BUREAU OF LABOR STATISTICS OVERSIGHT: FIXING THE CONSUMER PRICE INDEX—PART II

HEARING

BEFORE THE

SUBCOMMITTEE ON HUMAN RESOURCES

OF THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT HOUSE OF REPRESENTATIVES

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CONTENTS

BUREAU OF LABOR STATISTICS OVERSIGHT: FIXING THE CONSUMER PRICE INDEX—PART II

WEDNESDAY, APRIL 29, 1998

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HUMAN RESOURCES,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 11 a.m., in room 2247, Rayburn House Office Building, Hon. Christopher Shays (chairman of the subcommittee) presiding.

Present: Representatives Shays, Towns, Sanders, and Kucinich.

Staff present: Lawrence J. Halloran, staff director and counsel; J. Vincent Chase, chief investigator; Robert Newman, professional staff member; Jesse S. Bushman, clerk; and Cherri Branson, minority counsel.

Mr. SHAYS. I would like to call this hearing to order, welcome our witnesses, and welcome our guests. Welcome to the second in what may become an annual oversight event for this subcommittee, a hearing on the Consumer Price Index.

One year ago, less 1 day, we asked the Department of Labor's Bureau of Labor Statistics to describe their program to maintain the objectivity and improve the accuracy of our most widely used economic measure.

Today, we will assess their progress over the intervening 364 days, and we will discuss the Bureau's vision, strategic plan, and specific performance goals for constructing the most accurate cost of living index possible in the years ahead.

Just 2 weeks ago, the BLS announced several methodological improvements and data enhancements to the CPI. These primarily address the current failure to capture substitution by consumers of cheaper or alternative items in response to price increases. Beginning in January 1999, BLS will fix this flaw by using a geometric mean formula, in place of a straight arithmetic approach, to compute basic indexes for products now comprising more than 60 percent of the total CPI market basket.

It is estimated that this step alone will eliminate two-tenths of the estimated 1.1 percent upward structural bias in the index. In all, BLS believes this and other steps taken since 1995 trim eight-tenths of 1 percent from the CPI's overstatement of inflation, but what remains is of enormous significance.

The General Accounting Office has called for more frequent updates of CPI expenditure weights, the relative emphasis placed on price changes for various products, to make the index a more timely indicator of consumer spending patterns. BLS recently revised the decade old weights to reflect 1993–1995 spending. The Congressional Budget Office projects a $16.5 billion Federal budget savings, over fiscal years 2004 and 2008, if the next adjustment of expenditure weights is made in 5 years, rather than waiting 10 years as BLS has done in the past.

The advisory committee to study the CPI, called the "Boskin Commission," concluded that the static CPI needs to be systematically transformed into a far more dynamic cost of living measure, accounting for quality changes in goods, capturing the introduction of new products and services, and reflecting current consumer preferences. Without this broader approach to CPI reform, commission members believe the cumulative cost of over-indexing the budget over the next dozen years could exceed $1 trillion.

In response to calls for further CPI changes, BLS concedes the value of more frequent updates to market basket expenditure weights, sees the need to expand the breadth and timeliness of consumer spending data, and hopes to find ways to include the effects of new goods and new technologies on the cost of living. But the Bureau's plans to address these and other long range CPI issues lack specifics, and appear tentative.

So we asked the BLS Commissioner, the Federal Reserve Board, GAO, and other economic experts to describe an aggressive agenda for CPI improvement, one that brings both sound research and adequate resources to bear in building an inflation measure that keeps pace with an accelerating economy.

We realize there is no perfect cost of living index. Just as we are reminded each April, when Congress works to adopt a budget resolution, that a chronically imperfect CPI exacts potentially immense costs. The index will only remain relevant to the national economic debate if Congress and the public are confident that the CPI is as current, dynamic, and accurate as possible.

Again, we thank all our witnesses for being here today, and we sincerely look forward to their testimony.

At this time, I would recognize Mr. Towns, the ranking member of this subcommittee.

Mr. TOWNS. Thank you very much, Mr. Chairman. This is a very serious matter. This is the second hearing that this subcommittee has held to discuss changes in the economic measures which are used in calculating the Consumer Price Index. Today, we will examine changes in the calculation of the CPI index made recently by the Bureau of Labor Statistics as part of the modification it makes to the index—every 10 years.

At the first hearing, held on April 30, 1997, we heard testimony that improper economic assumptions used in the CPI resulted in the necessary increase in Government spending, and an inappropriate reduction in the amount of revenue Government could raise. These conclusions were based on the 1996 findings of the Boskin Commission. Although there is general agreement among the economists that the CPI overestimates the presence of inflation, many economists challenge the commission's findings. In essence, there is controversy, but no certainty, about the correct economic measure.

For those of us in Congress, the CPI has a different meaning. The budget implications of a change in the CPI could mean that major program changes could be achieved without an overt change in policy. A change in the CPI that is calculated, would directly alter the baseline projections of a change in indexing provisions that would represent a policy change as well as a cut in outlays. The Congressional Budget Office estimated that 5 years after an adjustment reducing the CPI by half a percentage point per year, the annual deficit would be reduced by over $25 billion. Forty percent of these savings would come from tax increases. The remaining 60 percent would come from decreases in the rate of growth and expenditures for entitlement programs.

Therefore, this kind of change in the CPI could affect almost 70 million persons, including 43.1 million Social Security beneficiaries, about 22.6 million food stamp recipients, about 3.9 million military and Federal Civil Service retirees, and their survivors, and 24.2 million children who eat subsidized meals in the school lunch program. Also, nongovernmental expenditure changes in the CPI would affect about 2.8 million workers who are paid according to collective bargaining agreements that are tied to the index. Further, let me point out, it could mean higher taxes for all Americans because the CPI is used to calculate the standard deduction used in determining your income tax bill.

Mr. Chairman, I know that the budget implications of a small percentage change in the CPI can offer a tempting solution to some difficult problems. However, let me caution. We must not forget about the elderly who rely on Social Security and Medicare, and those struggling Americans who rely on the Earned Income Tax Credit, food stamps, and Medicaid. Each of these programs would be adversely affected by a slight change in the CPI. It may be only half a percentage point to you, and to me, and to my colleagues of this committee, but to them it could be the difference between shelter or no shelter. It could be the difference between food or no food. It could be the difference between sick and well.

So, Mr. Chairman, before we advocate these kind of changes, let's be absolutely sure that we're making the best economic decisions for all Americans.

Thank you for holding this hearing. I look forward to the testimony coming from the witnesses because, as I indicated, this is a very, very serious issue.

I yield back.

Mr. SHAYS. I thank the gentleman for his fine statement, and would now call on Mr. Sanders from Vermont.

Mr. SANDERS. Thank you, Mr. Chairman, and thank you for holding this important hearing, and thank you for holding the last hearing we had to discuss this issue.

This is, as I think Mr. Towns just indicated, an issue of enormous consequence and the repercussions of it will be felt by tens and tens of millions of Americans, old people, workers, veterans, and many others. So this is big stuff, and before we go forward we should do a whole lot of thinking about it.

Now, I must tell you up front, Mr. Chairman, that I get very angry at people who see the cut, the possible cut in CPI as a back door effort to save the Government money. I think Mr. Towns just mentioned how this might be done. Gee, just a half a percentage point and we can save billions and billions of dollars and who's going to know it? Boy, and maybe we could even give more tax breaks to billionaires because they know it. They're down here and their friends are here everyday telling us how much more they need these tax breaks. So I regard, it is one thing to have a serious discussion, which is a difficult discussion, we'll have it today, I guess, about how we determine what the CPI is. But, Mr. Chairman, I would hope very much that we do not develop this whole discussion as a back door way to cut back on help that millions of Americans are entitled to, and that millions of Americans need in order to save the Government money so that maybe we can repeat what we did last year and that is cut taxes by $130 billion, much of which goes to the rich. Or maybe we can cut Medicare by $115 billion. So let's not do that. Let's have an honest discussion of what CPI is, but let's not do it as a back way to save the Government money and then build B–2 bombers, get corporate welfare out there, or give huge tax breaks to the rich.

Now, how do you determine the CPI? Boy, I don't envy any body up there. That is a tough issue. And I, maybe some of you will comment on this, but it seems to me that if I were an 18 or 20-year-old kid living in Los Angeles, CA, and I had my purchasing needs, and I was going out purchasing my first computer, and my stereo, or whatever 18 or 20-year-old's purchase, that is one thing. It's hard enough to determine that. But let me tell you something from the bottom of my heart that 80-year-old women in the State of Vermont—and I remember this discussion the last, that somebody on this committee said, "Gee, I remember, I bought a computer 10 years ago, and I paid huge sums of money. I just bought a much better computer for a lot less money." Gee, you know, you got to take that into account when you do your CPI.

Eighty-year-old widows in the State of Vermont are not out buying computers, that I can tell you, nor are they buying new stereos. You know what they're trying to do? They're trying to buy prescription drugs in order to stay alive. They're trying to heat their homes when the weather gets 20 below zero. So, frankly, I do not have a clue as to how you can even come up with a CPI for 20-year-old kids in California and 80-year-old women in the State of Vermont. Those are two different worlds. And if we're going to talk about Social Security, then we have to say, "fine."

If the thesis that we're operating under, as I understand it, Mr. Chairman, is that every year we're supposed to give a cost of living based on inflation. Then the inflation should be relevant to the people who are affected.

And my constituents in the State of Vermont, do you know what happened to them in the last year? They're paying a 30- or 40-percent increase in their Medigap. Do you know what Medigap is? Medigap is the cost of what they're paying for insurance that Medicare doesn't cover. Thirty-, forty-percent increase. They're paying off the wall prices for prescription drugs.

So I would suggest very strongly, Mr. Chairman, that we move toward, if we're looking at Social Security, if we're looking at Social Security and the needs of the elderly, that you need a calculation which is based on their needs. I would argue, and maybe there are some who disagree with me, that, in fact, because elderly people are more dependent on health care, and because health care costs have gone up faster than the general rate of inflation, I would argue that, in fact, current CPI's are underestimating, underestimating the needs of our senior citizens and should be raised, certainly, not lowered.

But, Mr. Chairman, I want to see fast statistics. I want to see Dr. Abraham and the others come up to me and tell me how much more it costs senior citizens in the State of Vermont, or in Connecticut, or in New York this year as opposed to last year, based on their needs, not on some 18-year-old kid in a warm weather climate. And then we can debate that. But I will vigorously oppose any back-door effort; I mean, I've seen it—what a cheap way, what a disgraceful way to save Government money, because it's only a half percent, gee, we're taking $100 away from somebody in Cleveland, OH. Who's going to know the difference? You multiply by it all the folks, we've saved billions of dollars and we can give it to the billionaires in another tax break. That is an outrage. And I will fight that tooth and nail. So I would hope you will come up with fast statistics to the people who are affected. You'll have to tell me before you cut one nickel, and I think you should raise the CPI, you'll have to tell me what the costs are this year and next year for elderly folks in the State of Vermont who are highly dependent on health care.

Thank you, Mr. Chairman.

Mr. SHAYS. I thank the gentleman at this time, and we will get to the panel after Mr. Kucinich makes an opening statement.

Mr. KUCINICH. Thank you very much, Mr. Chairman. I'm glad I came here in time to hear Mr. Sanders' remarks because, Mr. Sanders, I'm sure you understand that somebody has to be here to represent billionaires, and corporate welfare, and B–2 bombers, and tax breaks to the rich. It's not going to be you, but it's not going to be me either, but we recognize that somebody has to represent them and speak for them. So the record duly noted that they're included in all the discussions and debates here.

I'm pleased to see that the subcommittee continues to take a careful look at the Consumer Price Index, and any changes that are being considered or implemented by the Bureau of Labor Statistics. We do have a respected group of witnesses with us today from Government agencies, and research institutes and I welcome them to our deliberations.

When we talk about the CPI, there's a tendency to get wrapped up in details of statistical methods, the accuracy of economic projections. Those discussions are necessary, of course. I have confidence in the professional approach of the Bureau of Labor Statistics in evaluating all the relevant data. However, we must never lose sight of the true importance of the CPI, what I would call the human dimension of the CPI because the calculation of the Consumer Price Index has a direct impact on the lives of millions of Americans, especially the most needy among us. As we all know, the CPI is our Government's primary index for adjusting the payments made in a number of critical Government programs. The CPI affects the payments to nearly 45 million people who receive Social Security, and another 3.4 million veterans and their survivors. And, as you all know, the CPI index is used to determine poverty guidelines. And those guidelines affect the services going to some 38 million people, and many other programs, as you know, are impacted in a similar manner.

Now I cite the human dimension of the CPI to set the social and economic context for what I hope will be our discussions. Because when the debate turns to the possibility of lowering the CPI, we have to remember that we're talking about the lives and health of millions of Americans, young and old. They cannot be with us today literally, but they're sure represented here and no one should forget that for a moment.

