent).

These survey results align with the information AARP has been gathering from the public through our You've Earned a Say initiative over the past year. AARP members and older Americans recognize that Social Security did not cause our federal deficits and, therefore, the much-needed benefits of real, hardworking people should not be cut in order to remedy the deficit.

Social Security is Not a Deficit Driver

Social Security benefits are financed through payroll contributions from employees and their employers, throughout an individual's working life. The payroll contributions and benefits paid, including any administrative costs, are accounted for separately from the rest of the federal budget.

Further, by law, Social Security cannot pay out more in benefits (including administrative costs) than it has taken in over the life of the program. That is, the program has no statutory authority to borrow to pay benefits. Once the trust fund is exhausted, Social Security can only pay benefits to the extent it receives revenue from payroll contributions. As such, Social Security has not contributed to our large deficits.

To the contrary, Social Security has had cash surpluses each year for most of the past 30 years, taking in more revenue than it needed to pay in benefits. These surpluses, generated by the payroll contributions made by the American people, have been borrowed to meet other expenses of the federal government. In exchange, the federal government has issued Social Security Treasury bonds of equal value. That is, Social Security has reduced the past need for additional government borrowing from the public and resulted in a publicly held debt that is less today than what it otherwise would have been.

Social Security Deserves Its Own Conversation

AARP believes that reducing the nation's deficit and restoring confidence in our budget is important, but we also understand that Social Security is vital to the economic security of older Americans and the disabled; it has a dedicated funding source, is a separate and self-financed program, and did not add to our federal deficit. Therefore, AARP believes that cuts to the program should not be made to reduce the deficit.

According to the Social Security Trustees, even with no changes at all, Social Security has sufficient income from payroll contributions and assets in Treasury notes to pay 100 percent of promised benefits for the next 20 years, and can continue to pay approximately 75 percent of promised benefits thereafter. Social Security is therefore not in crisis, but the projected gap should be closed.

AARP believes that the current Social Security funding shortfall should be addressed sooner rather than later so that the fundamental structure of the program can

be retained and the protections it offers to almost all workers and their families can be protected and even enhanced. However, any such changes to the Social Security system must be made within the proper framework of increasing the retirement security of real people and protecting current beneficiaries who have paid into the program during their working lives. The chained CPI does neither.

In the face of declining pensions, shrinking savings, stagnating wages, and rising health costs, Social Security deserves its own national conversation that focuses on preserving and strengthening the retirement security of Americans and their families for generations to come. AARP welcomes that conversation and stands at the ready to engage with Congress, our members and other Americans on ways to strengthen Social Security now and in the future.

Conclusion

The promise of Social Security has endured for over 75 years. It is a promise that AARP believes embodies our deepest values as Americans – our obligations to one another – our obligations between generations – between parents and children – between grandparents and grandchildren – between those in retirement and those at work – between the able-bodied and the disabled. And AARP firmly believes that this promise must continue to endure as Social Security will continue to play a critical role in the lives of future generations of Americans.

Once again, AARP would like to thank Chairman Johnson and Ranking Member Becerra for the opportunity to share with our views on the important role Social Security plays, and will play, in the lives of both current and future generations of Americans. We look forward to working with you and the other members of this Committee to ensure that any changes to Social Security are done in a way consistent with the needs and wants of the American people.

Center on Budget and Policy Priorities

Submission of the Center on Budget and Policy Priorities

To the House Ways and Means Committee's Education & Family Benefits Tax Working Group

April 15, 2013

Low-Income Families and Individuals and Refundable Tax Credits

Introduction

The Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) encourage and reward work by parents. New and exciting research finds that these credits also improve the educational performance, future work effort, and health outcomes of children in these families. Below we describe this empirical research and recommend further improvements to the EITC and the Child Tax Credit (CTC). Specifically, we recommend:

1) Making permanent the recently extended improvements to the EITC and CTC, such as marriage penalty relief.

2) Filling a longstanding gap in the EITC by strengthening the credit for childless workers so that, for example, more single men are pulled into the formal job market and, among other benefits, improve their marriageability.

3) Adopting several simplification and compliance measures to reduce errors.

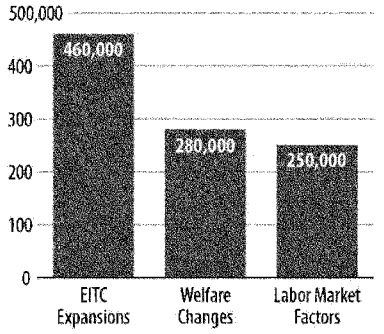
Research Overview

About 27.5 million working families with low and moderate incomes, most of whom are raising children, received the Earned Income Tax Credit (EITC) in 2010 to reduce their taxes and supplement their earnings.[1] Studies have found that the EITC encourages work and boosts children's achievement in school. Research also suggests that the EITC may improve infant health and that the improved school performance of children whose families receive the EITC translates into increased earnings and work hours when they are adults. The Child Tax Credit (CTC), designed to help offset the cost of raising children, also plays an important role in helping low-income working families. (Because the EITC has been in place for a longer period of time, most of the research is focused on the EITC though the same lessons likely apply to the CTC, which also phases in as earnings increase.)

[1] In 2010, the most recent year for which data are available, EITC filers with qualifying children received about 97 percent of EITC benefits. The other 3 percent went to poor workers not raising minor children, some of whom can qualify for a small childless workers' EITC. IRS, Statistics of Income Division.

Encouraging work. To qualify for the EITC and the low-income component of the CTC, a person must have a job. Numerous studies have found that the EITC promotes work. "[T]he overwhelming finding of the empirical literature is that EITC has been especially successful at encouraging the employment of single parents, especially mothers," write economists Nada Eissa of Georgetown University and Hilary Hoynes of the University of California, Davis.[2] In fact, while policymakers often point to the 1996 welfare law's creation of Temporary Assistance for Needy Families (TANF) as a primary reason for increased work among single mothers, the research indicates that the EITC expansion had an even larger effect than the welfare law in producing these gains.[3]

Figure 1
EITC the Biggest Factor in Boosting Employment Among Single Mothers



Source: CBPP analysis of results from Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families," Review of Economics and Statistics, May 2003 and data from March 1999 Current Population Survey.

Note: Categories from the Grogger study were combined for simplicity. The categories "time limits," "other reforms," and "maximum benefits" were combined into the category "welfare changes." The categories "minimum wage" and "unemployment rate" were combined into the category "labor market factors."

Improving children's school performance and health. A robust set of research — including studies that feature experimental designs and evaluations that use large samples from the general population with a robust set of statistical controls — finds that increasing children's incomes,

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[2] Nada Eissa and Hilary Hoynes, "Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply," October 10, 2005, http://www.econ.ucdavis.edu/working_papers/05-29.pdf.

[3] Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families," *Review of Economics and Statistics*, May 2003.

particularly when they are young, has a positive impact on educational outcomes. In a review of several experimental studies, leading researchers concluded that a credit worth about $3,000 (in 2005 dollars) to a working parent during a child's early years may boost that child's achievement by the equivalent of about two extra months of schooling.[4] Other researchers analyzed data for grades 3-8 from a large urban school district and the corresponding U.S. tax records for families in the district. Even under conservative assumptions they found that the additional family income from the EITC and CTC leads to significant increases in students' test scores.[5]

In addition, recent studies suggest that the EITC may also include important health outcomes. Recent studies indicate that expectant mothers who receive the EITC are more likely to obtain prenatal care and give birth to healthier infants, and less likely to smoke and drink during pregnancy.[6]

Increasing children's work effort and earnings as adults. Improving children's educational outcomes improves their future employment outcomes. Researchers reviewing experimental studies estimate that raising a poor family's income by $3,000 a year (a fairly typical amount for a family to receive from the EITC) between a child's prenatal year and fifth birthday is associated with a 17 percent increase in earnings in adulthood, and an additional 135 hours of work per year, compared to similar children whose families do not receive this increase in income.[7]

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[4] Duncan and Magnuson, "The Long Reach of Early Childhood Poverty," Winter 2011, which is based on an analysis of studies, including those cited here, of the impact of early-childhood poverty.

[5] Chetty, Friedman, and Rockoff 2011.

[6] Kevin Baker, "Do Cash Transfer Programs Improve Infant Health: Evidence from the 1993 Expansion of the Earned Income Tax Credit," University of Notre Dame mimeo, 2008, http://economics.nd.edu/assets/24011/baker_paper.pdf;

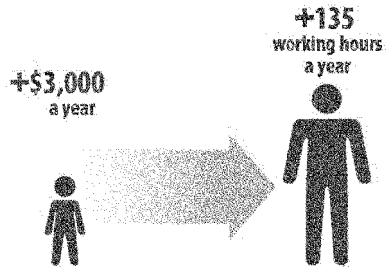
Kate W. Strully, David H. Rehkopf, and Ziming Xuan, "Effects of Prenatal Poverty on Infant Health: State Earned Income Tax Credits and Birth Weight," *American Sociological Review* (August 2010), 1–29, http://www.irp.wisc.edu/newsevents/workshops/2011/participants/papers/15-Strully.pdf; William N. Evans and Craig Garthwaite, "Giving Mom a Break: The Impact of Higher EITC Payments on Maternal Health," May 2011, http://www.kellogg.northwestern.edu/faculty/garthwaite/htm/EITC_Health_Final_Draft.pdf; Hilary W. Hoynes, Douglas L. Miller, and David Simon, "Income, The Earned Income Tax Credit, and Infant Health," NBER Working Paper No. 18206, July 2012, http://www.nber.org/papers/w18206.

[7] The $3,000 figure is in 2005 dollars, equivalent to approximately $3,530 in 2012. Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, "Early-Childhood Poverty and Adult Attainment, Behavior, and Health," *Child Development*, (January/February 2010), pp. 306-325.

Figure 2

EITC Income for Poor Children Linked to More Work Hours and Higher Earnings Later in Life

The change in annual adult work hours associated with a sustained $3,000 increase in income to children in working-poor families before age 6.



For each $3,000 a year in added EITC income that children in a working-poor family receive before age 6...

...their working hours increase by 135 hours a year between the ages of 25 and 37, and their annual earnings increase by 17%.