So thank you, Mr. Chairman, members of the committee.

Mr. SHAYS. I thank the gentleman.

Before swearing in the witnesses, I'll just take care of two items of business. I ask unanimous consent that all members of the subcommittee be permitted to place an opening statement in the record, and that the record remain open for 3 days for that purpose and, without objection, so ordered. I ask further unanimous consent that all witnesses be permitted to include their written statement in the record and, without objection, so ordered.

And I would just make another point before—well, let me first swear in the witnesses. And I'd ask them all to rise. Anyone else who you think might help you respond to a question that is accompanying you, I'd like them to rise as well. And if we call them, we'll have them identify themselves for the record.

[Witnesses sworn.]

Mr. SHAYS. I would just like to say before announcing our witnesses that there is no hidden agenda at this hearing. No. 1, I would make that point. And, second, that I think the interest of all the subcommittee members is to have the most accurate account, notwithstanding Mr. Sanders' comment. Whether it goes up or down, whichever way it takes us, if it's the most accurate, that's, I think, the preference of the committee. And I will say also that we were intending to have three hearings, and my staff director wasn't eager to have that. And so what he did was show me the formula for capturing substitution, the old arithmetic mean formula, and then the geometric mean formula and he showed this to me and said, "Do you really want three hearings?" And I said, "No, one will do fine." [Laughter.]

So, we have with us Dr. Katharine Abram, Abraham, excuse me, Commissioner, Bureau of Labor Statistics, and would like to thank her for her willingness to appear with other panelists, and not do what some Government officials like to do and ask to be all by themselves, because the exchange will be helpful and it will be a fair and open exchange and so, Dr. Abraham, I appreciate that. Second, we have Dr. Edward Gramlich, member of the Board of Governors, the Federal Reserve System, and welcome him as well. And then Dr. Robert Gordon, the advisory commission to study the CPI, known as the Boskin Commission, and he's from Northwestern University. We appreciate his being here. And Bernard Ungar, Director, Government Business Operations Issues, the U.S. General Accounting Office [GAO]. And he's accompanied by Lauren Yager, chief economist, acting; and Dr. Kathleen Scholl, who is the senior economist.

The committee will hear from the first four people I have mentioned, but all are invited to respond to questions, and comment on what you have heard from the members, as well as what you've heard from other participants in this hearing.

And, Dr. Abraham, we learned a lot from our last hearing a year ago, or nearly a year ago, and thank you for being here. And your intuition is right, if you'd also lower the mic. You're going to need to bring it a little closer. Thank you, we'll see how you sound.

STATEMENTS OF KATHARINE ABRAHAM, COMMISSIONER, BUREAU OF LABOR STATISTICS, U.S. DEPARTMENT OF LABOR; EDWARD M. GRAMLICH, GOVERNOR, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; ROBERT J. GORDON, THE ADVISORY COMMISSION TO STUDY THE CPI, NORTHWESTERN UNIVERSITY; AND BERNARD UNGAR, DIRECTOR, GOVERNMENT BUSINESS OPERATION ISSUES, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LAUREN YAGER, ACTING CHIEF ECONOMIST; AND KATHLEEN SCHOLL, SENIOR ECONOMIST

Ms. ABRAHAM. We'll try that.

Mr. SHAYS. Yes, you're going to have to still project. You're going to still have to project a bit. We'll let you know. Why don't you start and we'll see how you come across.

Ms. ABRAHAM. OK, thank you, Mr. Chairman. I do have a written statement that I'd like to have included in the record.

When I appeared before the subcommittee at the hearing last year, I talked about BLS' efforts over the years to improve the Consumer Price Index. This morning I'd like, if I could, to take a few minutes to talk about steps we've taken since that last hearing, and also the further steps that we have planned, to address the issues that have been raised concerning the CPI. And I'll try to speak in English, not formulas. [Laughter.]

There are, from my perspective, three broad issues that have been raised with respect to the CPI. First, the currency of the market basket used for—that underlies the index. Second, the whole issue of consumer substitution in response to relative price change. And, third, the treatment of new product introductions and of change in the quality of currently priced goods and services. I'd like to talk very briefly about what we've done and have planned to do to address each of those issues.

First then, the issue of the currency of the spending pattern that underlies the index. We have, as you already noted, introduced, effective with the data for January, an updated market basket that rests on consumer spending patterns over the 1993 to 1995 period. Second, we have requested funding, and I'm optimistic that we'll receive funding, to expand the size of our consumer expenditure survey, and also to develop computer systems that will allow us to introduce updated market baskets in the future that are more current as of the time they are introduced than was the one that we just introduced. As of January, when we put our new market basket in place, it was 3.5 years out of date; it had if you will, that much of an average lag. With the things we have planned, the next time we introduce a new market basket, there will be a lag of only 2 years. So I think that will be an important improvement. And, third, we have made a commitment to update the market basket more frequently in the future than the roughly every 10 years that has been our practice in the past.

The second issue that I'd like to speak to briefly is the issue of accounting for consumer substitution in response to relative price change. We have, as you know, just earlier this month announced changes in the way we calculate the subindexes that get aggregated to produce the overall index. That's adoption of the geometric mean formula that you held up on a piece of paper, which is, in our judgment, a way of dealing as best we can with consumer substitution that may occur among individual items within item categories. That change will take effect with the data for January 1999.

We also have requested funding to produce as a complement to the Consumer Price Index, an alternative measure economists have labeled a superlative index. That is a measure that accounts for consumer substitution that takes place across item categories, rather than within item categories. For reasons that I will be happy to go into if you would like, that's not a measure that we can produce as a monthly index that doesn't get revised, but it is something that we can produce either with a bit of a lag, or as a measure that's an approximation and then gets revised. So we've made a commitment to produce that alternative measure beginning in the year 2002. The reason for that delay is that we will wait until we have data from our expanded consumer expenditure survey which we'll be fielding next year.

The third issue I'd like to speak to is the treatment of new product introductions and change in the quality of goods and services. We have a couple of things that we're working on there. First, we have requested funding, again, as part of our Consumer Price Index improvement initiative, to collect additional data on prices and the characteristics of goods that would allow us to make more explicit regression-based adjustments for change in quality. We've done that kind of thing in the past in certain index components; apparel is the biggest example. Effective with the data for January, just several months ago, we introduced that better technique in the personal computers and peripheral equipment component of the index. Our future focus will be on looking at using regression-based adjustments for appliances and consumer electronics, which were index components highlighted in the Boskin Commission report.

Second, we have requested funding to ensure that in the future, when new goods appear on the market, the example I've got in my mind is electric cars, that we start collecting prices for those items shortly after they appear on the market rather than with a delay.

And, third, we are making changes in the way that we update our item samples to ensure that we focus on product and service areas that are impacted by rapid changes in technology.

The agenda that I've just described represents everything that, at the present time, we know how to do to improve the Consumer Price Index. As has long been our practice, we will continue to look for new ways to improve the index. We have an internal research staff which I'm proud to be able to say has produced much of the important work leading to past improvements in the CPI. But we are also actively reaching out to others in the academic community, and on the staffs of statistical agencies around the world.

Unlike the specific activities that I already have described, however, it's much more difficult to say what future improvement possibilities might be identified or on what schedule. I can only tell you that we will be aggressive in pursuing such possibilities and in applying our best technical judgment concerning their adoption in the index.

Thank you.

[The prepared statement of Ms. Abraham follows:]

Testimony of

KATHARINE G. ABRAHAM

COMMISSIONER OF LABOR STATISTICS

before the

SUBCOMMITTEE ON HUMAN RESOURCES
HOUSE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

APRIL 29, 1998

I very much appreciate the opportunity to appear once again before the Subcommittee to discuss the Consumer Price Index (CPI). As I indicated in my testimony a year ago, the Bureau of Labor Statistics (BLS) has a long tradition of being in the forefront of price measurement research and operational innovation. In that testimony, I chronicled a lengthy list of CPI improvements introduced by the BLS over the years, emphasizing especially important improvements introduced in 1995, 1996 and the first part of 1997. My understanding is that the Subcommittee wishes to review both the further changes we have made since last year and our plans for future improvements. I am proud of the progress we have made, and welcome this opportunity to review our accomplishments and discuss our future plans.

As the Subcommittee's invitation of April 17 notes, the BLS introduced a number of very important changes in the CPI effective with the data for January 1998, released two months ago on February 24. To be more precise, the CPI now is based on consumer spending patterns for the 1993 through 1995 time period, a new sample of geographic areas that better represents the current distribution of the U.S. population, and a new classification structure that better reflects the categories of goods and services consumers buy. These important changes represent the attainment of some of the more critical objectives of the large-scale effort to revise the CPI for which funds were first received in Fiscal Year 1995. Although major components of the CPI Revision project continue through Fiscal Year 2000, the changes introduced in February complete the expenditure weight and geographic area sample updating that also have been core components of every prior CPI Revision.

Although the updated market basket introduced in January is considerably more current than that it replaces, it still was 3½ years old as of its introduction date. Our proposed CPI improvement initiative, which I will discuss in a few moments, will allow us to introduce future expenditure weight updates in a more timely fashion. Further, it has become apparent that shortening the roughly 10-year interval between comprehensive updates to the CPI would be desirable, and we have work underway to determine a more appropriate time schedule for such updates. I should note, however, that the availability of new Census of Population information likely always will necessitate some form of periodic CPI updating to account for shifts in the distribution of the population. Thus, I suspect that updating of the CPI geographic sample may well, of necessity, remain a decennial statistical activity.

Finally, both for the sake of completeness and because it is important in its own right, I should call the Subcommittee's attention to an improvement in the treatment of quality changes in personal computers also introduced with data for January 1998. The revised item classification structure for the CPI that I already have mentioned includes a new stratum called Personal Computers and Peripheral Equipment. Analysts in the BLS Producer Price Index (PPI) program earlier developed and implemented a regression procedure, called a hedonic model, that attaches an implicit price to each important feature and component of the computer. Starting with the CPI for

January 1998, when a personal computer or selected item of peripheral equipment, such as a modem, in the CPI sample improves in some way, a regression-based quality adjustment to its price will be made. The value of the improvement, as derived from the regression estimates, will be deducted from the observed price for the product. Conversely, if a model deteriorates, the value of the difference will be added to the price. Application of this method will improve our measurement of price change for personal computers and peripheral equipment.

Up to this point, I have focused principally on the changes to the CPI introduced with the data for this past January. Now, as your invitation to testify requests, I would like to turn to the announcement we made earlier this month concerning the use of the geometric mean formula in the monthly CPI. We expect to incorporate this change into the CPI for the month of January 1999, to be published next February.

When I testified before the Subcommittee last year, I spent a considerable amount of time discussing the issue of substitution bias. At that time, I noted that BLS had begun publication of an experimental index utilizing a formula which allowed for some degree of consumer reaction to change in the relative prices of the goods and services being purchased. Prior to my arrival at the BLS in 1993, CPI staff had raised the possibility of adopting a geometric mean formula in some or all index components, possibly in conjunction with the CPI Revision then being launched. By 1996, the issue had become a key element of the report of the Senate Finance Committee's Advisory Commission to Study the CPI. In April of last year, we reported that we would conclude our review of the issue and announce our decisions by the end of 1997, and that we would incorporate whatever changes we believed prudent in the CPI to be published for the month of January 1999.

As I indicated in my March 31 letter to you, and as we also indicated in making our announcement the week before last, we found the evidence relevant to assessing the use of the geometric mean to be much sparser than we had expected. Taken in its entirety, however, the evidence unambiguously supports the proposition that consumers can, and do, alter their purchasing behavior in response to changes in the array of prices that they confront in the market place. Because the geometric mean estimator can better reflect the effects of such changes in consumer spending than can the current CPI formula, we have decided to implement the geometric mean estimator in most CPI basic indexes. The changes we will be making were announced on April 16, and, as originally planned, will become effective with data for January 1999.

The geometric mean estimator will be used in index categories that comprise approximately 61 percent of total consumer spending represented by the CPI-U and 64 percent of that represented by the CPI-W. The remaining index categories, which are shown on the attached table, will continue to be calculated as they are currently. Based upon BLS research, it is expected that adoption of the new formula will reduce the annual rate of increase in the CPI by approximately 0.2 percentage point per year.

Finally, Mr. Chairman, I would like to turn to the last question posed in your letter, which I believe was aimed principally at ascertaining our future plans and the resources required to implement those plans. In this regard, I would like to call your attention to the BLS Congressional Budget request for Fiscal Year 1999, in which we are seeking to build upon an initiative, started in 1998, to lay the groundwork for future improvements in the timeliness and accuracy of the CPI. For Fiscal Year 1999, our request seeks a total of $11.2 million and 47 FTE for the second phase of a three-year buildup to put this improvement program in place. The proposal has four major pieces.