Source: Source: Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, "Early-Childhood Poverty and Adult Attainment, Behavior, and Health," Child Development, January/February 2010, pp. 306-325

Reducing poverty. The EITC and the CTC lifted 9.4 million people — including 4.9 million children — above the poverty line in 2011, based on the Census Bureau's Supplemental Poverty Measure, a broad measure of poverty that counts refundable tax credit payments as income (and subtracts income and payroll taxes).[8] The improvements to these credits enacted in 2009 lifted an estimated 1.5 million of those people above the poverty line.[9]

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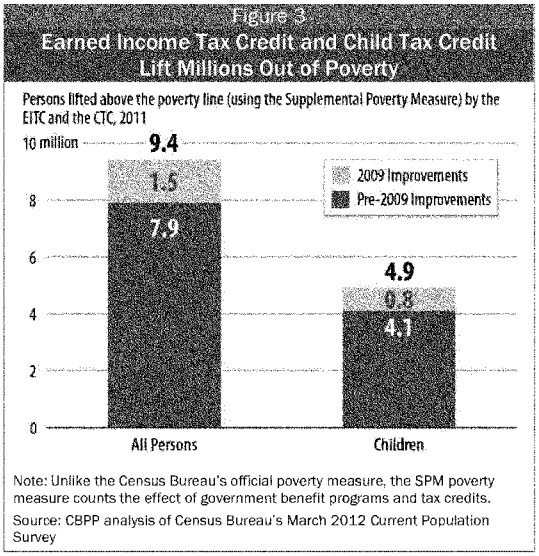
[8] The Supplemental Poverty Measure is based largely on the 1995 National Academy of Sciences recommendations for poverty measurement, with amendments reflecting more recent research and the recommendations of the Interagency Technical Working Group on Developing a Supplemental Poverty Measure. For a detailed description of the SPM, see Kathleen Short, "The Research Supplemental Poverty Measure: 2011," United States Census Bureau, November 2012, http://www.census.gov/hhes/povmeas/methodology/supplemental/research/Short_ResearchSPM2011.pdf

[9] The improvements enacted in 2009 were extended at the start of 2013. They are now scheduled to expire at the end of 2017.



Supporting low-wage workers. The minimum wage has eroded substantially, with the real value of the minimum wage falling 21 percent since its peak value in 1968,[10] and the share of good jobs appears to be disappearing for lower educated workers.[11] These trends underscore the importance of the EITC and CTC as policies that partially offset the decline in the real minimum wage and boost the after-tax income of lower-skilled workers.

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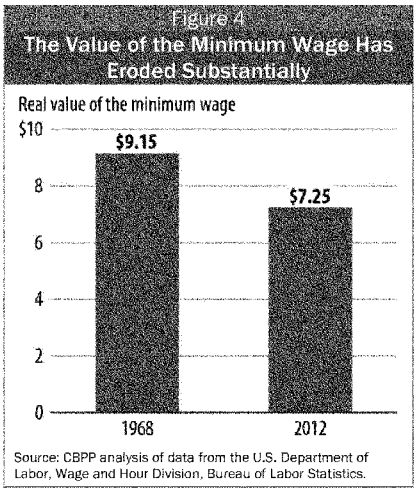
[10] CBPP analysis of data from the U.S. Department of Labor, Wage and Hour Division, Bureau of Labor Statistics (http://www.dol.gov/whd/minwage/chart.htm).

[11] Urban Institute economist Harry Holzer and coauthors from the National Science Foundation, the University of Chicago, and the U.S. Treasury Department concluded that over the long term, "good jobs are not disappearing for everyone, but . . . they are largely disappearing for less-educated workers." Harry J. Holzer, Julia I. Lane, David B. Rosenblum, and Fredrik Andersson, *Where are All the Good Jobs Going?* (New York: Russell Sage Foundation, 2011), p. 17.



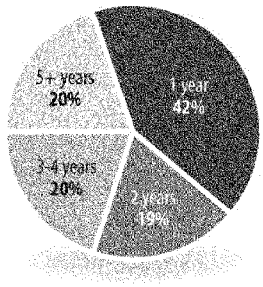
Providing a short-term safety net. Most EITC recipients claim the credit only temporarily, when a job disruption or other significant event reduces their income. A recent study covering an 18-year period found that 61 percent of EITC recipients received the credit for only one or two years at a time.[12] A forthcoming study finds that over time, EITC recipients as a whole pay more in federal income taxes than they receive in EITC benefits.[13]

[12] Tim Dowd and John B. Horowitz, "Income Mobility and the Earned Income Tax Credit: Short-Term Safety Net or Long-Term Income Support," *Public Finance Review* (September 2011), pp. 619-652.

[13] Communications with Tim Dowd of the Joint Committee on Taxation and John B. Horowitz of Ball State.

Figure 4
Most EITC Families Receive Credit for Only One or Two Years at a Time

Share of EITC families by consecutive years with EITC



Note: Data from 18-year period, 1989-2006.
Source: Tim Dowd and John B. Horowitz. "Income Mobility and the Earned Income Tax Credit: Short-Term Safety Net or Long-Term Income Support".

Proposals

The Earned Income Tax Credit and Child Tax Credit represent major pro-work and anti-poverty policy achievements. Unfinished policy work remains, however. The 2009 improvements to the EITC and CTC should be made permanent; the credit for workers without children should be strengthened, in part to help address low labor force participation rates among childless adults (particularly men); and proposals that simplify the credits and provide IRS with the authority it needs to tamp down on unqualified tax preparers should be adopted to reduce error rates.

Each is explained in more detail below. Note that while it is important to move forward, it is essential that any tax reform process not compromise the existing success of the EITC and CTC. This is why both the Bowles-Simpson deficit-reduction plan and the Senate's "Gang of Six" plan called for protecting these credits from cuts. Any tax reform process should provide the same protection.

Making the 2009 Improvements Permanent

The 2009 improvements reduced marriage penalties by increasing the amount of income that married couples can earn and remain eligible for the EITC; expanded the EITC for families with three or more children; and increased the support the Child Tax Credit provides to working-poor families by lowering the minimum earnings requirement. These improvements substantially increased the anti-poverty effects of the EITC and CTC. As shown in Figure 3, of the 9.4 million

people lifted out of poverty by the refundable credits, 1.5 million (including 800,000 children) were lifted out of poverty by the these provisions.

If the EITC improvements are not made permanent, substantial numbers of low-income married couples will face larger marriage penalties, and many families, particularly those with three or more children, will fall into, or deeper into, poverty. Altogether, Citizens for Tax Justice (CTJ) estimated that about 6.5 million working families, including 15.9 million children, would have lost some or all of their EITC in 2013 if the 2009 EITC improvements were not in place for 2013.[14]

If the improvements are not extended, working-poor families will be ineligible for the CTC unless their earnings surpass about $14,700, starting in 2018 (the equivalent of $13,400 in 2013). A single mother with two children working full-time, year-round at the minimum wage of $7.25 an hour — and earning $14,500 per year — will receive a $1,725 Child Tax Credit in 2018 if the CTC improvement is made permanent. But if the improvement expires, she will receive nothing, since the minimum earnings threshold for the child tax credit will be about $200 above her earnings. Failure to extend the improvement would also cut the CTC substantially for low-income families with earnings modestly above the $14,700 threshold. If the CTC improvements had not been extended for 2013, CTJ projects that approximately 8.9 million working families, including 16.4 million children, would have lost some or all of their CTC in 2013.[15]

Strengthen the EITC for Childless Workers

Although substantial progress has been made in recent years to make work pay for families with children, the current EITC suffers from a glaring gap: low income working people who are not raising minor children receive little or nothing. The proven pro-work aspects of the EITC are not available for young people just starting out, including low-income young men, a group with disturbingly low labor-force participation.

Childless workers under the age of 25 are currently ineligible for the childless workers' EITC. For eligible workers between the ages of 25 and 64, the average credit is $270, compared to an average credit of $2,790 for tax filers with children. The credit phases in at a rate of 7.65 cents on the dollar for the first $6,370 of earnings, then quickly phases out at the same rate, beginning at $7,970 — when earnings are equivalent to just 55 percent of full-time minimum wage earnings.

Childless workers are the lone group that is taxed deeper into poverty by the federal tax system. Under current law, a childless adult working full time at the minimum wage ($14,500) receives no EITC. Such an individual has a federal income and payroll tax burden of $2,669 in 2013.[16] A single childless adult with wages equal to the Census poverty line ($11,905 in 2013) faces a federal tax burden of $1,826 (including the employer share of the payroll tax).

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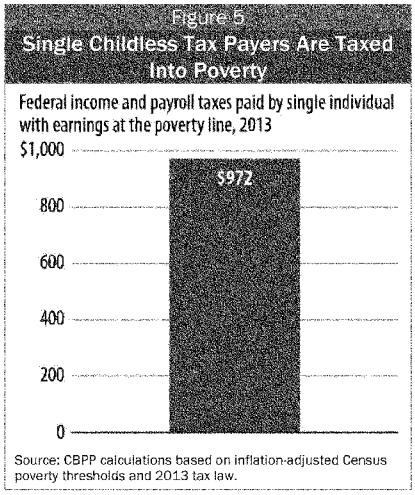
[14] Citizens for Tax Justice, "The Debate over Tax Cuts: It's Not Just About the Rich," July 19, 2012, http://ctj.org/pdf/refundablecredits2012.pdf.

[15] Citizens for Tax Justice 2012.

[16] This figure includes both the employer and employee shares of payroll tax.



Providing a more adequate EITC to low-income workers who aren't raising minor children has several behavioral benefits beyond raising these workers' incomes. Karl Scholz, an economist and formerly Treasury official who is one of the nation's foremost EITC experts, recommends a more generous EITC for young childless workers as one policy to raise their employment rate, writing: "increasing the return to work for childless workers will lower unemployment rates and achieve the dual social benefits of reducing incarceration rates and increasing marriage rates."[17] Increasing the childless worker's EITC will also help boost the income from work received by formerly incarcerated individuals who often face an inhospitable labor market upon re-entry.

The primary design parameters include:

- Eligibility age.
- Phase-in and phase-out rates.
- The level of income at which the phase-in ends (i.e. kink point #1) and the level of income at which the phase-out begins (i.e. kink point #2).
- The maximum benefit (equal to the phase-in rate multiplied by kink point #1).

We recommend lowering the eligibility age to 21, increasing the phase-in and phase-out rates to 15.3 percent, and moving the first kink point to $8,820 in 2014, raising the maximum credit to about $1,350. We discuss each in turn:

Age of Eligibility

[17] John Karl Scholz, "Employment-Based Tax Credits for Low-Skilled Workers," The Hamilton Project, December 2007, http://www.hamiltonproject.org/papers/employment-based_tax_credits_for_low-skilled_workers/

Currently, workers under age 25 are ineligible for the childless workers' EITC. We recommend that this age floor be lowered to 21, with a student-related exception as discussed below.

Less educated young people, particularly African American men, face a myriad of challenges, including:

- *Low and falling labor force participation rates.* In 2012, the labor participation rate of men aged 20 to 24 was 13.7 percentage points lower than the labor participation rate for men aged 25 to 54. Not only is the labor participation rate of young men low, but it has fallen and continues to fall. From 2001 to 2011, the labor-force participation rate of men aged 20 to 24 fell 6.8 percentage points, while the labor force participation rate of men aged 25 and 54 fell by 2.6 percentage points. Since 2009, the difference between the labor-force participation rates of prime-aged men (25-54) and younger men (20-24) has exceeded its previous historical peak in 1968.

- *Higher involvement in the criminal justice system.* The above figures *understate* the decline in employment among young men, since these numbers only consider the civilian population. Young men disproportionately interact with the criminal justice system, relative to their older peers. According to a recent Justice Department report, 18 percent of men between the ages of 20 and 24 were arrested in 2009. This percentage has increased since the 1980s.[18]

Congress placed the eligibility age at 25 when establishing the EITC for childless workers in 1993 to avoid giving large numbers of students from middle-class families access to the EITC. But as a result, many low-income workers who are *not* students are denied the EITC, and the opportunity to influence employment decisions at the start of the careers of low-income individuals who are not attending college (or are doing so part-time while they work) is lost.

Moreover, at the time that the childless workers' EITC created in 1993, there was no ready way to identify students, who are likely to depend primarily on their parents for support. In 1998, however, Form 1098-T was created to allow taxpayers and the IRS to verify eligibility for the Hope Scholarship and Lifetime Learning credits. This form could be used to identify low-income workers under age 25 who are students at least half time, enabling the EITC to be targeted to low-wage workers who are not students at least half time.

We recommend that the age floor be lowered to 21, with the exception that childless workers between the ages of 21 and 24 who are full-time students would remain ineligible.

Phase-in and Phase-out Rates

As discussed above, the current EITC for childless workers phases in at just 7.65 percent (and phases out at the same rate). This means that it offsets just half of an eligible person's payroll tax burden. This is why a number of previous proposals — including proposals from former Senator John Kerry and Rep. Charles Rangel — would have doubled the phase-in rate for the childless workers' EITC to 15.3 percent. We strongly recommend raising the credit rate to 15.3 percent to

[18] Howard N. Snyder, "Arrest in the United States, 1980-2009," Bureau of Justice Statistics, Department of Justice, September 22, 2011, http://www.bjs.gov/content/pub/pdf/aus8009.pdf

offset payroll tax burdens fully and, in particular, to make the credit larger so that it has a more powerful effect in inducing people to enter the work force (as well as in reducing the extent to which single workers are taxed into, or deeper into, poverty). We also suggest raising the phase-out rate (for budget reasons) also to the same 15.3 percent.

Kink Points

The first kink point is the level of earnings at which the phase-in ends. The first kink point times the phase-in rate determines the maximum credit. For example, under current law, the first kink point in 2014 would be $6,460. The second kink point is the income level at which the credit begins to phase-out. It represents the highest income amount at which an eligible person receives the maximum credit. All eligible people earning amounts between the kink points — commonly referred to as the "plateau" — receive the maximum credit. Beyond the plateau (i.e. beyond the second kink point), people receive a smaller credit and eventually no credit.

The phase-out rate is how quickly the credit is reduced for people earning more than the second kink point. In an ideal world, the credit would not phase out. Such a design would reduce adverse marginal tax rate effects and potential unfavorable work disincentives. This feature, however, would be prohibitively expensive. Moreover, given that the most powerful labor participation effects are around the "to work" vs. "not to work" decision, it is more important to focus budget resources on the phase-in and maximum credit than on the phase-out.

We recommend putting a priority on raising the first kink point. Specifically, we propose to raise it to $8,820 in 2014 — raising the maximum credit to about $1,350. For the second kink point, we suggest simply keeping the length of the plateau the same as it is under current law, which would put it at $10,425 in 2014.

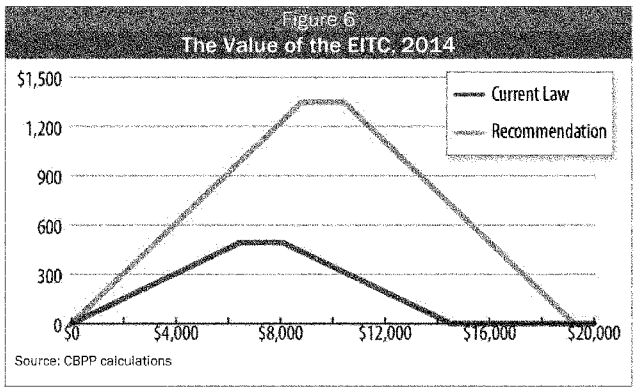


Table 1: Options for Expanding the EITC for Childless Workers in 2014		
Parameters	Current Law	Recommendation
Earned Income Base Amount	$6,460	$8,820
Credit Percentage	7.65%	15.30%
Max Credit	$494	$1,350
Begin Phaseout	$8,080	$10,425
Phaseout Percentage	7.65%	15.30%
End Phaseout	$14,540	$19,245
Rough 10-year costs (in billions)		$76
Note: Our rough estimate of the 10-year costs of the EITC under current law is $17 billion		

Table 2: Value of the EITC for Single Childless Individuals, 2014			
Income	Notes	Current Law	Recommendation
$7,250	At current minimum wage, 1,000 hours of work a year (part-time)	$494	$1,109
$12,127	Poverty Line	$185	$1,089
$13,224	At 1,500 hours of work per year at a $9 minimum wage in 2015* (3/4 of full-time)	$101	$921
$14,500	2,000 hours (full-time) of work at current minimum wage ($7.25/hour)	$3	$726
$17,632	2,000 hours of work per year (full-time) at a $9 minimum wage in 2015*	$0	$247
Note: A $9 2015 minimum wage is $8.82 in 2014 dollars			

Simplification and Improving Compliance

In addition to making the recently extended improvements permanent and strengthening the EITC for workers who are not raising children, we also recommend adopting a series of simplification and compliance measures to reduce errors, including errors made by tax preparers who are not properly trained. Most of these simplification measures were proposed by George W. Bush's Treasury Department and included in several Bush budgets.

Simplification is central to any strategy to shrink EITC errors. Treasury analysts have estimated that the number of tax returns either claiming the EITC in error or claiming too large an EITC fell by approximately 13 percent following implementation of a package of EITC simplification measures enacted in 2001.[19] Treasury followed that up by proposing additional simplifications to the

[19] U.S. Department of the Treasury, "Performance and Accountability Report, Fiscal Year 2009," App. B, p. 219.

EITC to reduce errors; these simplifications were included in several of President Bush's budgets between 2004 and 2008. Congress did not act on these proposals, but they continue to have strong merit. These proposals, which we highly recommend (and which have a modest cost), include the following:

- *Simplifying the rule governing how parents who are separated can claim the EITC.* Normally, married couples must file joint returns to claim the EITC, but for obvious reasons, separated parents often file their own returns. In such a case, a complex rule governs whether the custodial parent may claim the EITC if she files a separate return. For her to do so, she and her spouse must have lived apart for more than six months of the tax year, and she must have lived with the qualifying child for more than six months of the year; this part of the rule is straightforward. But she also must be able to claim head-of-household filing status, and to do so, a parent must meet IRS' "household maintenance" test. This test is very complicated, hard to apply, and poorly understood.[20] As a result, numerous errors result, with low-income working mothers who are separated but not yet divorced mistakenly claiming head-of-household status and the EITC.

  Because low-income parents who separate may take a long time to obtain divorces (or court decrees of separate maintenance) — especially if they have difficulty affording the legal expenses — such errors can continue for a number of years. The proposal that the Bush Administration advanced would simplify these requirements by permitting a separated parent who lives with her qualifying child for more than six months of the year — and lives apart from her spouse for at least the final six months of the year — to claim the EITC without having to meet the complex head-of-household filing test. The National Taxpayer Advocate recently made a recommendation to Congress[21] that builds on and improves upon the earlier Treasury proposal, by also removing the head-of-household test when married couples are (1) living apart on the last day of the tax year and (2) have negotiated a written, legally binding separation agreement by the end of that year. In other words, the custodial parent would be able to file as unmarried and claim the EITC, if otherwise eligible, if the other spouse were absent from the home for the last six months of the year *or* if the couple were living apart and had a legal separation agreement by the end of the year.

  (A separation agreement is used to divide any property and debts that either spouse has incurred, as well as provide for custody, visitation, and support of any minor children of the relationship. Separation agreements are used by separated couples looking to settle property and custody prior to a divorce judgment. The agreement is accomplished outside of court. Properly drawn and notarized, it is considered legally binding. It does not entail the expense of going to court to reach agreement on these matters and obtaining a divorce, which couples may be unable to afford and may delay for considerable periods.)

  This simplification should lead to a significant reduction in EITC errors.

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[20] Among other things, the household maintenance test requires filers to show that they pay more than half of household expenses from their own income and requires them not to count child support payments and public program benefits as part of that income even though such payments or benefits are commonly used for household expenses.