First, in order to improve the timeliness of future CPI Revisions, we are proposing an expansion of approximately 50 percent in the size of the sample of households that supports the Consumer Expenditure Survey. About four-fifths of the proposed cost of the CPI Improvement proposal would be devoted to this project. At the present time, three years of expenditure data are required to construct a CPI market basket with an acceptable degree of accuracy. The proposed expansion will reduce the number of years of expenditure data required to two. Combined with a separate project to modernize the CPI market basket update system, this expansion will allow the BLS to reduce substantially the lag between collection of expenditure information and the introduction of future updated CPI market baskets. If funded, this proposed change will greatly enhance the Bureau's ability to adopt a policy of more frequent weight updates.

In addition to supporting more timely updates of CPI expenditure weights, the expanded sample for the Consumer Expenditure Survey also will support the publication of production-quality superlative indexes which, as I mentioned in last year's testimony, will account for substitution across CPI item categories in response to relative price changes. At present, these measures are produced on an experimental basis, and the CPI improvement proposal will provide us with the additional resources needed to produce them on a regular schedule, to a higher standard of precision and reliability.

Finally, we are requesting funds to support expanded pricing of goods and services together with the collection of richer information on those items' characteristics, to support additional regression-based quality adjustment applications. While it is not possible to predict the outcome of this work in advance, we do know that application of these methods has proven to be of value in improving adjustments for changes in product characteristics. In addition, for particular item groups that are greatly affected by the introduction of new goods, BLS will be able to replace or augment existing samples of priced items, the objective being to bring new goods and services into the index on a more timely basis.

In summary, Mr. Chairman, with the support of Congress and the Administration, the BLS has been able to make substantial progress in improving the accuracy and relevance of the Consumer Price Index. Certainly, more can and will be accomplished. But, just as certainly, further progress depends critically on the continued support of those making decisions about the Federal budget. Our success in improving the CPI also depends on the public's continued belief that our decisions about the construction of the index are arrived at independently and impartially, using the most appropriate techniques available to us. Preservation of that independence and impartiality should be important to all who depend upon the CPI.

ATTACHMENT A: Components Retaining the Arithmetic Mean (Laspeyres) Formula

1. Selected shelter services:

A) Rent of primary residence

B) Owners' equivalent rent of primary residence

C) Housing at school, excluding board

2. Selected utilities and government charges:

A) Electricity

B) Utility natural gas service

C) Residential water and sewerage maintenance

D) State and local registration, license, and motor vehicle property tax

E) Telephone services, local charges

F) Cable television

3. Selected medical care services:

A) Physicians' services

B) Dental services

C) Eyeglasses and eye care

D) Services by other medical professionals

E) Hospital services

F) Nursing homes and adult daycare

Mr. SHAYS. Thank you very much.

Dr. Gramlich.

Mr. GRAMLICH. Thank you, Mr. Chairman and members of the subcommittee. I'd like to compliment you for holding these hearings, for the role that you've played in promoting improvements in the Consumer Price Index, and also I'd like to compliment BLS for what they've done as Katharine Abraham has just said.

The hearings that this subcommittee held last year on the CPI provided a clear summary of the arguments surrounding some of the difficult measurement problems confronting the BLS.

Mr. SHAYS. I'm going to just have you tilt that. You can just tilt it in front of you more. I want it to get your voice.

Mr. GRAMLICH. OK.

Mr. SHAYS. Is that all right?

Mr. GRAMLICH. Yes.

Mr. SHAYS. Can you still see your paper? Yes, that's good.

Mr. GRAMLICH. A useful categorization of these issues divides them into two parts. The first relates to the formula that is used by BLS for building up the overall CPI from the individual pieces collected by field representatives, and the second set of issues concerns the individual prices themselves, and in particular how these prices are adjusted to account for the quality change in the introduction of new goods. Rather than to re-hash arguments surrounding difficult and controversial aspects of price measurement related to new goods and quality change, a useful approach, we think, might be to seek a common ground among the participants in this discussion. This means pushing forward where there is some agreement, or greater agreement, on the set of issues related to the aggregation formulas used to buildup the CPI, the first issue that I described earlier.

As some have put it, we should go first after the low-hanging fruit on the statistical tree. In that regard, the striking aspect of hearings that you held last year was the virtual unanimity that a price index that measures the cost of purchasing a fixed market basket of goods and services, as the CPI now does, represents an upper bound on the true changes in the cost of living. The reason is that consumers respond to changes in relative prices by altering the composition of their purchases, and this response lowers the cost to them of the price changes.

There are two types of substitution bias. There's a lower-level bias, that the BLS is already dealing with, and upper-level bias referring to the present lack of substitution among 211 items in the typical consumer's market basket. What I'm going to say from now on refers only to the upper-level bias, because the lower-level bias has been largely taken care of.

As the CPI is currently constructed, there's no account for the upper-level substitution possibilities available to consumers. Indices that do take account of such substitutions can be calculated, economists refer to these as "superlative indices."

Mr. SHAYS. Excuse me, doctor, I don't usually interrupt but I'd like you to just define "upper," and "lower," to the committee?

Mr. GRAMLICH. The upper-level is the substitution between the 211 categories, and the lower-level is within those categories. That formula that you held up refers to substitution within those categories that the BLS is already going to correct in its changes next year.

Mr. SHAYS. So upper is substitution among categories, and lower is substitution within categories?

Mr. GRAMLICH. That's right. On an experimental bias, the BLS already produces superlative indices dealing with this upper level substitution bias, but these indices are only available with a considerable lag. Using data from recent decades, several studies have constructed indices to take full account of consumer substitution and have used these indices as benchmarks to compare to the actual CPI. Through such comparisons, it is possible to assess the amount of bias in the CPI arising from this upper-level substitution bias. Although estimates depend in the time period and other particulars, the research broadly suggests that the changes in this upper-level substitution bias could reduce the rate of change in the CPI by about 0.2 percentage points a year. For example, if the current CPI showed an increase of 2.0 percent a year, year over year, then after correcting for this type of substitution bias, the CPI could be expected to show an increase of about 1.8 percent a year. This might not sound like much but, compounded over many years, such a change would have marked implications for any program or contract that is indexed to the CPI.

To correct fully for upper-level substitution bias, it would be necessary to know how market baskets change on a regular basis in order to capture the substitution among different items. The expenditure data required for such calculations are obtained from the consumer expenditure survey. Because of collection and processing time, these data are only available with a lag so that the figures for 1997 are not expected to be available until later this year. Thus, the data from the consumer expenditure survey cannot be used to construct a real time price index that fully captures consumer substitution among items. This lag is the reason that BLS' experimental superlative index is only available with a delay.

It is possible to deal with the problem. And this is the main point I'd like to make. The Boskin Commission, represented today by Robert Gordon, suggested as a possible solution of the use of something known as a "trailing Tornqvist price index." This index would use an index formula which can capture substitution among items that would update weights each year. To be operational in real time, the index would need to use lagged or trailing weights. For example, the average weights from 1994 to 1995 could be used for calculating the 1997 changes in the cost of living. There are other approaches suggested by economists that approximate this type of thing.

One approach that this subcommittee could consider would be to commission a study of substitution bias to be undertaken by the staff of the BLS. The BLS could be asked to compare their current procedures with those that have been proposed by these other researchers. They could determine which of these alternative approaches provides the most timely and accurate approximation to the superlative index, published by the BLS. Recalling that while the superlative indices may be the best, they are only available with a considerable lag.

There is one other issue I'd like to raise and that is that even the best real time approximation to a superlative index would not match the superlative index that would ultimately be constructed once the expenditure share data became available.

To deal with this problem, the Boskin Commission suggested pursuing a two-track approach. For the first track, BLS could continue to publish a monthly index in real time that would never be revised. This index would be much like the current CPI, except that it could be based on aggregation formulas that minimize upper-level substitution bias. For the second track, BLS could publish, with a lag, a superlative index that incorporated full information on changing expenditure shares and that could be revised subsequently to incorporate other improvements to the CPI as well.

This two-track approach has advantages and disadvantages. On the positive side, the two-track approach would provide indices for users with divers need, a never revised index for those for whom revisions would propose operational difficulties, and a revisable index that would be the best possible measure of changes in the cost of living. On the negative side, the publication of two different price indices might generate confusion. If that confusion were judged to be a serious problem, BLS could alternatively produce a single measure that was revised and ultimately incorporated all information in the best possible way. Were this to be done, Government and private contracts that are linked to the CPI would have to alter their indexation procedures, something that I don't think would be a particular problem.

But returning to the primary message, a study of substitution bias and an outside review panel holds the promise of forming the basis of a reasonable professional consensus on limited technical changes that would correct this upper-level substitution bias, and make the CPI a more accurate measure of the cost of living. Such a consensus, I think, is critical for maintaining public support and confidence in our statistical programs.

Thank you very much.

[The prepared statement of Mr. Gramlich follows:]

Introduction

Mr. Chairman and members of the Subcommittee, I am pleased to appear before you to discuss improving the Consumer Price Index. I begin by thanking this Subcommittee for holding today's hearing and for its past work in examining the issue of bias in the CPI. Although these issues are difficult and complex, your demonstrated interest has helped keep the focus on ways to improve the index further.

The Consumer Price Index plays a central role in many aspects of private and public decision making: The CPI is the key price measure for indexation of federal spending and tax programs, and many contracts in the private sector are linked to the CPI. In addition, the CPI is used for inflation adjusting the Treasury's indexed bonds, which help to provide a reading on expectations of future inflation and on real interest rates. The CPI is also among the inflation measures examined in the conduct of monetary policy. Thus, it is essential that the nation strive for as accurate a measure as possible.

In that regard, the Bureau of Labor Statistics has made laudable progress in the past several years. Sample rotation problems that were uncovered by BLS researchers have largely been eliminated. The measurement in the categories of rent, computers, pharmaceuticals, and health care services has been improved. Looking ahead, the recently announced decision to apply the geometric-mean aggregation procedure should largely rectify so-called "lower-level" substitution bias. The shift in emphasis from geography to product categories for sample rotation provides an opportunity for BLS to ameliorate some of the bias associated with new goods, provided that it actively rotates the sample for products undergoing rapid innovation. But while these steps are impressive, the hard work must continue if the CPI is to keep up with an ever-changing economy.

The hearings that this Subcommittee held last year on the CPI provided a very clear summary of the arguments surrounding some of the difficult measurement problems confronting the BLS and the range of professional opinions concerning the quantitative significance of those problems. A useful categorization divides these issues into two parts. The first relates to the formula used by BLS for building up the overall CPI from the individual prices collected by field representatives. Although these issues are quite technical, they are fairly well understood by the BLS and by economists outside the statistical agencies. The second set of issues concerns the individual prices themselves, and in particular, how these prices are adjusted to account for quality change and for the introduction of new goods. These issues are extremely difficult--both conceptually and practically--and there is much less consensus about the quantitative significance of the bias associated with new goods and quality change. Research into all of these questions has continued over the past year, but, to my knowledge, there have been few major developments that would alter significantly the opinions voiced by the witnesses at last April's hearing.

Improving the CPI

Rather than rehash arguments surrounding the difficult and controversial aspects of price measurement related to new goods and quality change, a more useful approach might be to seek common ground among the participants in this discussion. This means pushing forward where there is greater agreement on the set of issues related to the aggregation formulas used to build up the CPI. As some have put it, we should first go after the "low-hanging fruit" on our statistical trees. In that regard, a striking aspect of the hearings that the Subcommittee held last year was the virtual unanimity that a price index that tracks the cost of purchasing a *fixed* market basket of goods and services, such as the CPI now does, represents an upper bound on changes in the true cost of living. I doubt there exists a professor teaching microeconomics who doesn't routinely demonstrate this characteristic of fixed-weight price indexes to his or her classes. The reason is that consumers respond to changes in relative prices by altering the composition of their purchases, and this response lowers the cost to them of the price changes.

Consider a couple of examples. If chicken goes on sale, some consumers would buy more chicken and less beef or pork. Also, as computer prices have fallen dramatically in recent years, consumers have increased their purchases of computers. At present, however, the market basket used in constructing the CPI changes only once every ten years. Although BLS has just updated this market basket, the current methodology for the CPI will lock this market basket in place for the next decade, implying that consumers are assumed not to do any substitution at all over this period. Under these procedures, the CPI will fail to capture the ways in which consumers adjust their spending patterns to take advantage of changes in relative prices.

We should distinguish between two levels of substitution bias. In the discussion here, I am focusing on what has been termed "upper-level" substitution bias. Based on surveys of what consumers buy, the BLS has a list of 211 items in the typical consumers' market basket. Upper-level substitution bias arises from substitution among these items that is not captured by the CPI, such as between chicken and beef or between breakfast cereal and other breakfast items. In addition, consumers also make substitutions among different varieties of the same item in their market baskets, such as when consumers switch between different brands of breakfast cereal. By early 1999, the BLS will have largely accounted for this "lower-level" substitution when it implements a geometric-means formula to combine individual prices at the lowest level in the index.

Although the CPI as currently constructed does not account for the upper-level substitution possibilities available to consumers, indexes that do take account of such substitutions can be calculated; economists refer to them as superlative indexes because of their desirable properties. Indeed, on an experimental basis, the BLS already produces superlative indexes, but these indexes are only available with a considerable lag. In any case, using data from recent decades, several studies have constructed indexes that take full account of consumer substitution and have used these indexes as benchmarks to compare to the actual CPI. Through such comparisons, it is possible to assess the amount of bias in the CPI arising from upper-level consumer substitution. Although estimates depend on the time period considered and other particulars of these studies, this research broadly suggests that correcting upper-level substitution bias could be expected to reduce the rate of change in the CPI by about 0.2 percentage point per year; for example, if the current CPI showed an increase of 2.0 percent over a year, then after correcting for this type of substitution bias, the CPI could be expected to show an increase of about 1.8 percent. Although this might not sound large, a bias of this size compounding over many years has marked implications for any program or contract that is linked to the CPI.

Reducing Upper-level Substitution Bias

To correct fully for upper-level substitution bias it would be necessary to know the composition of market baskets each month, in order to capture the substitution among different items. The expenditure data required for such calculations are obtained from the Consumer Expenditure Survey. And, because of collection and processing time, these data are only available with a lag, so that the figures for 1997 are not expected to be available until the fall of 1998. Thus, the data from the Consumer Expenditure Survey can not be used to construct a "real time" price index that fully captures consumers' substitution among items. This lag is the reason BLS's experimental superlative index is only produced with a delay. But, the important question should not be whether it is possible to construct a perfect index, but rather whether techniques are available for creating a monthly cost-of-living index that would represent an improvement over the CPI as currently constructed.

The answer is yes. The Boskin Commission, which included my distinguished colleague Robert Gordon, suggested as a possible solution the use of a "trailing Tornqvist" price index. This index would use the Tornqvist index formula--which can capture substitution among items--and would update weights each year. To be operational in real time, this index would need to use lagged, or trailing, weights. For example, average weights from 1994-1995 could be used for calculating 1997 changes in the cost of living. Another approach has been suggested by Matthew Shapiro and David Wilcox. They have devised a so-called constant elasticity of substitution--or CES--index that appears to largely eliminate upper-level substitution bias. In contrast to the current setup that assumes no substitution among items, the class of CES indexes imposes a positive degree of substitution among all items, and alternative CES indexes would impose different degrees of substitutability. These authors searched to find the degree of substitutability that provided the closest approximation to a benchmark "superlative" index, but which can be implemented on a monthly basis in real time. There may well be other approaches worthy of serious consideration to rectify the problem of upper-level substitution bias.

Moving Forward

To spur progress on this issue, about which there appears to be considerable agreement, one approach that this Subcommittee could consider would be to commission a study of substitution bias to be undertaken by the staff of the BLS. The BLS could be asked to compare their current procedures with those that have been proposed by other researchers. Specifically, I would suggest that they determine which of these alternative approaches provides the most timely and accurate approximation to the "superlative" indexes published by the BLS, recalling that, while these superlative indexes may be the "best," they are available only with a considerable lag. In evaluating the alternatives, the objective should not be to establish a "perfect" measure--such a goal is unattainable. Rather the objective should be to produce the best measure of the cost of living that can be constructed in real time from existing knowledge and data.

At the same time, the Subcommittee could establish a formal panel of outside experts to review the BLS's evaluation of the alternatives and to provide an independent assessment of the BLS study to the Committee. The panel could also consult with the research staff of the BLS on the design of the study and the interpretation of the results. If differences remained after completion of the study, the panel of experts would provide a mechanism for independent assessment of alternative approaches that could be helpful to this Subcommittee's oversight responsibilities.

A Two-Track Approach

Let me raise one further issue that would inevitably arise from such a study. Even the best real-time approximation to a superlative index would not match the superlative index that ultimately could be constructed once expenditure share data ultimately became available. To deal with this problem, the Boskin Commission suggested pursuing a two-track approach. For the first track, BLS could publish a monthly index in real time that would never be revised. This index would be much like the current CPI except that--going forward--it could be based on an aggregation formula that minimizes upper-level substitution bias. For the second track, BLS could publish, with a lag, a superlative index that incorporated full information on changing expenditure shares and could be revised subsequently to incorporate other improvements to the CPI as well.

This two-track approach has advantages and disadvantages. On the positive side, the two track approach would provide indexes for users with diverse needs: a never-revised index for those for whom revisions would impose operational difficulties and a second index that would be the best possible measure of changes in the cost of living. On the negative side, I am concerned that the publication of two different price indexes as part of the CPI program might generate some confusion. If this confusion were judged to be a serious problem, BLS could alternatively produce a single measure that was revised and, ultimately, incorporated all information on spending patterns in the best possible way. For example, the CPI for April could be initially constructed using one of the approximations to a superlative index that I described above, but when full data on consumer expenditure shares became available some months later, the level of the CPI for April could be revised to be an exact superlative index rather than a close approximation. Were this to be done, government and private contracts that used the CPI for indexation would have to switch over to a level adjustment, using only the final CPI for April to set April's payments. The importance and feasibility of these switches could also be addressed by the BLS study.

Returning to my primary message, a study of substitution bias and an outside review panel holds the promise of forming the basis of a reasonable professional consensus on limited technical changes that would correct substitution bias and make the CPI a more accurate measure of the cost of living. Such a consensus is critical for maintaining public support and confidence in our statistical programs. That confidence can only be enhanced when the government is striving to develop the most accurate measures possible.

Mr. SHAYS. Thank you, Dr. Gramlich.

Dr. Gordon.

Mr. GORDON. I'm very delighted to be here as a representative of the five-member Boskin Commission which actually no longer exists, having been disbanded more than a year ago after we made our final report.

Mr. SHAYS. Doctor, you have a wonderful, loud voice but I just want you to lower the mic, just so, yes, thank you, that's great.

Mr. GORDON. It was now a little more than 3 years ago that this process was kicked off by testimony by Alan Greenspan, and after a round of testimony by a large number of academics, a little less than 3 years ago, the Boskin Commission was established.

I have a written statement but I'm going to, what does the red light mean?

Mr. SHAYS. No, it's a mistake. Thank you. We're starting you with green right now. It's going to turn red once and we'll roll it over and we'll stop you before it turns red a second time. It's 5 minutes, it gives you a sense.

Mr. GORDON. I have a prepared statement, and I'm not going to have time, obviously, to go through the whole thing, and I'm going to skip over the initial debate about the Boskin Commission recommendations and some of our responses to the critics because I think what you're more interested in is what we think of what the BLS has been doing since the commission's report was issued.

I wanted to emphasize that throughout the whole process the relations between the commission members and the BLS have been most cordial and constructive, much of the research that we cite in forming our estimates was originally performed at the BLS. And BLS officials were open in their recognition, as they still are, that there are many problems with the CPI of various levels of difficulty. One of our main recommendations, as we've already had pointed out, that is the movement to geometric mean has now been accepted and announced a couple of weeks ago by the BLS for implementation next year. And I think the commission members are fully supportive of their decision to apply that only to 60 percent of the CPI and we understand their reasons why they would not want to apply geometric mean to the whole 100 percent.

Quality adjustment is very difficult and one of the reasons, in defending our estimates, that we think the number we came up with is roughly right, despite some claims that a few of our category estimates of quality change were overstated, is there are a large number of improvements that are hard to quantify. For that reason, I think, we agree with the BLS that we may never get a perfect CPI but I wanted to point out that the current issue of Consumer's Reports, May 1998, contains a lot of advice to consumers about when to repair existing consumer items and when to throw them out. And along the way they have a whole list of the kinds of quality improvements that we did not take into account. For instance, a new refrigerator will consume at least $250 less in power over its lifetime than older units. New dishwashers are much quieter and more frugal with power and water. New washing machines are markedly more energy efficient than old ones. A new TV set, in almost any size, will offer more than the one it's replacing. New CD players hold more discs than older ones. New gasoline lawnmowers run more cleanly and efficiently. So quality change is quite pervasive and, indeed, some of it is very hard to measure.

Probably swamping the importance of unmeasured quality improvements is the most important omission from our estimate of the overall bias in the CPI and that is the value contributed by new products. Here it's important to distinguish two problems with the CPI. The first is the late introduction of new goods. New products, like air conditioners, microwaves, and VCR's, typically decline in relative price early in their lifetimes after which relative prices level off. In each of the cases I just mentioned, air conditioners, microwaves, and VCR's, the introduction into the CPI took place many years after introduction on the marketplace. On average, say, 8 to 10 years late. So that much of this initial price decline was simply missed.

The other dimension of new products is that consumers receive value from their very invention. They like stereo sound better than mono, they like color TV better than black and white, and so on. And it's the latter part, the consumer value of new products, that we did not include at all in our estimate of the 1.1 percent bias.

There's another piece of evidence that I've cited before and I can update that for you. There's an alternative measure of consumer price inflation, produced by the Department of Commerce, called the personal consumption deflator, and it uses all the ingredients from the CPI. It's affected by quality change for most of the CPI categories. It's affected by the substitution biases we've been discussing, yet it has different measures for medical care, airline fares, and computers, at least until right at the moment. And to update the number, the PC deflator has risen over the last 12 quarters at 0.5 percent less than the CPI despite all of the elements that it has in common with the CPI.

And in my written testimony, I go through a little calculation and suggest that if you took the bias that remains in the PC deflator and add that 0.5 percent difference, you'd get about 1.3 instead of 1.1 as an estimate of bias in the CPI over that period. Now that period is in the past, 1995–1997, and there have been a number of changes since.

Let me focus, at the end, on the—those of our recommendations where the BLS has not yet committed itself, at least in public, and suggest some of the things that Congress could help with.

There is no dispute with our first recommendation that the BLS should attempt to implement the principle that the CPI is an index of cost of living. But there has been no movement so far on our second, and I think one of our most important recommendations, that the BLS should produce a second index; Ed Gramlich has already mentioned this, which we call the research base index, produced only annually so there's no confusion with the real time monthly index, and subject to continual revision as new information becomes available either on weights, on quality change, or on the value of new products.

Upper level substitution bias is another area where, as has already been mentioned, while the CPI has moved after a 10-year interval to more up-to-date weights for aggregating these 211 categories, they have not committed themselves to an ongoing moving set of weights which would change every year, the so-called trailing Tornqvist idea.

There's been no mention yet, today, of the problem of outlet substitution bias. One reason is there's been almost no research on that, academic or otherwise. We know by one index that the share of discount department stores has increased from 45 to 65 percent of total sales over the past decade, but I don't know of any measures yet that would produce a measure of the average discount at that group of stores compared to more traditional stores. The BLS needs to carry out itself, or fund in the academic community, a major research effort to collect data on retail price differentials to complement existing data on sales by type of stores that we already have in the census of retailing.

We've seen no response yet to our recommendations that the pattern of data collection be updated and improved. At present, too many resources are devoted to collecting prices at the local level. There are thousands of price quotes for bananas in at least 40 different metropolitan areas. The bananas are imported. How different can the price of bananas be in Boston versus Burbank, or in Burlington versus Burbank, I should say? By eliminating some of this redundant data collection, the BLS could free up resources for a more concerted effort to introduce new products more promptly. But let me emphasize that our recommendation for a second research-based index certainly needs adequate and additional resources, and we wouldn't claim that they could do everything we're suggesting simply by reallocating their current budget.

The current agenda of BLS initiatives represents progress within the current framework, but reveals little willingness so far to open up and reconstruct the framework itself. Something like nibbling around the edges, without taking a bite out of the core. The commission agrees with the BLS that we do not believe it is possible to produce a perfect index, partly because some of these quality improvements and new products contributions are intangible. But commission members do not agree that the Congress, or the American people, should be satisfied with the failure thus far of the BLS to confront the core of the Boskin Commission recommendations.

Thank you.

[The prepared statement of Mr. Gordon follows:]

Slightly more than three years ago, on March 11, 1995, the possibility of an upward bias in the CPI, and its implications for the indexation of Social Security and for the Federal budget, were suggested in testimony to the Senate Finance Committee by Alan Greenspan. After further testimony by government officials and academic experts, that committee established the Advisory Commission to Study the Consumer Price Index, better known as the "Boskin Commission." The Commission issued its final report in December, 1996, and was disbanded after a further round of testimony in early 1997.

In my brief remarks today, I will summarize the main elements of the debate set off by the Boskin Committee report, including several of the substantive criticisms and our response to them. Then, after acknowledging the changes thus far made by the BLS in response to our recommendations, I will review the most important of the remaining recommendations and what specific steps the BLS might take to implement them.