[21] Taxpayer Advocate Service, "2012 Annual Report to Congress, Vol. I," pp. 513-520

- *Allowing filers who live with a qualifying child but do not claim the child for any tax benefit to claim the smaller EITC for workers not raising a child.* Sometimes either of two adults who live in the same household with a child may qualify to claim the child for the EITC. This can occur, for example, when a mother, aunt, and child live together; the aunt may be eligible to claim the child for the EITC if the mother does not. If the mother does claim the EITC for the child, however, current rules *prohibit* the aunt from claiming the smaller EITC for very poor workers who are not raising a minor child even if she otherwise qualifies. The Bush Treasury proposal would address this inequity by removing the disqualification that applies to the aunt in such a case. This proposal would reduce errors; under current rules, the aunt may mistakenly assume she can claim the EITC for childless workers, since she is not claiming a qualifying child for the EITC. If she claims the childless workers' EITC, however, an error is said to occur.

- *Eliminating the EITC investment income test.* Under current law, low-income filers are ineligible for the EITC if they have investment income such as interest, dividends, capital gains, rent or royalties that exceeds $3,300 a year (in 2013). Very few EITC claimants have investment income above this level. However, EITC claimants in general must navigate their way through complex instructions to determine whether they have income that would be defined as investment income for EITC purposes. The 14-line IRS worksheet necessary to meet this requirement refers to ten separate lines on Form 1040 and to four separate schedules.

  The investment income test also creates a "cliff," since a worker with investment income of $3,300 is eligible to claim the full EITC while a worker with investment income of $3,301 is unable to claim any EITC. In addition, the test discourages savings among low- and moderate-income families. Although not as crucial as the two aforementioned simplifications, Treasury earlier proposed to remove this test, which would simplify tax filing and reduce errors.

Finally, we recommend that the Congress, if needed as discussed below, pass legislation to ensure that the IRS's commercial tax preparer initiative moves forward:

IRS regulation of commercial tax preparers. Two years into IRS implementation of a new initiative to regulate commercial tax preparers, a January 2013 decision by the U.S. District Court of the District of Columbia has shackled this important tax compliance effort by ruling that IRS does not have statutory authority for the regulatory mechanism it developed. Several hundred thousand commercial preparers, most previously under no requirements of competency to file tax returns on behalf of taxpayers, had already been brought in under the requirement to obtain Preparer Tax Identification Numbers (PTINs) in order to be permitted to prepare and file tax returns for individual taxpayers. Further requirements for these preparers to pass a tax law competency test and certify completion of continuing education courses to update tax law knowledge were phasing in, to take full effect for the 2014 tax filing season.

The IRS has served notice of its intent to appeal the District Court decision. However, if the IRS is unsuccessful upon appeal, it is important that Congress pass legislation authorizing the regulatory approach adopted by the IRS. This effort is a cornerstone of IRS tax compliance efforts. It is particularly vital to efforts to control EITC and CTC overpayments, since a large majority of tax credit claims are filed by commercial preparers, most of whom do not fall under CPA or Enrolled Agent requirements to demonstrate competency. Investigations by GAO and TIGTA have earlier documented commercial preparer ignorance or deliberate flouting of eligibility rules for refundable credits. The regulations, proposed by IRS in 2009, met with broad approval from tax professional

organizations, low-income taxpayer advocates and within the tax preparation community. As IRS stated when announcing the new approach in 2009, "…registration will make it easier for the IRS to locate and review the returns prepared by a tax return preparer when instances of misconduct are detected."[22]

The regulations developed by the IRS closely follow recommendations that have been made by the National Taxpayer Advocate consistently since 2002, and which previously passed the Senate in 2004 as part of the Tax Administration Good Government Act.[23]

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[22] Internal Revenue Service, "Return Preparer Review," December 2009, p. 33, www.irs.gov/pub/irs-pdf/p4832.pdf

[23] National Taxpayer Advocate, "FY 2002 Report to Congress," www.irs.gov/pub/irs-utl/arc2002_section_one.pdf, pp 69-73 and "2003 Annual Report to Congress, " p. 270, www.irs.gov/pub/irs-utl/nta_2003_annual_update_new_1-15-042.pdf

Consortium for Citizens with Disabilities

Commemorating 40 Years
Of Disability Advocacy
1973-2013

Statement for the Record

Hearing on the President's and Other
Bipartisan Entitlement Reform Proposals, April 11, 2013

Subcommittee on Social Security
Committee on Ways and Means
U.S. House of Representatives

Submitted May 2, 2013 on behalf of the undersigned members of the Consortium for Citizens with Disabilities:

ACCSES
American Association on Health and Disability
American Council of the Blind
American Music Therapy Association
Association of Assistive Technology Act Programs
Association of University Centers on Disabilities
Autism National Committee
Bazelon Center for Mental Health Law
Brain Injury Association of America
Children and Adults with Attention-Deficit/Hyperactivity Disorder
Community Access National Network
Community Legal Services
Council of State Administrators of Vocational Rehabilitation
Disability Rights Education and Defense Fund
Disability Rights Legal Center
Easter Seals
Epilepsy Foundation
Goodwill Industries International
Health and Disability Advocates
Lupus Foundation of America
National Alliance on Mental Illness
National Association of Councils on Developmental Disabilities
National Association of Disability Representatives
National Association of State Head Injury Administrators
National Committee to Preserve Social Security and Medicare
National Council for Community Behavioral Healthcare

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National Council on Independent Living
National Down Syndrome Congress
National Down Syndrome Society
National Industries for the Blind
National Organization of Social Security Claimants' Representatives
National Respite Coalition
NISH
Paralyzed Veterans of America
Special Needs Alliance
The Arc of the United States
United Spinal Association

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The Consortium for Citizens with Disabilities (CCD) is a working coalition of national organizations working together to advocate for national public policy that ensures the self-determination, independence, empowerment, integration and inclusion of the 57 million children and adults with disabilities in all aspects of society. The undersigned members of CCD submit this Statement for the Record of the April 11, 2013 House Ways and Means Social Security Subcommittee hearing on the President's and Other Bipartisan Entitlement Reform Proposals.

The undersigned organizations strongly oppose the use of the chained Consumer Price Index for All Urban Consumers ("chained CPI-U") to determine the Social Security cost-of-living adjustment (COLA). We also strongly oppose using the chained CPI-U to determine COLAs for other benefit programs such as veterans' benefits, to calculate the federal poverty guidelines, and for other vital anti-poverty programs including the Earned Income Tax Credit.

We support thoughtful efforts to strengthen the Social Security system's long-term financing but changes to the programs should not be made in the context of deficit reduction, and should ensure a benefit formula that provides adequate protection against inflation and does not push more people into poverty. The Social Security system is a vital part of our social insurance safety net and protects some of the poorest and most vulnerable Americans. Careful consideration should be given to the potential impact on seniors and people with disabilities before making any changes to such critical programs.

The Chained CPI-U and People with Disabilities

Although some might describe use of the chained CPI-U as a mere technical change, it would likely have dramatic impacts on current and future Social Security and Supplemental Security Income (SSI) beneficiaries. In fact, as noted by the Congressional Budget Office, the impact of the chained CPI-U "would be especially large for some disabled beneficiaries; they generally become eligible for Social Security benefits before age 62 and thus can receive COLAs for a longer period of time."[1] As discussed below, many beneficiaries with

[1] Testimony of Jeffrey Kling, Congressional Budget Office, April 18, 2013, before the Committee on Ways and Means Social Security Subcommittee, on "Using the Chained CPI to Index Social Security, Other Federal Programs

disabilities rely on Social Security or SSI for most or all of their income. Additionally, like many seniors, people with disabilities often spend a disproportionate amount of their monthly budget on out-of-pocket medical expenses and on housing. Most beneficiaries with disabilities have already economized as much as possible and have little room in their budgets to make additional substitutions as envisioned under the chained CPI-U.

For a Social Security beneficiary receiving the average 2012 Disability Insurance benefit, the chained CPI-U would result in benefit cuts of about $347 per year (2.6%) after 10 years, $720 (5.4%) after 20 years, and $1,084 per year (8.13%) after 30 years. These cuts could be devastating and force people to make terrible life and death choices between paying for a prescription or buying food.

In addition, using the chained CPI-U to calculate the Social Security COLA would result in a significant, two-part cut in SSI benefits. Unlike Social Security, where initial benefits are based on a worker's wage history, the SSI initial payment levels are based on a federal benefit rate that is adjusted using the CPI-W. Using the chained CPI-U, the SSI initial payment levels would grow at a lower rate, meaning that a person's benefits would be cut even prior to application – and then would be cut a second time through lower cost-of-living adjustments.

Using the chained CPI-U to calculate the Social Security COLA would also result in a significant benefit cut for the Military Retirement and Veterans' Pension Benefit Programs, which by law receive a COLA based on the Social Security COLA. Finally, it would likely impact Veterans' Disability Compensation, which receives a COLA enacted each year by Congress that typically provides an adjustment equal to the Social Security COLA.

Furthermore, if applied government-wide, the chained CPI-U would affect many other programs that are vital to people with disabilities. For example, income eligibility standards for many parts of Medicaid, for the Supplemental Nutrition Assistance Program (SNAP; formerly known as the food stamp program), and for over 30 vital anti-poverty programs are based on the federal poverty guidelines. Applying the chained CPI-U to the federal poverty guidelines would likely result in fewer adults and children with disabilities qualifying for Medicaid, SNAP, and essential programs such as the Child Nutrition Programs, Head Start, and the Low-Income Home Energy Assistance Program (LIHEAP).

The Administration's FY 2014 Budget Proposal

As noted earlier, we support thoughtful efforts to strengthen the Social Security system's long-term financing but believe changes should not be made in the context of deficit reduction.

The Administration's FY 2014 budget proposal includes provisions intended to soften the impact of the chained CPI-U, but the fact that so many protections are being considered highlights the reality that the chained CPI-U is not the right policy for Social Security. The proposed protections are well-meaning, but inadequate to address the needs of extremely vulnerable beneficiaries. For example, switching to chained CPI-U in FY 2015 would mean that the

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and the Tax Code for Inflation."

spending capacity of Social Security disability beneficiaries would fall even further behind annual increases in health-care and related costs that disproportionately impact people with disabilities. Yet, the proposed "benefit enhancement" would provide no relief for 15 years, and would not be fully realized for another 10 years. Additionally, some beneficiaries with severe, lifelong disabilities can begin receiving Social Security as young as age 18. Under the Administration's proposal, such beneficiaries with disabilities would receive two benefit adjustments at 15 and 25 years – but would have no protection from the chained CPI-U after that.