Our report identified four sources of upward bias in the CPI and estimated values for the extent of bias attributable to each category. These were upper-level substitution bias involved with the way in which the 200 item categories are aggregated, lower-level substitution bias occurring within the 200 categories, outlet-substitution bias created when the CPI ignores price reductions achieved by consumers shifting to discount outlets, and the most important category, bias created by inadequate allowance for quality change in existing products and the benefits to consumers created by new products. Our final report estimated values for these four sources of bias of 0.15, 0.25, 0.10, and 0.60 percent per annum, respectively, for a total upward bias in the CPI of 1.1 percent per annum. We recognized that the estimates for each of the categories was necessarily imprecise and established a range of 0.8 to 1.60 around our point estimate of 1.10 percent per year.

Much of the initial reaction centered on the implications of the Report for the indexing of Social Security, the income tax system, and other programs. While our report contained estimates of the implications of an upward bias in the CPI for the Federal budget, both in the past and in the future, we did not make a specific recommendation on an alternative formula for indexation but merely said that "the President and Congress must decide." In the event, the Congress did not take action to alter any indexation formula, and time limits require me to skip over the portion of the debate about our report concerning such issues as the creation of a separate CPI for the elderly or the complex conceptual issue of whether an increase in life expectancy should be treated as a change in the cost of living and would warrant a change in the current provision of Social Security benefits.

Instead, my focus today will be on the accuracy of the CPI itself independent of issues involving how the CPI is used.[1] It is important to stress from the outset that throughout the development of the report and the aftermath, relations between the Commission members and the BLS have been cordial and constructive. Much of the research we cite in forming our estimates of bias was originally performed by BLS staff members. BLS officials were open in their recognition that there were many problems in the CPI that needed to be

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1. A detailed statement of the criticisms of the report and an extended response to them is contained in Boskin *et. al.* (1998). A full reference to this article and many other references contained therein is presented as an Appendix to this testimony. The most detailed and accessible critiques of the report by BLS officials are Moulton and Moses (1997) and Abraham, Greenlees, and Moulton (1998). My response to the Moulton-Moses paper is contained in my printed discussion in the same source.

addressed, they worked together with us to identify the nature of the problems and potential solutions, and they generally welcome the attention that our Commission and final report has directed to the need for more investment in the quality of government statistics, both in the CPI and more broadly. Some of the initial BLS reactions to our report were contained in a paper by the former head of research at the BLS, who was generous to our report and called it "the most influential critique of the CPI in decades." Subsequent to the release of our report, the BLS has moved swiftly to implement one of our major recommendations.

The portion of our report and recommendations concerning upper-level and lower-level substitution bias received widespread support and little if any criticism. In fact, the leading academics outside the government who have studied this issue (Shapiro and Wilcox, 1997) have suggested that we may have understated the upper-level substitution bias by 0.1 percent. The recommendation that the BLS has swiftly adopted is in this category, lower-level substitution bias, and this occurred on April 16, 1998, when the BLS announced that roughly 60 percent of the CPI would shift to geometric means for lower-level aggregation, and I believe that our Commission members are supportive to the factors that the BLS cited in excluding roughly 40 percent of consumer expenditure from such treatment in such areas as purchased shelter, utilities, and selected medical care services.

The criticisms of our report centered on our treatment of quality change and new products. While at least one prominent academic feels that our report understated the value of new products, most of the criticisms implied that we had overstated the extent of bias, for one or more of five reasons. Critics claimed that (1) we did not give adequate credit for the quality adjustments already performed by the BLS, (2) the kind of quality adjustments we advocated could not be performed in "real time" by the BLS, (3) we did not take adequate account of quality deterioration, (4) we extrapolated beyond existing research to form estimates of quality-change bias for product categories where no research existed, and (5) that we were elitists, identifying biases only in products consumed by the rich.

We have responded in detail to each of these criticisms and others. We have shown that the extent of quality adjustment by the BLS is both minor, according to their own calculations, and irrelevant, since our estimates were largely based on evidence independent of BLS data. We recognize the difficulties of "real time" quality adjustment and for that reason included as one of our core recommendations the establishment of a second "research-based" CPI, to be published annually with a lag and subject to revision. As for quality deterioration, we have found the examples to be few and to be outnumbered by improvements which we did not take adequately into account, in part because they are intangible and hard to measure. To those who question the subjective aspect of our quality bias estimates and our extrapolations beyond existing research, we conceded that our bias estimates may have been too high in particular cases but presented evidence that they were too low in others.[2] Finally, far from being elitist, we pointed out that some of our largest estimates of bias were for TV sets, owned by virtually every American household, VCRs, owned by 80 percent of households, or more important, medical care which touches the life

2. See Gordon's comments on Moulton-Moses (1997), some of which are included in Boskin *et. al.* (1998).

of every American..

While some of the numbers we applied to particular categories in our quality change evaluation may have been too high, others are too low. A subsequent study of cellular phones by Hausman (1997) identified a major bias in the telephone category which we did not take into account, and suggestions to us by Robert E. Hall and others indicate that the CPI understates the rate of *decline* of long-distance telephone service prices by substantially more than we recognized. My own studies of quality-adjusted prices of television sets, as well as a BLS study of television sets for a shorter period, indicate a major upward bias in the CPI for that product category.[3]

We thought hard about what we might have left out, that is, omitted sources of bias in either direction. There are many dimensions of quality improvement which academic research has not and probably never will capture, including the faster speed and reduced vibration of jet planes compared to piston planes (including the regional jets currently being introduced), improved reliability and safety of appliances and automobiles, improved sound quality of audio equipment, reduction in the noise, weight, and installation cost of room air conditioners, and immeasurably better picture quality of color TV sets. In its latest May 1998 issue, *Consumer Reports* advises consumers when to repair old products and when to replace them, and along the way it creates a new list of quality improvements that are not

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3. My study covered 1983-97 and is based both on the Sears catalogue and on *Consumer Reports*. The unpublished BLS study by Moulton and co-authors used the hedonic price technique and covered more models although over a shorter period (1993-97). The Moulton study found an upward bias in the CPI at roughly the same rate as assumed in our report, about 3 percent per annum. My study found an upward bias of 5 to 6 percent.

included in either our report nor taken into account in the CPI: a new refrigerator will consume "at least $250 less in power over its lifetime" than older units; new dishwashers are "much quieter and more frugal with power and water;" new front-loading washing machines "are markedly more energy efficient than old models;" a new TV set in almost any size will "offer more than the one it's replacing;" new CD players "hold more discs than older ones;" new gasoline lawn mowers "run more cleanly and efficiently." Notably, there have been no advances worth a remark on some other products, including washing machines, ranges, dryers, VCRs, riding mowers, vacuum cleaners, and microwave ovens.

Probably swamping the importance of unmeasured quality improvements is our most important omission, the value contributed by new products. Here it is important to distinguish two problems with the CPI.

The first problem is the late introduction of new goods into the CPI. New products like air conditioners, microwaves, and VCRs, typically decline in relative price early in their history, after which prices level off. Clunky and unreliable VCRs were introduced in the late 1970s at more than $1,000, soon to be replaced by electronic, programmable, and reliable models with better recording and playback capabilities at $200. Most of this price decline had already occurred when VCRs were finally introduced into the CPI in 1987 -- by that year fully half of Ameircan households owned VCRs, and all of the price decline they had experienced was simply omitted from the CPI. The cellular phone is a more contemporary example — by some measures the prices of cellular phone service had declined by 90 percent by the time the cellular phone was finally included in the CPI in January, 1998.

In addition to the first problem involving new products — the late delay of these products into the CPI after much of the price decline has already taken place — the second and potentially more important problem is that the very invention of a new product creates value. Consumers like stereo better than mono sound, they like color better than black and white TV, they like the option of viewing recent movies at home without the expense of babysitters, they like the convenience of microwave ovens, and they surely appreciate the increasing availability of new diagnostic medical tests, non-invasive laser surgery, shorter stays at hospitals, less pain from a variety of procedures, and the four years of increased longevity that medical science has made possible over the past two decades. None of these benefits of modern life is included in our overall bias estimate of 1.1 percent per year.

Our omission of the value of new products is the main reason that I believe our 1.1 percent overall estimate is too low. But there is other evidence as well. In the past three years an alternative measure of consumer price inflation, the personal consumption deflator of the Department of Commerce, has increased at a rate about 0.5 percent slower than that of the CPI. It uses more up-to-date weights and alternative measures for the prices of computers, airline fares, and medical care. But otherwise it is based on the individual components of the CPI and incorporates about two-thirds of the bias in the CPI. By this alternative piece of evidence, the CPI could be biased upward by the 0.5 difference with the PCE, plus another 0.75 points of the 1.1 point bias we compute, for a total of 1.25 percent per year rather than the 1.1 percent per year suggested by our report.[4]

Thus far I conclude that the Boskin report conclusions have survived the initial round of criticism quite well. Our estimate of upper-level substitution bias may have been too low, and the examples cited by the BLS in which we may have exaggerated quality change bias are likely to be outweighed by the sources of understatement cited above — products we neglected, intangible but undeniable sources of quality change, and our failure to quantify the value of invention itself, that is, what consumers have gained from the fact that new products now exist that did not years or decades ago.

Let me now focus on some of our recommendations where the BLS has not yet committed itself, and make some specific recommendations that could require Congressional support and funding.

There is no dispute with our first recommendation, that the BLS should attempt to implement the principle that the CPI is an index of the cost of living, in the theoretical sense accepted by economists. Indeed Abraham-Greenlees-Moulton (1998, hereafter A-G-M) say explicitly that "this seems basically right to us" (p. 27). But thus far there has been no movement on our second and extremely important recommendation, that the BLS should produce a second index, "research-based," produced only annually with a lag, and subject to continual revision. The purpose of this second index is to confront the fact of life, that

4. The annual rate of change of the "core" CPI (excluding food and energy) exceeds that of the "core" PCE deflator (excluding the same items) by an average rate of 0.5 percent per annum during the 12 quarters 1995:Q1 to 1997:Q4. Of our total 1.1 percent bias, the PCE deflator corrects for the 0.15 percent rate of "upper-level" substitution bias and perhaps 0.2 percent of our 0.6 percent adjustment for quality change and new products. The PCE deflator is still subject to the 0.25 percent rate of lower-level substitution bias, 0.1 percent of outlet substitution bias, and at least 0.4 percent of quality change bias.

studies of quality change for individual products and services take time, and the BLS cannot possibly be expected to incorporate every new research finding in the monthly CPI, especially since that, for good reasons, can never be revised. Establishment of the second index will take a reorientation of research effort by the BLS. There will need to be a larger research department and one that subcontracts to established organizations (Consumers Union or the equivalent) to carry out long-term studies of changes in the quality of consumer products and services. One frustrating aspect of *Consumer Reports* is that a huge amount of information has been collected over the years that would allow a time-series data base to be constructed on quality attributes, energy use, and repair incidence for a wide variety of products. At the moment the time-series aspects of these data are not published and are often difficult to extract from successive studies published in the magazine; this is just the sort of research record that the BLS should be negotiating to preserve and to obtain. Since the BLS cannot do everything all at once, the Commission members are sympathetic with Nordhaus' (1998) suggestion that we should advance beyond "the war of the anecdotes" by randomly selecting a sample of consumer goods and services for intensive study (i.e., not just doing research on those that are easy to study but research a sample of everything, easy and difficult alike). Quite a bit can be accomplished relatively rapidly with bar scanner data, which allows a much faster introduction of new products and a much more adequate treatment of substitution at the level of individual goods and services.

Upper-level substitution bias is another problem area. In January, 1998, the CPI finally updated its upper-level weighting system from 1982-84 expenditure weights to 1993-

95 weights. However there has been no commitment to the Commission's major recommendation that the Laspeyres formula be abandoned, and that the infrequent ten-year revision cycle be abandoned and replaced by a "permanent" revision cycle, with the upper-level weights revised every year to respond, with only a one-year or two-year lag, to the shifting pattern of consumer expenditures.

The problem of outlet substitution bias has been subject to virtually no research, academic or otherwise. We know that by one index the share of discount department stores has increased from 45 percent to 65 percent of the total over the past decade, but no systematic series exists to produce a measure of the average discount in one type of store as contrasted with another. While the BLS has maintained its position that price differentials for a given good reflect differences between full-service and minimal-service outlets, we maintain the position that many discount retail chains enjoying an increase in market share -- Wal-mart, Target, Home Depot -- provide the same service or better service than the K-Marts and bankrupt Woolworths and Montgomery Wards which are losing market share. The BLS needs to carry out itself, or fund in the academic community, a major research effort to collect data on retail price differentials to complement existing data on sales by type of store available from the Census of Retailing.

We also have seen no response to our recommendations that the pattern of data collection be updated and improved. At present far too many resources are devoted to collecting prices at the local level; there are thousands of price quotes for bananas in at least 40 different metropolitan areas. Yet bananas are imported -- how different can the price changes be in Boston versus Burbank? By eliminating much redundant data collection on relatively straightforward and homogeneous goods, like apples and bananas, the BLS would free up resources for a more concerted effort to introduce new products more promptly and greatly expand the effort to price and assess the quality of more complex goods and services, using scanner data where feasible.

How is Congress, the Administration, and the public to assess whether the BLS responses and initiatives are adequate? Pollak (1998) makes a persuasive case that technical and scientific issues be cordoned off from political issues like indexation, and that an ongoing advisory body be constituted by an outside nongovernmental body like the National Academy of Sciences, unlike the Boskin Commission which was a creation of the U. S. Senate.

Pending creation of such a committee, there is an ongoing role for members of the Boskin Commission to advise those who inquire, such as the current House subcommittee, whether the activities and orientation of the BLS represent an appropriate and adequate response to the Commission's report. The current agenda of BLS initiatives as reported by A-G-M (1998) represents progress within the current framework, but reveals little willingness to open up and reconstruct the framework itself (I would describe it as "nibbling around the edges without taking a bite out of the core"). The Commission agrees with the BLS that "we do not believe it to be possible to produce a perfect cost-of-living measure." However, Commission members do not agree that the Congress nor the American people should be satisfied with the failure thus far of the BLS to confront the core of the Boskin

Commission recommendations, its timid agenda for reform, and its lack of ambition in setting a major challenge to itself and to Congress to work toward a Consumer Price Index that would set a clear standard for statistical agencies around the world.

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References to the research used in the Boskin Commission Report and to the subsequent debate begins with the Table of Contents of the symposium on this issue contained in the Winter, 1998, issue of the *Journal of Economic Perspectives.* The subsequent pages contain references from the paper by Boskin *et. al.* in that issue.

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Contents

Volume 12 • Number 1 • Winter 1998

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Mr. SHAYS. Thank you, Dr. Gordon.

Mr. Ungar.

Mr. UNGAR. Mr. Chairman, members of the subcommittee, we're pleased to be here today to discuss our work that we have done over the last couple of years on the Consumer Price Index. I'd like to provide a short summary statement, and I, and my colleagues would then be available, along with the other panel members, to respond to questions.

I would like to talk briefly about two issues that we have looked at. The first has been mentioned and it deals with the need for, and advantages of, updating the current market basket weights more frequently than every 10 years or so, which has been BLS' practice recently, or at least since 1940.

In October 1997, we issued a report on that topic. All the evidence that we gathered during the course of our work for that report pointed to the need to have more frequent updates, to have the CPI be more accurate, regardless of which direction it would go in.

The evidence that we gathered did include the use of a number of knowledgeable professionals, including a previous commissioner of BLS, and other researchers, including several members of the Boskin Commission. Practices of a number of other countries were also looked at to see how they compared with the practices with our country.

Although there are some differences in the types of indexes, and how they go about calculating their indexes, we still noted that they had more frequent update practices. We also looked at the results of a great deal of BLS research that had been done over many decades that relate to the differences in indexes, before and after introduction of new indexes, and using different alternative means of computing indexes.

And, finally, we looked at the cost of updates, or the estimated cost of updates, versus the potential benefits. And all that information collectively led us to believe that it would be quite helpful to have a more frequent update. We recommended that to BLS in our report, and as the commissioner indicated, BLS did agree with our recommendation. However, she appropriately noted that the evidence that exists to date doesn't really point to a particular time period or time interval, or when the most appropriate time to update would be. BLS is currently considering that as far as we understand. So we're certainly looking forward to the decision that BLS comes up with in terms of the frequency of updates, assuming the current fixed market basket is continued to be published and used.

The second issue that we looked at is a little different from what the other panel members have discussed. At the subcommittee's request, we looked at the extent to which BLS has addressed efforts to improve the quality of the CPI in its plans that had been prepared under the Government Performance and Results Act of 1993, otherwise known as "the Results Act."

There are two topics I'd briefly like to talk about here. One has to do with the extent to which its 1999 performance plan, which it recently released, addressed the area of improving the CPI's quality. I might point out, however, the BLS is not required by the statute to issue a strategic plan or a performance plan. The Department of Labor is required to do so. It did prepare a plan and included BLS' material. However, I would note that the Department of Labor did instruct its components, including BLS, to prepare both strategic plans and performance plans to cover their own activities. And, of course, BLS did so.

In terms of BLS' 1999 performance plan, we noted that it did include at least seven objectives, or excuse me, seven performance goals that were specifically related to improving the accuracy or the quality of the CPI. We also felt that, given this was the first year for which the act required such plans, that BLS did a reasonably good job of identifying the major aspects, the major components or topics that are required to be covered in the plan. We believe that with continued experience BLS will certainly do much better in the future.

There were a few areas where we thought BLS could improve its plan, and particularly in terms of how useful it would be to others, outside of BLS, in looking at the plan. For example, as BLS notes, all of its goals and the indicators that are associated with those goals are really stated in output terms or activity terms, not in outcome terms. Also, they're very generally stated; they're not numeric, they're all measurable, but we think they could be a little more specific. For example, on its goal to expand the size of the CEX sample size, it mentions that as a goal but it doesn't give exactly, as a part of the goal, how large it's going to be and what the base has been; so, it would be difficult for somebody looking at that to tell exactly how much progress BLS has made at the end of the year.

The other area that we would suggest BLS look at for the next plan, which would be for 2000, would be to have more detail or a better description of how it intends to verify or validate the data that it will be using to determine whether or not it met its seven performance goals. It currently does include a description in its plan of what it intends to do. Although, again, it does mention that it's basically activity oriented or milestone achievement, not outcome oriented. Since all the seven performance goals relate to improvement in accuracy, or related outcomes, it appeared to us that it would be helpful to have some insight as to how BLS might go about showing that those performance goals will be met in terms of improved accuracy.

The second broad issue that we looked at with respect to BLS' efforts under the Results Act had to do with a comparison, at the subcommittee's request, of the extent to which the BLS strategic plan, and the performance goals indicated therein, link up to the Boskin Commission recommendations that were made to BLS. The Boskin Commission report specifically identified 12 recommendations to BLS. Subsequently, the commission noted that another issue that it had discussed in the report actually should have been a recommendation. It was not labeled as such, so, there is a total of 13 recommendations to BLS. We did not see a linkage between BLS' performance goals and indicators for eight of those recommendations. I might add that the BLS is certainly not required to have particular types or subject matters covered in its goals. That's something that's at its discretion. They did, however, have either direct or indirect linkages from our perspective to the other five. We believe it would be helpful for BLS, in its next plan, to at least discuss the linkages, or lack thereof, between its plan or the goals in its plan and the Boskin Commission recommendations. BLS has some concerns about that but we, nevertheless, believe it would be helpful to have such discussions.

[The prepared statement of Mr. Ungar follows:]

MAKING THE CPI MORE REFLECTIVE OF CURRENT CONSUMER SPENDING

Summary of Statement by
Bernard L. Ungar, Director
Government Business Operations Issues
General Government Division

The principal source of information on trends in consumer prices and inflation in the United States is the Consumer Price Index (CPI), which is published by the Bureau of Labor Statistics (BLS). To determine the level of inflation in consumer prices, the CPI tracks prices for a fixed "market basket" of goods and services that urban consumers purchase for day-to-day living.

As requested by the Subcommittee, GAO's testimony today addresses certain topics related to the CPI. The first is the need for BLS to make the CPI expenditure weights more current by updating them more frequently than at 10-year intervals, as GAO reported in October 1997. BLS uses expenditure weights to aggregate market basket items into the overall index number. The preponderance of evidence GAO obtained pointed to the need for and advantages of more frequent updates. This evidence included the (1) views of professionals knowledgeable about the CPI, (2) practices of other countries, (3) results of research that show that the age of expenditure weights affects the CPI, and (4) the sizable effect more frequent updates could have on the federal budget in comparison to the relatively small costs associated with updates. BLS has said it agrees with GAO's recommendation for more frequent updates and is considering the appropriate update frequency.

GAO also examined how well those elements of BLS' strategic plan and performance plan that focus on improving the CPI would meet the criteria in the Government Performance and Results Act of 1993 and related guidance, even though the BLS plans are not required to comply with the statutory requirements. In examining BLS' fiscal year 1999 performance plan, GAO found that it was partially successful in providing a picture of BLS' intended performance to improve the CPI's quality. Further, the plan did not fully portray how BLS' strategies and resources would help achieve the performance goals for improving CPI quality or how BLS would ensure that the data it uses to assess its performance are credible.

GAO also reviewed the linkage between the goals in BLS' strategic plan relating to improving the CPI and the 1996 Boskin commission recommendations to BLS. GAO found linkages between some, but not all, of the commission's recommendations and the plan's performance goals and indicators. Neither BLS' strategic plan nor its fiscal year 1999 performance plan discusses such linkages or the lack of them. BLS and the Department of Labor question the usefulness of discussing recommendations contained in particular reports, such as the Boskin commission report, in long-range planning documents. However, GAO believes such a discussion would enhance the plans' usefulness and credibility to CPI stakeholders given the great interest shown in the Boskin commission recommendations by Congress and others.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to assist the Subcommittee in its deliberations with the Bureau of Labor Statistics (BLS) on the Consumer Price Index (CPI), one of the most important indexes produced by the federal government. The Subcommittee has asked us to address several topics related to making the CPI more reflective of current consumer spending.

According to BLS, the CPI is the principal source of information on trends in consumer prices and inflation in the United States and affects nearly all Americans because of the many ways it is used. For example, it is often used to increase wages and benefit payments to adjust for the erosion of consumer purchasing power due to inflation. In 1997, the federal government adjusted the benefits of 43.6 million Social Security beneficiaries and 21.4 million food stamp recipients because of the growth in consumer prices as reported by the CPI. In addition, federal tax brackets are adjusted automatically by the CPI to prevent inflation-induced increases in tax rates.

To gauge the level of inflation in consumer prices, the CPI tracks prices for a fixed "market basket" of goods and services that urban consumers purchase. These purchases are for food, clothing, shelter, fuels, transportation, medical care, entertainment, and other goods and services that people buy for day-to-day living. Only those expenditures made by consumers (not including businesses) are captured in the CPI.

Congress has been concerned with whether the CPI accurately reflects consumer spending, and the Senate several years ago chartered the Advisory Commission to Study the Consumer Price Index (also referred to as the Boskin commission). The commission concluded in its December 1996 report that the fixed market basket CPI (1) becomes less and less representative of consumer spending over time as consumers respond to price changes and new consumer choices and (2) overstates the true cost of living.[1] The commission estimated the size of the overstatement for the next few years to be 1.1 percentage points per year, and it made recommendations to BLS and to the President and Congress. Within the community of professional economists and statisticians, the commission's report is supported by some and opposed by others.

As requested, I will discuss three topics today: (1) the need for and advantages of more frequent updating of the CPI expenditure weights, (2) the nature of the work we are currently doing with regard to the CPI, and (3) BLS' coverage of CPI improvement efforts in its strategic plan and fiscal year 1999 annual performance plan.

[1]The Boskin commission's December 1996 report to the Senate Committee on Finance was titled Toward a More Accurate Measure of the Cost of Living.

NEED FOR AND ADVANTAGES OF
MORE FREQUENT UPDATING OF
THE CPI EXPENDITURE WEIGHTS

In an October 1997 report, we concluded that the CPI expenditure weights should be updated more frequently than at the current rate of approximately every 10 years to make the fixed market basket CPI more timely in its representation of consumer expenditures.[2] The CPI is based on a fixed market basket of goods and services purchased by urban consumers. These items are assigned weights by BLS to give proportionate emphasis for price changes of one item in relation to other items in the CPI. The weights used to aggregate the items into the overall index number for the CPI are based on the Consumer Expenditure Survey, which BLS uses to determine what goods and services consumers are buying. Historically, BLS has changed the expenditure weights only when making major revisions to the CPI. Since 1940, that has occurred about every 10 years.

My comments on the need for and advantages of more frequent updating of the CPI expenditure weights are based largely on our October report and will provide information on (1) the views of individuals knowledgeable about the CPI on the issue of updating the expenditure weights between major revisions to the CPI, (2) the updating practices of other industrial countries, (3) the cost to update the expenditure weights, (4) the possible

[2] Consumer Price Index: More Frequent Updating of Market Basket Expenditure Weights Is Needed (GAO/GGD/OCE-98-2, Oct. 9, 1997).

effect on the federal budget of more frequent updates, and (5) BLS' response to our recommendation that it should update the expenditure weights more frequently.

More Frequent Updating Deemed
Desirable by Individuals Knowledgeable
About the CPI

We spoke with 10 individuals who were former officials of BLS or who had otherwise studied the CPI, and they were unanimous in stating that 10 years between updates of the expenditure weights was too long. However, there was less agreement among the individuals on exactly how often the updating should occur. Five, including the chairman and three members of the Boskin commission, said more frequent updating of expenditure weights was less important than other ways of making the CPI more reflective of current consumer spending. Dr. Boskin told us that if there were no changes in existing products or no new products in the economy, then updating the expenditure weights would be the only step that BLS would need to take. However, since the economy does change, with new products being developed and product improvements occurring constantly, he believed more frequent updating was only one step among a number that should be taken to improve the CPI.