The Importance of Preserving Social Security, SSI, and other Vital Programs for People with Disabilities

Millions of people with disabilities and their families rely on the Social Security Old-Age, Survivors, and Disability Insurance programs; SSI; Veterans' Disability Compensation; and other programs that would be affected by the chained CPI-U to meet their basic needs. The undersigned groups strongly support taking steps to achieve the long-term financial solvency of Social Security. We understand that it is vitally important to take steps to strengthen the long-term financing of the Social Security system so that it can continue to provide the critical income support on which many of the most vulnerable members of our society depend.

Social Security benefits, however, are already very modest and should not be cut. In February, 2013 the average Disability Insurance benefit for a disabled worker was about $1,130 – just over the federal poverty line – and the average SSI benefit was just $526 per month – about half the federal poverty level for a single person, and just $17.53 per day.

Social Security beneficiaries rely on these benefits for a significant portion of their income. Social Security disability benefits comprise more than 90 percent of the total income for almost half of non-institutionalized disabled workers, and more than 75 percent of total income for the vast majority of disabled worker beneficiaries. Social Security benefits equal half or more of the **total** family income for about half of disabled worker beneficiaries, and over 57% of SSI beneficiaries have no other source of income. Poverty rates among disabled worker beneficiaries are twice as high as for other Social Security beneficiaries but would be even higher if not for Social Security Disability Insurance benefits.

The same is true for beneficiaries of Social Security retirement benefits. The average yearly benefit for the lowest 20% of income earners receiving retirement benefits in 2008 was $10,206 and that represented 94% of their family income. Any cut to benefits will likely mean that a basic need (like food, medicine, or shelter) will not be met for the people who depend almost entirely on Social Security benefits.

Conclusion

The undersigned members of CCD strongly support thoughtful efforts to strengthen the Social Security system's long-term financing. The sooner such action is taken the better as the modest changes that are required to restore long-term actuarial balance to the program can be made gradually and fairly given enough time to implement the changes. Strengthening Social Security

does **not** require cutting benefits. Changing the Social Security COLA to be based on the chained CPI-U would do just that.

We urge the Subcommittee to oppose the use of the chained Consumer Price Index for All Urban Consumers ("chained CPI-U") to determine the Social Security COLA.

* * * *

Submitted on behalf of the undersigned members of the Consortium for Citizens with Disabilities:

ACCSES
American Association on Health and Disability
American Council of the Blind
American Music Therapy Association
Association of Assistive Technology Act Programs
Association of University Centers on Disabilities
Autism National Committee
Bazelon Center for Mental Health Law
Brain Injury Association of America
Children and Adults with Attention-Deficit/Hyperactivity Disorder
Community Access National Network
Community Legal Services
Council of State Administrators of Vocational Rehabilitation
Disability Rights Education and Defense Fund
Disability Rights Legal Center
Easter Seals
Epilepsy Foundation
Goodwill Industries International
Health and Disability Advocates
Lupus Foundation of America
National Alliance on Mental Illness
National Association of Councils on Developmental Disabilities
National Association of Disability Representatives
National Association of State Head Injury Administrators
National Committee to Preserve Social Security and Medicare
National Council for Community Behavioral Healthcare
National Council on Independent Living
National Down Syndrome Congress
National Down Syndrome Society
National Industries for the Blind
National Organization of Social Security Claimants' Representatives
National Respite Coalition
NISH
Paralyzed Veterans of America

Special Needs Alliance
The Arc of the United States
United Spinal Association

National Active and Retired Federal Employees Association

Joseph A. Beaudoin
National President

Paul H. Carew
National Vice President

Elaine C. Hughes
National Secretary

Richard G. Thissen
National Treasurer

April 17, 2013

Subcommittee on Social Security
Committee on Ways and Means
U.S. House of Representatives
B317 Rayburn House Office Building
Washington, DC 20515

Dear Subcommittee Member,

As you examine proposals to change how inflation is measured for purposes of determining cost-of-living adjustments (COLAs) to important earned retirement benefits at your April 18, 2013, hearing, I would like to share the concerns of the five million federal employees and annuitants represented by the National Active and Retired Federal Employees Association (NARFE).

Inflation protection is a vital part of any federal benefits program, and we welcome a discussion surrounding the adequacy of the current measure. We must caution, however, that having this discussion within the context of deficit reduction strategies clouds the debate regarding the role inflation plays in the lives of our nation's seniors, veterans and the disabled.

As you consider this issue, I urge you to oppose proposals that would substitute the chained CPI for the current index (the CPI-W) as the measure of inflation for federal civilian and military retirement annuities, veterans' benefits, disability insurance benefits and Social Security benefits.

Do not be misled; the chained CPI is not a more accurate measure of inflation for seniors. Proponents of the chained CPI claim it provides a better measure of inflation by taking into account how consumers substitute one item when the price of another item increases; for example, by switching from steak to chicken when the price of steak rises. Accounting for this type of substitution, however, fails to measure lower standards of living that result from substituting a less desirable alternative. Seniors, in particular, as a result of living on a fixed income, often find such substitution impracticable, as they are already purchasing lower priced goods.

Second, neither the chained CPI nor the CPI-W accurately reflects changes in consumer prices experienced by the seniors who rely on the measures to adjust their incomes appropriately. Notably, while health care accounts for about 12 percent of spending for those 62 or older, it accounts for only 5 percent of spending for the general population.

National Active and Retired Federal Employees Association
www.NARFE.org | 606 N. Washington Street, Alexandria, VA 22314 | **phone** 703-838-7760 | **fax** 703-838-7785

Federal Workers Protect America's Heartbeat Show your support at **www.PROTECT***AmericasHeartbeat***.org**

Meanwhile, health care costs are rising faster than other goods – last year, health care inflation was 3.7 percent while the CPI-W indicated the average price of consumer goods increased 1.7 percent.

When you measure costs experienced by Americans 62 years of age or older, as the Bureau of Labor Statistics (BLS) does when calculating an experimental price index for elderly consumers, the CPI-E, inflation is actually greater than the CPI-W reflects, a clear sign that switching to the chained CPI is a move in the wrong direction.

A switch to the chained CPI is a reduction to the earned and promised retirement benefits of middle-class Americans. Although politicians as ideologically diverse as the members of the Republican Study Committee and President Obama have referred to the chained CPI as a technical adjustment, that characterization obscures the obvious – individuals who have worked their whole lives to earn their retirement benefits will receive less money in the future. That sounds like a real benefit cut to them, and it is.

Using the chained CPI instead of the CPI-W would reduce COLAs by an estimated 0.3 percent per year. Because this difference would compound over time, it would result in estimated yearly benefits 3 percent lower after 10 years, 6.2 percent lower after 20 years and 9.4 percent lower after 30 years.

The average annual Social Security benefit is only $15,000 per year. By using the chained CPI, someone earning that annuity would receive, in total actual dollars, an estimated:

- $2,936.45 less after 10 years;
- $13,612.09 less after 20 years; and,
- $36,742.92 less after 30 years.

How does someone with an income of $15,000 per year make up that difference?

Federal retirees under the Civil Service Retirement System (CSRS), which does not provide Social Security benefits, rely on their federal annuity as their sole source of income. Therefore, a switch to the chained CPI would have a particularly acute impact on their retirement benefits.

Federal employees covered by the Federal Employees Retirement System (FERS) would actually be hit twice, through their federal pensions and their Social Security benefit. Additionally, FERS does not even provide full inflation protection if inflation is greater than 2 percent. With an average annual annuity of $13,164, FERS retirees also would receive an estimated:

- $2,577.02 less after 10 years;
- $11,945.97 less after 20 years; and,
- $32,245.58 less after 30 years.

Finally, the chained CPI hurts the most vulnerable. Using the chained CPI as an inflation measure would decrease benefits for low income seniors and the disabled, including disabled veterans, while simultaneously increasing taxes on lower and middle-income taxpayers. Current seniors, especially those who are older than 65, will be hit the hardest by a switch to the chained CPI – they are likely to have fewer sources of income, are unable to return to work given their age, and have higher medical expenses.

The average Social Security benefit is $15,000 annually, which is, by itself, a low income. For seniors that rely solely on their Social Security benefits, every dollar the chained CPI reduces their income may be a vital one. While some proponents of the chained CPI have coupled their support for it with an increase in benefits for the poorest elderly, such as those receiving Supplemental Security Income (SSI), it is difficult to see how you save money for deficit reduction without hurting low income seniors when the average Social Security benefit is so low.

Individuals receiving veterans' benefits or disability benefits (SSDI) will be hit particularly hard by a switch to the chained CPI. Because many of these individuals rely on benefits for a longer period of time, the compounding effect from reduced COLAs caused by a switch to the chained CPI will take a more substantial toll on their total benefits.

Additionally, using the chained CPI for tax purposes would increase taxes on lower and middle-income taxpayers. According to a Joint Committee on Taxation report, by 2021, the tax liability for those with incomes between $10,000 and $20,000 would increase by 14.5 percent, and by 3.5 percent for incomes between $20,000 and $30,000, while those with incomes of $1 million and above would see an increase of only 0.1 percent. The chained CPI hits our nation's most vulnerable twice.

The impact of these combined changes would fall hardest on those who live the longest, as their savings dwindle, and on those whose sole source of retirement income is from their government benefit, including Social Security and civilian or military retirement annuities.

For these reasons, I urge you to oppose proposals to base COLAs for federal civilian retirement annuities and Social Security benefits on the chained CPI. If you have any questions or concerns, please contact NARFE Legislative Director Jessica Klement via e-mail at jklement@narfe.org or phone at 571-483-1264.

Thank you for your consideration of NARFE's views.

Sincerely,

Joseph A. Beaudoin
National President

National Education Association

1201 16th St., N.W. | Washington, DC 20036 | Phone: (202) 833-4000

Dennis Van Roekel
President

Lily Eskelsen
Vice President

Rebecca S. Pringle
Secretary-Treasurer

John Stocks
Executive Director

October 22, 2013

United States House of Representatives
Committee on Ways and Means
Washington, DC 20515

Dear Representative:

On behalf of the more than 3 million members of the National Education Association (NEA), we offer our views in connection with the April 17 hearing, "President's and others Bipartisan Entitlement Reform Proposals."

Over the past two years, drastic and austere deficit reduction without accompanying revenue increases has marred our economic landscape. Students, teachers, working families and seniors – the most vulnerable of our society - have all paid an extraordinary price due to these cuts. Meanwhile, some in Congress have shown they are serious about finding a balanced approach to moving the country forward and restoring our economic strength by putting students ahead of political ideology while demanding corporations and the rich pay their fair share in taxes. It shows a real commitment to returning to solid fiscal footing without jeopardizing the important economic gains made during the past four years.

This measured and balanced approach to deficit reduction should be utilized in all arenas – especially when considering changes to retirement programs. A long held Republican idea, which appeared in the President's FY2014 budget, proposes cutting $100 billion in Social Security benefits by recalculating the cost of living for beneficiaries by using the Chained CPI or Chained Consumer Price Index. These painful cuts to Social Security benefits by using the Chained CPI, as well as $400 billion in new cuts to Medicare, represent an unfair burden on those that can least afford and least deserve it – seniors, people with disabilities, and veterans.

One of the most problematic aspects of the Chained CPI is that the cuts are larger the longer you receive benefits. By age 85, the individual who began to receive benefits at 65 would be losing $984 in benefits that year; by age 95, the annual cut would be $1,392. Many seniors do not have retirement savings to supplement the income they receive from Social Security. This proposed adjustment won't result in seniors choosing to purchase cheaper items at the grocery store; it will cause them to choose between spending money on food or on health care.

For some beneficiaries, the reduced increase in Social Security benefits will be completely consumed by the increase in Medicare premiums, which Chained CPI does not account for, effectively leaving current beneficiaries with no cost of living adjustment at all. No matter how it is presented, the use of the Chained CPI is a benefit cut. Social Security belongs to the people

who have worked hard all their lives, contributed to the program, and relied on the promise that they and their family will be able to collect benefits that accurately reflect the cost of living when they retire.

Nearly 1.2 million NEA members will be eligible for full retirement within the next 10 years. These people are educators that have devoted their lives to students. We urge you to think of them and the many working families across this country as you consider the path forward.

Sincerely,

Mary Kusler

Mary Kusler, Director of Government Relations

National Senior Citizens Law Center

STATEMENT OF GERALD A. McINTYRE
NATIONAL SENIOR CITIZENS LAW CENTER

HEARING ON
THE PRESIDENT'S AND OTHER BIPARTISAN ENTITLEMENT REFORM PROPOSALS

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON SOCIAL SECURITY

April 18, 2013

The National Senior Citizens Law Center has for over forty years worked to protect the rights of low income older adults with a special focus on issues of health and economic security.

The annual cost of living adjustment (COLA) for Social Security and other federal benefits is an essential element of economic security for older Americans. Without it many more would be reduced to living in poverty as they age. For that reason, we oppose the current proposal to provide only a partial cost of living adjustment by use of the Chained Consumer Price Index (CPI).

Rather than repeat many of the arguments the Committee has already heard against the use of the Chained CPI, we want to indicate our full support for all the positions set forth by Nancy J. Altman in her statement before the Committee on April 18, 2013.

However, there are a couple of additional points we would like to make. The first is that our opposition to use of the Chained CPI extends to all federal old age, retirement and disability programs. This includes veterans benefits, federal employees retirement programs and Supplemental Security Income (SSI).

Finally, we want to emphasize that the Chained CPI would have a far worse impact if it were extended to the SSI program. The reason for this is that the cost of living adjustment is applied to the SSI program in a way that is totally different from all other government programs. In the case of Social Security, veterans benefits or federal employee retirement benefits the COLA is first applied to the individual's initial monthly benefit.

In the case of SSI, the COLA is applied, not to the individual's monthly benefit, but to the Federal Benefit Rate (FBR), which is the maximum amount of federal dollars that can be paid and which serves as the basis of the formula for determining eligibility and amount of benefits. This is a very important difference. It means that if an inadequate measure is used to determine the COLA, an individual will feel the cumulative impact in the initial benefit, not just years later as with Social Security.

EXAMPLE - It is useful to compare how a switch to the Chained CPI in 2013 would affect two

individuals, Abigail and Bernice, both age 45 in 2013. Assume that both begin receiving benefits at age 65 in 2033, with Abigail receiving Social Security benefits and Bernice receiving SSI. Since Abigail receives Social Security Retirement, the Chained CPI will have no impact on her initial benefit. However, twenty years later in 2053, when she is 85 years old, she will definitely feel the cumulative impact of twenty years of a seriously deficient COLA. On the other hand, when Bernice receives her first SSI check in 2033, that initial benefit will already have been reduced by the same percentage that Abigail will experience at age 85. When Bernice reaches age 85, the percentage reduction in her SSI check will be as great as what Abigail would experience with her Social Security benefit at age 105.

While we disagree with the Administration on the use of the Chained CPI generally, we want to commend them for opposing the use of the Chained CPI in the SSI program in recognition of this important distinction in how it would apply to SSI.

CONCLUSION

It would be a serious mistake to use the Chained CPI to calculate the COLA for any federal retirement or disability benefit. To use the Chained CPI for calculating the SSI COLA would be especially disastrous both because the percentage reduction in benefit levels would be much greater and because this is the most vulnerable group of older Americans.

RetireSafe

RetireSafe

Standing Up For America's Seniors!

May 22nd, 2013

The Honorable Sam Johnson
Chairman of the House Committee on Ways and Means Subcommittee on Social Security

Chairman Johnson:

I submit this statement as a spokesman for RetireSafe's 400,000 supporters nationwide to voice our continued concern with the many discussions concerning our Nation's debt and the focus on cutting older Americans' benefits as a solution for that debt. The issues regarding Social Security and Medicare reform are numerous and RetireSafe has taken strong stances in the past and will continue to be involved as these discussions go forward. Today, however, on the eve of this hearing on "Bipartisan Entitlement Reform", we want to focus on one important aspect of reform that has been discussed lately and has found some favorable acceptance by the Administration and by both Democrats and Republicans. I speak of the chained CPI and its perceived impact on Social Security and the national debt.

The consumer price index (CPI) is a method used to calculate the cost-of-living-adjustment (COLA) for Social Security and many other programs. The COLA was initiated to ensure that the purchasing power of everyone's Social Security benefit was not eroded by inflation. To ensure that the benefit check they got this year buys the same amount of goods and services that it bought last year. The chained CPI's acceptance has been driven by some economist's calculation that a COLA based on the chained CPI would be smaller, reducing benefit payments and subsequently lowering the national debt. I think it would be fair to conjecture that if the chained CPI would have been estimated to result in an increase in the COLA rather than a decrease we would not be having this discussion about the CPI at all. The point I want to make is that the chained CPI, or any CPI, should not be used as a method to reduce the debt or to "preserve" Social Security by cutting benefits. The CPI used for the calculation of the Social Security COLA should have only one purpose, to preserve the value of the Social Security benefit. That should be its only job. Trying to use it for anything else is disingenuous and a trick to hide benefit reduction.

I have written numerous times about how and why the CPI that is used today to calculate the COLA is flawed; that it uses data for young urban wage earners and clerical workers and doesn't reflect the spending patterns or expense requirements of seniors. We have vigorously supported a bill that would calculate an accurate CPI, the CPI for Seniors Act, which will mandate a fair and correct CPI for seniors, and thus a fair annual Social Security COLA. That's all it does, it doesn't "fix" anything, and it doesn't reduce anything. It just preserves the purchasing power of that Social Security check that seniors count on each and every month.

It is also important to remember that other entitlement reforms that have been put forth to date would only affect future Social Security beneficiaries. The instigation of the chained CPI and the ensuing reduction in benefits will affect all seniors **right now** and the compounding affect will increase that impact more and more each year.

An option that deserves serious consideration is the creation of an accurate and fair CPI for seniors to ensure it does its simple and singular job of protecting the purchasing power of the Social Security checks that come each month. Entitlement reform and debt reduction should be dealt with in a clear and forthright manner, not hidden behind a chained CPI.

Thair Phillips
President, RetireSafe

1616 H Street NW, Suite 902. Washington D.C. 20006
www.retiresafe.org

Robert Munson

Robert L. Munson
120 Howard Ave
Middlesex, NJ 08846
April 17, 2013

To: House Ways and Means Committee
Hearing: President's and Other Bipartisan Entitlement Reform Proposals
Hearing Date: April 18, 2013
Re: Chained CPI

My comment is in the form of a scenario, which I have not found an answer to on the web. I offer a possible interpretation. Is it correct?

So I go to the store and buy a basket of goods. At the grocery checkout the total comes to $100. My (simplified) CPI-U is 100 and my (simplified) C-CPI-U is 100.

A few years later, I go again and load up my cart with the same basket of goods. At the checkout the total comes to $105, so my CPI-U is 105. But before buying, I substitute oranges for apples and rice for potatoes. I have the same nourishment from the groceries, but the substitutions have lowered the total price to $104.50, so my C-CPI-U is 104.5. So far so good.

Then later, for a third time, I return to the grocery store with information on the prices I paid previously. I notice something unusual – the price of each item is exactly 10% more than on my first visit. Apples are 10% more, oranges are 10% more, potatoes are 10% more and rice is 10% more. CPI-U is easy to figure out – 110, since my original market basket now costs $110 at checkout. Since I have no need to make substitutions, the C-CPI-U should also be 110.

Am I right? Would my (simplified) C-CPI-U be 110, matching CPI-U?