Practices of Other Industrial Countries

We also obtained information on the updating practices in Japan, Italy, Germany, France, Canada, and the United Kingdom, which along with the United States have made up the Group of Seven (G-7) countries.[3] All of them track consumer prices through a market basket of goods and services and weight the prices of the items in the market basket. According to information provided by BLS and contained in international publications, all six update their consumer price indexes more often than the United States. Two updated the weights of their consumer price indexes annually, and the other 4 did so approximately every 5 years. However, BLS officials noted that the updates by the six countries do not comprise the same level of detail as used for the CPI; for example, some do not use consumer expenditure surveys as does the United States.

Cost to Update the Expenditure Weights Is Estimated to Be Relatively Small

The estimated cost of updating the expenditure weights is relatively small in comparison to the cost of major revisions. To estimate the cost for our October 1997 report, we assumed that an update to the expenditure weights would have occurred in 1992 and would occur in 2003, which is 5 years after major revisions to the CPI market basket. On the basis of data supplied by BLS, the estimated cost to have updated the weights in 1992

[3]The G-7 countries have met to coordinate economic and monetary policy.

would have been $2.4 million spread over 3 years. According to BLS, the estimated cost to update the expenditure weights in 2003 would be $3.1 million over a 3-year period. In comparison, BLS reported that the major CPI revision in 1987 cost $47 million over 5 years and, at the time of our report, expected the cost of the 1998 major revision to be about $66 million over 6 years. BLS explained this difference in cost by pointing out that an update of the expenditure weights would exclude many activities that are included in major CPI revisions.

More Frequent Updates Could
Affect the Federal Budget

Because federal tax brackets and federal payments, such as those to Social Security beneficiaries, are adjusted for inflation, a CPI that more accurately measures inflation could affect the federal budget. BLS estimated the annual range of change in the CPI, if the expenditure weights were updated on a 5-year cycle, from 0 (zero)–no change–to a decrease of 0.2 percentage point. We asked the Congressional Budget Office (CBO) to use the midpoint of BLS' range (a decrease of 0.1 percentage point) to estimate the effect on the federal budget. CBO estimated that, assuming no other changes in policy or economic assumptions, if updating the weights in 2003 (5 years after the 1998 major revision) reduced CPI growth by 0.1 percentage point annually, the projected budget surplus would be increased by a cumulative total of $16.5 billion over the 5-year period of 2004 through 2008.[4]

Most of the impact of such a reduction in the CPI would be on federal outlays--such as reduced payments to Social Security beneficiaries, which account for most of the outlays–and most of the impact would occur in the later years. For example, according to estimates by SSA actuaries using an annual 0.1 percentage point reduction in CPI growth, the average monthly benefit check for retired workers in 2004 would be reduced by $0.91, from $939.94 to $939.03; by the fifth year (2008), the average monthly check would be reduced by $4.86, from $1,065.98 to $1,061.12.

BLS' Response to Our October 1997 Recommendation

In our October 1997 report, we recommended that as long as a fixed market basket CPI is published, the Commissioner of BLS should update the expenditure weights of the CPI's market basket of goods and services more frequently than every 10 years. BLS plans to publish, starting in 2002, a CPI index based on the concept of superlative index formulas, which would enable that index to be more current than the fixed market basket index in reflecting consumer spending. The Boskin commission recommended use of a superlative

[4]In our October 1997 report, we gave a 4-year CBO projection of $10.8 billion, which was based on a March 1997 baseline. CBO used a March 1998 baseline to make the 5-year projection.

index formula to construct the CPI, although BLS believes the recommendation did not specify how a true superlative index might be constructed. Moreover, BLS does not view the superlative index as a replacement for the fixed market basket index, and said it would continue to publish the fixed market basket CPI.

In commenting on GAO's recommendation, the BLS Commissioner said she supports more frequent updates of the expenditure weights. However, she said neither economic theory nor empirical evidence demonstrates the superiority of any particular update interval. This has been the principal reason why BLS has not updated the expenditure weights between major revisions to the CPI. Other reasons cited by BLS included difficulties in obtaining funds to bring about change to the CPI and concern with what would be the best approach to improve the CPI.

Although theoretical guidance is not available on all facets of updating expenditure weights, such as exactly how often updates should occur, the preponderance of the data we reviewed supported the need for updating expenditure weights more frequently than approximately every 10 years. Recognizing that the data are not perfect and do not isolate the effects of using outdated expenditure weights, comparisons of price indexes with old and new weights that go back to those made for the first revision in 1940 indicate that price indexes computed with more current weights were always different from indexes computed with older weights. These comparisons and more recent research conducted by BLS tend to show lower rates of inflation with indexes using newer weights.

Since last fall when we received the Commissioner's comments, the Commissioner has told this Subcommittee that BLS is committed to more frequent updating of the weights used to calculate the CPI. In March 1998, the Commissioner said that, although BLS had not yet decided on the optimal frequency of weight updates, it was clear that a reduction in the current (approximately 10-year) period between updatings was warranted.

CURRENT GAO WORK ON THE CPI

At the request of the Ranking Minority Member of the Senate Committee on Governmental Affairs, the Honorable John Glenn, we are gathering information from BLS related to the quality adjustment issues raised by the Boskin commission. To better inform policymakers and other commentators on this issue, we have been asked to describe the policies, procedures, and practices that BLS currently uses to account for differences between a new item and the item it replaced. This replacement process is necessary when an item is no longer available for BLS to price. Within this process, BLS determines if the new item is comparable to (i.e., the same as) the old item that disappeared. We are in the process of collecting information to describe what BLS does when the two items are not comparable. We anticipate issuing our report early next year.

BLS' COVERAGE OF CPI IMPROVEMENT
EFFORTS IN ITS STRATEGIC PLAN AND
1999 PERFORMANCE PLAN

For this testimony, you asked us to review certain planning documents BLS prepared for improving the accuracy of the CPI. The model for such planning documents is the Government Performance and Results Act of 1993, also referred to as the Results Act. The Act seeks to improve the efficiency, effectiveness, and accountability of federal programs by establishing a system to set goals for programs based on their intended purposes, measure the performance of those programs, and use performance information to improve results. As you know, if successfully implemented, the Results Act will help agencies focus on how to improve their programs' performance in achieving desired results.

The approach to performance-based management and accountability envisioned by the Results Act is a dynamic and iterative process in which one stage builds on and reinforces the progress made at earlier stages. Under the Results Act, agencies first were to prepare long-term strategic plans that set the general direction for their efforts. The strategic plans agencies prepared were to be the starting point for agencies to set performance goals for programs in their annual performance plans.

The Results Act does not require component agencies of departments, such as BLS, to prepare strategic and annual performance plans. However, some component agencies have prepared those plans as BLS has done at the direction of the Department of Labor. Although the strategic and annual performance plans prepared by component agencies such as BLS are not required to comply with the requirements of the Results Act, these component agencies may use the statutory requirements as guidance in developing their strategic and performance plans. In addition, the Department of Labor instructed BLS to follow OMB's guidance to federal agencies for implementing the Results Act in preparing its annual performance plan. Moreover, Labor included the entire BLS strategic plan as part of the department's strategic plan.

BLS' strategic plan includes an agency strategic goal to "improve accuracy, efficiency, and relevancy of our economic measures and program outputs through increased application of state-of-the-art statistical techniques, economic concepts, technology, and management processes." The CPI is one of these economic measures, and one of the strategic plan's objectives is to improve the quality of the CPI. The strategic plan provides performance goals and performance indicators for this objective (see app. I for those for fiscal year 1999).

BLS' fiscal year 1999 annual performance plan lists the same agency performance goals and performance indicators for the CPI that are listed for fiscal year 1999 in BLS' strategic plan. Thus, the performance goals and indicators in the 1999 annual performance plan are linked to those in the strategic plan.

Observations on BLS' Fiscal Year 1999
Annual Performance Plan

As you requested, we reviewed BLS' performance plan for fiscal year 1999, focusing on the plan's elements that related to the objective of improving the quality of the CPI. To do this review, we used criteria in the Results Act, Office of Management and Budget's (OMB) guidance on developing the plans (Circular A-11, part 2), our February 1998 guidance for congressional review of the plans,[5] our April 1998 guidance for assessing agencies annual performance plans,[6] and the December 17, 1997, letter to OMB Director Raines from eight congressional leaders that includes suggestions for how to make the performance plans more useful. For purposes of our analysis, we collapsed the six requirements for annual performance plans in the Results Act and the related guidance into three core questions: (1) To what extent does the agency's performance plan provide a clear picture of intended performance across the agency? (2) How well does the performance plan discuss the strategies and resources the agency will use to achieve its performance goals? (3) To what extent does the agency's performance plan provide confidence that its performance information will be credible?

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[5]Agencies' Annual Performance Plans Under the Results Act: An Assessment Guide to Facilitate Congressional Decisionmaking (GAO/GGD/AIMD 10.1.18, Feb. 1998).

[6]The Results Act: An Evaluator's Guide to Assessing Agency Annual Performance Plans (GAO/GGD-10.1.20, April 1998).

Overall, BLS' fiscal year 1999 performance plan would partially meet the criteria in the Results Act and related guidance, although, as stated previously, we recognize that the plan was not required to comply with the statutory requirements. Considering that this is the first Results Act performance plan that BLS has produced, the plan contains a great deal of useful information to inform Congress and others about how BLS intends to accomplish its mission. We expect that as BLS gains experience, future performance plans will build upon this initial effort and become increasingly more useful to Congress and the public. Specifically with respect to the CPI, BLS' fiscal year 1999 performance plan provides a partial picture of BLS' intended performance relative to its goals aimed at improving the quality of the CPI. Further, the plan does not fully portray how BLS' strategies and resources will help achieve BLS' performance goals for improving CPI quality or how BLS will ensure that information it uses to assess actual performance against CPI improvement goals is accurate, complete, and consistent.

Under the criteria in the Results Act and related guidance, agency annual performance plans are to contain goals for each of the program activities identified in the agency's budget and should express them in objective, quantifiable, and measurable form to allow comparison between actual and planned performance. Agencies can use their discretion in determining their performance goals. Agency plans should also contain indicators to be used in measuring or assessing the relevant outputs, service levels, and outcomes of each program activity. In our view, BLS' performance goals associated with improving the quality of the CPI, which are shown in appendix I, are linked to its budget and are objective and measurable. As BLS notes, the goals are generally expressed as significant milestones expected to be accomplished during the given year.

Because of the way in which the goals are expressed, BLS' performance indicators for accomplishing the milestones are activity or output oriented rather than outcome oriented. BLS notes this in its plan and says that, over time, it will show how its indicators relate to desired outcomes, such as improving the accuracy of the CPI. The use of output-oriented goals is allowed under OMB's guidance for implementing the Results Act. The guidance notes that, although outcomes should be used whenever possible, outputs may be used for several reasons, including when outcomes may not be scheduled for achievement in the fiscal year covered by the plan. However, it appears to us that the goals and indicators BLS cites in its performance plan are, for the most part, changes to the CPI that BLS expects to complete in fiscal year 1999 that are aimed at improving the CPI's quality. Thus, it would appear that BLS' performance plan would be more fully responsive to OMB's guidance if the goals or indicators included an outcome dimension to reflect the results of BLS' activities. Such outcome-oriented goals or indicators could relate to improvements in the accuracy, efficiency, or relevancy of the CPI.

Furthermore, BLS' goals and indicators could be more specific and quantifiable to enable better stakeholder comparisons of actual results with established goals. For example, BLS' indicator for its performance goal to expand the Consumer Expenditure Survey (CE) sample is: "Begin data collection and processing of larger sample." In its justification for its submission for the President's budget, BLS requested resources to expand the sample size of the CE by approximately 50 percent. The performance goal as set forth in the annual plan is not as specific, however, and does not inform the reader that BLS plans to expand the CE by 50 percent. Also, if the baseline measure cited the prior CE sample size, which it does not do, then CPI stakeholders could determine whether BLS has achieved its goal to expand the CE by 50 percent when it reports its results. We also note that none of the performance goals to improve the quality of the CPI provide baseline measures.

Under the criteria in the Results Act and related guidance, annual performance plans should briefly describe the agencies' strategies and the human, capital, financial, and other resources they will use to achieve their performance goals. BLS' performance plan indicates that state-of-the-art statistical techniques, economic concepts, technology, and management processes will be applied to achieve its performance goals aimed at improving the quality of the CPI. It also mentions the operational processes and technological advances that BLS is making. Further, the plan points out that BLS is requesting additional funding for fiscal year 1999 of about $9.1 million and 36 full-time equivalent employees to undertake initiatives needed to improve the CPI's timeliness and accuracy.