Robert L. Munson

The Social Security Institute

TESTIMONY OF
LAWRENCE A. HUNTER, PH.D.
PRESIDENT
THE SOCIAL SECURITY INSTITUTE

ON
THE CHAINED CPI

SUBMITTED TO THE
SUBCOMMITTEE ON SOCIAL SECURITY
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

APRIL 18, 2013

4305 Fauquier Ave., Suite A, P.O. Box 216,
The Plains, Virginia 20198

Testimony of
Lawrence A. Hunter, Ph.D.
President
The Social Security Institute
on
The Chained CPI
Submitted to
Subcommittee on Social Security
Committee on Ways and Means
U.S. House of Representatives
April 18, 2013

"A promise made is a debt unpaid." ~Robert W. Service

Introduction

My name is Dr. Lawrence A. Hunter, President of the Social Security Institute (SSI), a 501(c)(4) non-profit, non-partisan, seniors' advocacy organization located in The Plains, Virginia. SSI seeks to promote the retirement security of today's seniors and the seniors of tomorrow. Our top policy priorities are to ensure that promises made by Congress to today's seniors in the Social Security program are promises kept and to seek reform of the program to make it just and sustainable for the seniors of tomorrow.

On behalf of SSI and the many thousands of seniors who support our efforts, I am submitting this written statement in opposition to the proposal to substitute the Chained CPI for the CPI used currently (CPI-W) to calculate annual cost-of-living allowances (COLAs) for Social Security recipients.

Three Reasons Not to Substitute the Chained CPI for the Current CPI-W

For more then three decades, I have conducted and published extensive research on Social Security in all its facets, including the financial problems that plague the program long term and what must be done to reform the program. I believe there are three primary reasons Congress should reject the President's Chained CPI proposal—a bipartisan proposal supported by many Republican Members of Congress, I might add.

First, contrary to much disinformation spread about the CPI, it currently underestimates true inflation rather than overestimates it. This is not the first time a president has proposed fiddling with the CPI as a backhanded means of cutting Social Security benefits for current retirees. In fact, the CPI has been altered numerous times during the past four decades in ways that have compounded and exacerbated the understatement of inflation so that today consumer price inflation, as reported by the current CPI-W, is understated by roughly 7 percent a year.

The compounding effects on Social Security benefits of the changes made to the CPI have been dramatic. As CPI expert John Williams puts it:

> "Changes made in CPI methodology during the Clinton Administration understated inflation significantly, and, through a cumulative effect with earlier changes that began in the late-Carter and early Reagan Administrations have reduced current social security payments by roughly half from where they would have been otherwise… The compounding effect since the early-1990s has reduced annual cost of living adjustments in social security by more than a third." (See http://www.shadowstats.com/article/consumer_price_index for a thorough analysis of what is wrong with the current CPI and how replacing it with the Chained CPI would only make matters worse.)

It would be wrong to compound these errors further by enacting another misguided change to the inflation index. If anything, the current CPI should be changed in the other direction to reflect the higher rate of inflation more accurately, especially the relatively greater price increases faced by most senior citizens.

Second, Social Security is in need of a complete overhaul, and patchwork proposals such as the Chained CPI confuse true reform with *ad hoc* tinkering designed to reduce spending on the program in the name of deficit reduction and debt control. Even if the Chained CPI were well conceived—which it is not—substituting it for real reform will only make agreement on real reform harder to obtain. Tinkering with the CPI is not reform, and seniors know it. Finagling the CPI only reinforces the cynicism about Washington that pervades the land.

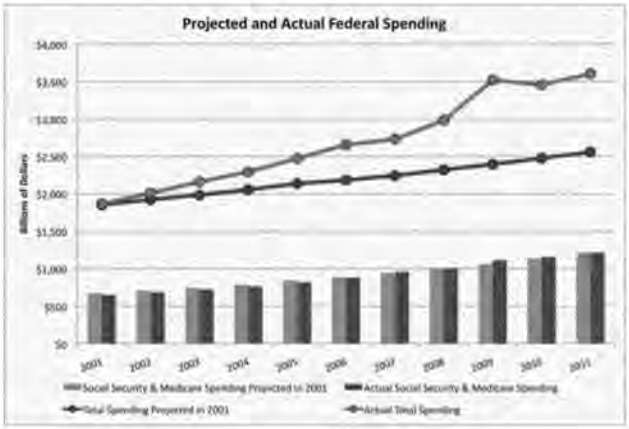
Already Americans believe that when politicians say "tax reform," they mean "tax increases," and when they say "Social Security reform," they mean "benefit cuts." And make no mistake about it; the so-called Chained-CPI "reform" would constitute a significant benefit cut for current retirees. According to the Social Security Administration, the average earner retiring at age 65 would lose $658 each year until they turned 75 under Chained-CPI, and a $1,147 cut by 85. And, the so-called "birthday bump" in the Obama Administration's Chained-CPI proposal (an increase in benefits in the 20th year to help offset the cuts), still fails to make up for the benefit cuts.

Finally, Social Security does not currently contribute to the annual federal budget deficit, and therefore it should not be tampered with in the name of deficit reduction. Pinning the blame for the deficit and debt increases on Social Security erroneously conflates tomorrow's anticipated Social Security deficits with today's general fund deficits, which are completely unrelated to Social Security and are caused by excessive federal spending in every federal program other than Social Security.

In 2001, the Congressional Budget Office (CBO) projected that combined Social Security and Medicare spending (orange bars in chart below) would equal $1,211 billion in 2011. Last year, combined Social Security and Medicare spending (green bars) amounted to almost exactly that, $1,216 billion.

In other words, as this chart demonstrates, Social Security and Medicare spending combined last year was exactly what CBO projected it would be back in 2001 when CBO was projecting a $900 billion federal budget surplus. At the same time, as the chart also demonstrates, total federal spending (red line) rose much faster that was projected (blue line). As a result, the federal government spent a trillion dollars more in 2011 than was projected the day Bill Clinton left

office. It is unambiguously clear that the additional trillion dollars in spending came from somewhere else, not the retirement programs, and certainly not from Social Security.



The Raid On Social Security and the Chained CPI Ruse

For more than 20 years after Congress "reformed" Social Security in the mid-1980s, American workers were forced to overpay Social Security taxes to build up a surplus in the Social Security Trust Fund, which now holds more than $2.5 trillion in federal bonds as a result. Workers and retirees were promised those surpluses would safeguard and guarantee their Social Security benefits and secure them from cuts.

Instead, Congress raided the Trust Fund and used the surpluses to expand the rest of the federal government by spending the surpluses on everything *but* Social Security; on everything from paper clips to battleships.

According to the Social Security Trustees, there are sufficient federal bonds in the Trust Fund to ensure that all Social Security benefits are paid in full and on time for another 20 years, until 2033. This arrangement is no different than private pension funds holding federal bonds as assets. Therefore, it is impossible to justify any cuts to Social Security benefits between now and 2033 on the grounds of deficit reduction and debt control. As for looming Social Security deficits after 2033, Congress remains derelict in its duty by refusing to overhaul the program for the long term to avoid the program's implosion. Arguments that the Chained CPI is the first incremental step toward such an overhaul are disingenuous and quite simply baloney. The Chained CPI is an immediate benefit cut without a scintilla of real reform, pure and simple.

The United States Supreme Court ruled in 1960 (*Flemming v. Nestor*, 363 U.S. 603) that Social Security does not constitute a legally binding contract, and therefore Congress may alter or even repeal the program at will without paying recipients compensation. However, the promises made by Congress to the American people with Social Security combine with the self-evident *quid pro*

quo on which the program is based (FICA contributions sooner in exchange for retirement benefits later) to create an indisputable political and moral obligation far more important than a mere legal contract. Congress has demanded that workers pay a lifetime of FICA contributions to earn their promised benefits, and it would be the height of hypocrisy and villianry for Congress to renege on that promise because it cannot find the courage to reduce other excessive federal spending.

Additionally, Congress is obliged to pay all interest on the Social Security bonds and redeem them when the time comes to pay current retirees' Social Security benefits in full and on time as promised. In the words of poet Robert W. Service, "A promise made is a debt unpaid."

The Social Security Trust Fund holds more than $2.5 million of federal debt, and regardless of payroll tax cash flow, there is no justification for cutting current retirees' benefits as long as interest on that debt and bond redemption provide sufficient revenue to the Trust Fund to cover all benefit payments. As the Social Security Administration says, "The investments held by the trust funds are backed by the ***full faith and credit of the U. S. Government***. The government has always repaid Social Security, with interest. The special-issue securities are, therefore, just as safe as U.S. Savings Bonds or other financial instruments of the Federal government."

Reneging on Congress's Social Security promises by chiseling COLA payments through the Chained-CPA ruse would be every bit as devastating to the integrity and legitimacy of the United States Government as would reneging on interest or on principal repayment of the national debt held by the public. Which raises an interesting question: The principal on Treasury-Inflation Protected Securities (TIPS) currently is adjusted for inflation using the CPI-U, not the CPI-W. Will the Chained-CPI also apply to TIPS, and if not, why not? If so, this switch would represent the first step in reneging on the full faith and credit of the United States Government. And if that is the case, which it indisputably would be, why isn't it also a crack in the full faith and credit of the United States Government to go back on the promise—the debt—to seniors who faithfully and diligently paid their payroll taxes every payday expecting the government to make good on its promise?

Prioritize Social Security and Cut Other Non-Essential Government Programs

Congress and the president have spent the United States to the brink of bankruptcy, and significant federal spending cuts must be made. However, there is more than adequate other extravagant and wasteful federal spending that can be cut to lower the deficit and reduce the national debt without touching Social Security benefits for current retirees.

To be blunt about it, proposals such as the Chained CPI are devious ways to take money out of seniors' pockets to pay for Congress's uncontrollable spending addiction. Proposals such as the Chained CPI hide behind technical jargon to renege on the promise Congress made three decades ago assuring workers that if they dutifully overpaid their Social Security taxes each and every payday of their working careers, their Social Security benefits would be secure.

Washington insiders become a sad parody of themselves when the co-chairs of the Bowles-Simpson Commission play Humpty Dumpty and make words mean whatever they want by putting out statements such as this one: "This change [Chained CPI] should not be regarded as a benefit cut or a tax increase. It should be regarded more as a technical change to achieve

Congress's stated goal of keeping pace with inflation in as accurate a way as possible."

So now "technical change" is right up there with "tax reform" and "entitlement reform" when it comes to Washington disinformation. No amount of hiding behind technical statistical jargon can hide the fact that the substitution of the Chained CPI for the CPI-W will cut Social Security benefits unjustifiably for current retirees, right now and for their rest of their lives.

Before Congress even thinks about cutting Social Security, it should lay off the hoards of meddling, counterproductive bureaucrats who have cushy government jobs at taxpayers' expense—jobs that pay twice what real workers earn in the private sector; bureaucrats who have Cadillac healthcare plans paid for by American taxpayers, many of whom can't even afford health insurance themselves; bureaucrats who have the best retirement system in the world, a retirement system Washington denies every other working American by keeping them chained inside the Social Security system which is a bad deal getting worse everyday that goes by.

Social Security is fundamentally different than any other government entitlement, both in what it promises and the inescapable dependency on government it creates. Social Security constitutes a form of serfdom that young workers are forced to enter under the penalty of unemployment or even imprisonment if they resist its shackles.

Once someone has toiled as a worker serf for a time, his servitude to the state becomes virtually inescapable, and emancipation for most people becomes impossible, even in theory. The point of no return occurs when the worker serf ceases being able to provide for his own retirement because so much of his earnings, which otherwise could have been used to invest in his own retirement, have been expropriated by the state to pay retirement benefits for existing retirees covered by the program. The worker serf is placated in his bondage with the promise that the government will force future worker serfs to do the same for him when he retires—a kind of reciprocal serfdom.

Social Security is unlike Medicare, where even after retirement a retiree theoretically could be cashed out of the program and set free to procure medical care on the open market through a private insurance arrangement—receiving better care at less cost than under Medicare and actually reducing government expenditures in the process. No such arrangement is feasible to replace a retiree's dependence on government retirement-income payments once the worker passes beyond the point of no return. Like the bite of a vampire, the government's sucking sustenance from the worker-host not only debilitates him; it also gradually transforms him from worker-host into retiree-parasite.

Yes, Social Security is broken for the long run but the problem cannot be fixed quickly or cheaply, and it certainly cannot be fixed by doubling down on the current model, namely forcing everyone to work longer, chiseling benefits, raising taxes or turning the program into a gigantic welfare program by means testing it.

There is, fortunately, a simple way out of this mess, a solution that allows Social Security to heal itself.

Free To Choose

The whole idea of a coercive, government-woven retirement safety net, for which all are forced to help pay, violates fundamental principles of liberty. But once the jaws of the snare have closed around so many people, as it has done since the inception of Social Security, it is difficult to extricate the victims without doing them considerable further harm.

That is why the only solution to reforming Social Security is to give everyone the choice between staying in the current system and receiving every penny they are currently promised or voluntarily opting out of the existing program into a new system that is both financially sound and more fully reflects the principles of liberty, namely allowing workers to invest the money they currently pay in Social Security taxes in the private market.

Many analysts have trapped themselves into believing this opt-out approach is fiscally undoable because of the so-called "transition" problem of paying the benefits of everyone who opts to remain in the old program while simultaneously allowing workers who opt out to direct a sufficient portion of their payroll taxes into a true retirement-saving plan. But, that is a false dilemma based on the false premise that it is impossible to cut other federal spending sufficiently to make up the revenues required to pay all benefits of those who remain in the old program.

The federal government has become so bloated that cutting and reallocating other federal spending could pay for the cost of paying all the benefits of everyone who wants to remain in the program. It is simply a matter of setting priorities and putting a practical and just solution to the Social Security problem near, if not at, the top of the list. As I demonstrate below, Social Security already has become such a bad deal for younger workers—and it is becoming a worse deal rapidly every year that goes by—that the system will naturally transition itself, in effect healing itself, as more and more younger workers opt out, thus rapidly reducing the out-year unfunded liability of the system.

Giving people the freedom to choose to leave Social Security voluntarily over time is the only practical and just solution to the Social Security dilemma. Trying to re-engineer the program in the committee rooms of Congress is doomed to make a bad deal even worse while it inevitably will shift costs in a counterproductive, anti-growth redistributive scheme. Turning Social Security into a gigantic welfare program that makes virtually everyone in the country dependent on government is the antithesis of a viable solution.

Policy makers who insist on cutting Social Security down to size and turning it into a welfare program are trapped in a time warp and don't seem to realize how dramatically the world of Social Security has changed. The original Social Security arrangement—where workers could indeed expect a considerably higher-than-market rate of return in Social Security benefits in exchange for the taxes they paid—has reversed itself. Many workers retiring today can expect to receive a negative return on the exchange, and that number will grow in the future.

Research conducted by C. Eugene Steuerle and Stephanie Rennane of the Urban Institute, makes it possible to quantify the magnitude of the problem. Steuerle and Rennane calculate the "lifetime value" of both Social Security taxes paid by and benefits promised to workers/retirees:

> "The 'lifetime value of taxes' is based upon the value of accumulated taxes, as if

those taxes were put into an account that earned a 2 percent real rate of return (that is, 2 percent plus inflation). The 'lifetime value of benefits' represents the amount needed in an account (also earning a 2 percent real interest rate) to pay for those benefits."

A couple of examples illustrate the magnitudes involved. (All amounts are in expressed in constant 2011 dollars adjusted to present value at age 65 using a 2 percent real interest rate.)

A two-earner married couple both retiring in 2011, who both earned the average wage ($43,500 in 2011) throughout their working careers would pay a lifetime-value of Social Security taxes equal to $611,000 and expect to receive a lifetime-value of Social Security benefits equal to only $560,000. Right out the gate, then, this typical couple pays nine percent more in Social Security taxes than they can hope to recover in Social Security benefits, hardly a good deal. And now the president wants to cut those benefits more?

But what if, for the sake of comparison, Social Security were repealed and compensation were paid, say, by grandfathering all current retirees so they received all their promised benefits (still a negative return)? And, what if compensation also were expanded to grandfather in benefits, to a lesser extent, of older workers—the extent of the grandfathering being dependent upon how far past the point of no return a worker had gone in being able to replace Social Security benefits by accumulating retirement savings through private investment of the freed-up Social Security taxes he no longer would have to pay? Wouldn't it be possible, theoretically speaking to repeal the program for all workers who have not passed the point of no return? In theory, yes but let's look at the data to see what it implies.

A couple of average earners age 47 will turn 65 in 2030. By then, they will have paid the government a lifetime-value of Social Security taxes amounting to $826,000, and they will receive benefits having an expected lifetime value of only $721,000, a 15 percent discrepancy, which measures the increasing magnitude of the net loss Social Security is imposing on workers. [Had they been permitted to invest that same sum during their working careers and earned the average, after-tax rate of return to capital during that period—approximately three percent real—the lifetime value of their funds would have equaled slightly more than a million dollars at age 65.] If Social Security were repealed next year—again for the sake of demonstrating how far under water workers are submerged in the program—the value of the Social Security taxes this couple already paid since they began work at age 18 in 1983 would amount to $369,000, which would become, in effect, abandoned assets.

What would this couple's chance of recouping lost benefits be if they could invest the freed-up income they no longer would be forced to pay in Social Security taxes after repeal? Using Steuerle's and Rennane's same assumptions, the couple would be able to accumulate at age 65 only $277,000 by investing their freed-up Social Security taxes. So, under uncompensated repeal, this couple not only would be forced to forfeit without recompense all the taxes they had paid prior to repeal ($369,000), they also would fall short of replacing the repealed Social Security benefits ($721,000) by some $444,000. Without providing compensation well down the age ladder, it is clear the bad deal becomes worse after repeal for a significantly sized cohort of workers too old to dig themselves out of the hole Social Security dug them into and too young to benefit from the Social Security windfall that profited their elders.

This hypothetical repeal scenario is meant to illustrate the unavoidable problems Congress will encounter if it tries to re-engineer Social Security without providing people a guarantee and a choice. This circle cannot be squared from inside congressional committee rooms.

A few back-of-the-envelope calculations suggest that most workers currently over the age of 30 would be harmed to some extent by an hypothetical uncompensated repeal solution. For example, the 47 year-old couple of average earners passed the point of no return around 1995. In other words, had Social Security been repealed in 1995 when they were 30, the couple would have been able to accumulate a lifetime value of retirement benefits of approximately $692,000 at age 65 by investing their freed-up Social Security taxes at an after-tax, three-percent real rate of return, which still would fall four percent short of replacing the pre-repeal value of their promised lifetime Social Security benefits of $721,000.

The point of this exercise is to illustrate that any reform imposed on everyone, from outright repeal to a re-jiggered pay-as-you-go scheme, necessarily will create new winners and losers and thus end up breaking faith with the American people. The only way out of this dilemma is first to prioritize Social Security at the top of America's spending priorities. Second, make an iron-clad commitment to pay all promised Social Security benefits, in full and on time, to any worker who desires to remain in Social Security. Third allow any worker who wants to do so to opt out of Social Security and direct their FICA contributions into a real retirement-saving plan. Fourth, cut the rest of government to pay for it. Workers past the point of no return will remain in the program while the vast majority of workers not yet beyond the point of no return will opt out in large numbers to get a better deal.

Social Security has become such a bad deal, getting worse everyday, that an increasing share of workers will opt out as time goes by, and the program will naturally go the way of the horse and buggy without the need to actually repeal or re-engineer it or go broke trying to salvage it as currently configured. Guaranteeing workers who choose to stay in the program all the benefits they have been promised—unadulterated by benefit cuts, COLA chiseling, means testing, higher minimum retirement ages and other re-engineering devices—will avoid a war between winners and losers and will eliminate the need to concoct a compensation scheme for losers, which itself would likely to turn into a politically manipulated boondoggle.

Conclusion

The following two principles should guide Congress in deciding how to overhaul Social Security:

- **Freedom to Choose:** Allow workers who desire to do so to opt out of the program and direct their FICA contributions into a true retirement program with a range of options.
- **Promises made, promises kept:** Guarantee workers who are in too deep to opt out that they will receive everything Social Security promises if they elect to remain in the program.

There is plenty of money available to overhaul Social Security and remain faithful to both principles, if only Congress would prioritize Social Security at the top of the list and cut the rest of excessive, non-essential federal spending to pay for it.

Thank you.

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