However, BLS' performance plan does not fully portray how BLS' strategies and resources will help achieve the BLS performance goals. We believe such information would better enable CPI stakeholders to see how BLS intends to achieve each goal and the associated resources it will need to do so. BLS' performance plan does link each performance goal aimed at improving the quality of the CPI with BLS' program activities listed in the President's budget and shows the increased amount of funding and full-time equivalent staff associated with achieving all such goals. However, BLS' performance plan does not show the funding level associated with the individual program activities identified in its performance plan, as provided in OMB's Results Act guidance.

Finally, under the criteria in the Results Act and related guidance, agencies should describe the means to be used to verify and validate performance data. According to this guidance, the means used should be credible and specific to ensure that performance information is sufficiently complete, accurate, and consistent. BLS' performance plan for fiscal year 1999 does not specify the procedures BLS intends to use to verify and validate the information related to its performance goals for improving CPI quality. However, in its performance plan for fiscal year 1999, BLS states that over time it will validate its indicators by showing how they relate to desired outcomes, such as improving accuracy. In addition, we believe it would be more useful to CPI stakeholders if the plan included information to demonstrate the credibility of the data BLS will use to measure its performance.

Observations on Linkage Between
Boskin Commission's Recommendations
and BLS' CPI Performance Goals and Indicators

As you requested, we also compared the extent to which certain BLS performance goals and performance indicators contained in its strategic plan that relate to improving the CPI reflected the recommendations made in December 1996 by the Boskin commission.

Overall, we found linkages between BLS' performance goals and indicators relating to improving the CPI and three Boskin commission recommendations (see app. II). The commission referred to these specific recommendations as short-run recommendations--that is, those that the commission thought could be implemented immediately, with little additional resources or no data collection initiatives.[7] These recommendations were to develop a monthly index that would adopt a superlative index formula at the upper level of aggregation in the index, to be called the CPI, and replace the current fixed market basket CPI;[8] use a geometric means formula at the lower level of aggregation in the CPI;[9] and expand the use of regression techniques. We based the linkages on concepts that

[7]The Boskin commission placed its recommendations to BLS into three categories: short run, intermediate run, and longer run. We placed two unclassified recommendations into a general/overall category.

[8]The Boskin commission referred in its recommendation to a particular form of superlative index but BLS does not agree that the form referred to should be characterized as a superlative index.

[9]On April 16, 1998, BLS announced that, beginning in January 1999, it will use a geometric mean formula to aggregate the lower-level categories for approximately 61 percent of total consumer spending represented in the CPI.

were identified in the recommendations and the performance goals and indicators. For example, we made a linkage between the Boskin recommendation that said BLS should move to a geometric means at the elementary aggregates level and the performance goal and related indicators that mentioned geometric means.

BLS' performance goals and indicators that we linked did not always address the full scope of the Boskin recommendations. For example, BLS has identified a series of performance indicators for the performance goal "develop alternative measures of change in living costs" that would result in published superlative indexes by fiscal year 2002, which we linked to the third Boskin commission recommendation. We note that the plan's discussion of this performance goal and its indicators does not address several aspects of that Boskin recommendation, such as abandoning the current fixed market basket CPI. In addition, this performance goal and related indicators indirectly relate to the two overall Boskin commission recommendations for BLS to establish a cost-of-living index as its objective and to develop and publish a monthly index and an annual index. If the strategic plan provided more detailed information, it would help inform stakeholders about the frequency (monthly and/or annually) with which the planned alternative index measures will be published and would allow CPI stakeholders to make appropriate linkages to the Boskin commission's recommendations.

We found no linkage between the performance goals and indicators and the eight intermediate and longer-run recommendations of the Boskin commission. To determine

BLS' views on these recommendations, we relied upon a written statement BLS sent to the Chairman of the Joint Economic Committee in June 1997.[10] BLS has provided Congress with its views on the Boskin commission report on several occasions; for example, in addition to the June 1997 statement, it also provided testimony to the Senate Budget Committee in January 1997 and to the House Budget Committee in March 1997. BLS informed us that any Boskin commission recommendation for which linkages cannot be identified in its strategic plan were those that either restate current BLS/CPI policy, are presently in development, or have been explicitly rejected by BLS. Further, BLS said that it had initiated work related to many of the areas covered by the Boskin commission's recommendations prior to the issuance of the commission's report.

BLS told us that both it and the Department of Labor question the usefulness of discussing recommendations contained in particular reports, such as the Boskin commission report, in long-range planning documents, including BLS' strategic plan and fiscal year 1999 annual performance plan. However, given the high degree of interest that Members of Congress, the Federal Reserve, and others who are concerned about the accuracy of the CPI have shown in the Boskin commission's report and recommendations, we believe that a discussion of the relationship of the goals in BLS' performance plan for fiscal year 2000 to the Boskin commission recommendations, or an

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[10]BLS, "Measurement Issues in the Consumer Price Index," paper prepared in response to a letter from Representative Jim Saxton, Chairman of the Joint Economic Committee, June 1997.

explanation of the absence of such relationship, would add to the plan's credibility and usefulness to CPI stakeholders.

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Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other Members of the Subcommittee may have.

CPI-RELATED OBJECTIVES, PERFORMANCE GOALS, AND FISCAL YEAR 1999 PERFORMANCE INDICATORS FOR BLS' STRATEGIC GOAL TO IMPROVE ACCURACY, EFFICIENCY, AND RELEVANCY OF ECONOMIC MEASURES

Performance goal	Fiscal year 1999 performance indicator
Objective: Improve the quality of the Consumer Price Index (CPI)	
Improve the CPI sample design and estimation methodology used for CPI rent and Owner's Equivalent (REQ) estimates.	Use new sample design and estimation methodology for rent and REQ in published CPI.
Update the CPI market basket's Housing sample to reflect current demographic and geographic population characteristics.	Updated Housing sample used in published CPI.
Update the CPI market basket's Commodities and Services sample to reflect current geographic population and expenditure patterns of all goods and services.	Published CPI includes o certain previously unpriced services, o prices collected for new goods and services entering the market place, o quality adjustment for certain goods and services based on supplemental sample of prices and characteristics, and o new item samples based on Telephone Point of Purchase Survey.
Develop alternative measures of change in living costs.	Produce updated superlative indexes in an enhanced research environment utilizing 1997 Consumer Expenditure Survey data.
Expand the Consumer Expenditure Survey sample.	Begin data collection and processing of larger sample.
Test an experimental CPI using geometric means.	Incorporate changes into the official CPI.
Objective: Improve service sector coverage in major BLS programs: Consumer Price Index, Producer Price Index, International Price Program, and Productivity.	
Increase the coverage of service industries' price and productivity indexes.	Published CPI includes certain previously unpriced services.

Source: BLS' strategic plan and fiscal year 1999 performance plan.

OUR ANALYSIS OF THE LINKAGE BETWEEN THE BOSKIN COMMISSION'S RECOMMENDATIONS AND BLS' STRATEGIC PLAN FOR FISCAL YEARS 1998 THROUGH 2002

Boskin commission's recommendation	BLS' performance goal	Performance indicator, by the end of fiscal year		
		1998	1999	2002[a]
General/overall				
1. BLS should establish a cost-of-living index as its objective in measuring consumer prices.	[b]	[b]	[b]	[b]
2. BLS should develop and publish two indexes–one published monthly and the other published and updated annually and revised historically.	[b]	[b]	[b]	[b]
Short run–recommendations that the commission thought could be implemented immediately, with little additional resources or new data collection initiatives.				
3. The timely monthly index should continue to be called the CPI and should move toward a cost-of-living concept by adopting a "superlative" index formula to account for changing market baskets, abandoning the pretense of sustaining the Laspeyres formula.	Develop alternative measures of change in living costs.	Begin research on design issues. Produce updated superlative indexes utilizing 1996 Consumer Expenditure Survey data.	Produce updated superlative indexes in an enhanced research environment utilizing 1997 Consumer Expenditure Survey data.	Publish production quality superlative indexes to supplement the official CPI.
	Expand the Consumer Expenditure Survey sample.[c]	Prepare for sampling; hire and train interviewers.	Begin data collection and processing of larger sample.	[d]
4. BLS should move to geometric means at the elementary aggregates level.	Test an experimental CPI using geometric means.	Determine which CPI basic indexes are best calculated with the geometric means formula.	Incorporate changes into the official CPI.	[d]

Boskin commission's recommendation	BLS' performance goal	Performance indicator, by the end of fiscal year		
		1998	1999	2002[c]
BLS should greatly expand the use of hedonic regression techniques to deal with quality change."	Update the CPI market basket's Commodities and Services sample to reflect current geographic population and expenditure patterns of all goods and services.	[f]	Prices collected for new goods and services entering the market place. Quality adjustment for certain goods and services based on supplemental sample of prices and characteristics.	[d]
Intermediate run–reforms that the commission said are feasible within the current state-of-the-art but that would require new data collection, reorganization of activities, and changes in the detail of the various sub-indexes produced by the CPI				
5. BLS should study the behavior of the individual components of the index to ascertain which components provide most information on the future longer-term movements in the index and which items have fluctuations that are largely unrelated to the total and emphasize the former in its data collection activities.	[f]	[f]	[f]	[f]
6. BLS should change the CPI sampling procedures to de-emphasize geography, starting first with sampling the universe of commodities to be priced and then deciding, commodity by commodity, what is the most efficient way to collect a representative sample of prices from which outlets, and only later turn to geographically clustered samples for the economy of data collection.	[f]	[f]	[f]	[f]
7. BLS should investigate the impact of classification, that is item group definition, on the price indexes, to improve the ability of the index to fully capture item substitution.	[f]	[f]	[f]	[f]

Boskin commission's recommendation	BLS' performance goal	Performance indicator, by the end of fiscal year		
		1998	1999	2002[a]
8. There are a number of additional conceptual issues that require attention. The price of durables, such as cars, should be converted to a price of annual services, along the same lines as the current treatment of the price of owner-occupied housing. Also, the treatment of "insurance" should move to an ex-ante consumer price measure rather than the currently used ex-post insurance profits based measure.	[f]	[f]	[f]	[f]
9. BLS needs a more permanent mechanism for bringing outside information, expertise, and research results to it.	[f]	[f]	[f]	[f]
Longer run--recommendations the commission identified as emphasizing topics and areas that need additional research and attention.				
10. BLS should develop a research program to look beyond its current "market basket" framework for the CPI.	[f]	[f]	[f]	[f]
11. BLS should investigate the ramifications of the embedded assumption of price equilibrium.	[f]	[f]	[f]	[f]
12. BLS should develop a number of new data collection initiatives to make some progress along these lines.	[f]	[f]	[f]	[f]

Note: The strategic plan includes additional agency performance goals and performance indicators, such as those related to the 1998 major revision of the CPI, which are excluded from this table because they cannot be directly linked with the stated Boskin commission recommendations. For a detailed response by BLS to the Boskin commission's recommendations, see "Measurement Issues in the Consumer Price Index," a paper prepared in response to a letter from Representative Jim Saxton, Chairman of the Joint Economic Committee, June 1997.

[a]For the agency performance goals listed, there were no performance indicators listed for fiscal years 2000 and 2001.

[b]To the extent that BLS addressed the short-run recommendations, we view these general/overall recommendations as having an indirect linkage to BLS' performance goals and performance indicators.

[c]As part of its fiscal year 1998 budget enhancements proposal, BLS stated that an expanded Consumer Expenditure Survey would permit the CPI program to produce a superlative form index. We therefore linked this goal to the third recommendation. It could also be linked to a Boskin recommendation that was addressed to Congress--"Congress should provide the additional resources necessary to expand the CES sample and the detail collected, to make the POPS survey more frequent, and to acquire additional commodity detail from alternative national sources, such as industry surveys and scanner data."

[d]According to BLS officials, BLS expects to complete its milestones for the performance goal before fiscal year 2002.

[e]This recommendation was added to the 12 stated recommendations because, according to commission members, "...we should have listed it as a numbered explicit recommendation in the last section, since at least one eminent scholar in the field interpreted its exclusion as a downweighting of its significance. We meant the opposite--it was so obvious (to us) as not to even require repetition as an explicit formal recommendation." (See Michael J. Boskin et al., "Consumer Prices, the Consumer Price Index, and the Cost of Living," Journal of Economic Perspectives, Vol. 12, No. 1, Winter 1998, ft. no. 11, p. 14.) We also classified it among the short-run recommendations since BLS has incorporated it in its strategic plan for fiscal year 1999.

[f]No linkage was found between the Boskin recommendation and BLS' performance goals and indicators.

Source: BLS and Toward a More Accurate Measure of the Cost of Living, Final Report to the Senate Finance Committee from the Advisory Commission to Study the Consumer Price Index, December 4, 1996.

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Mr. SHAYS. Thank you very much. You know, I was thinking, as we've gone through, what I'd like to do before any of us start our questions is, Dr. Abraham, if you want to just comment on what you've heard, I'd be happy to give you that opportunity. I noticed you were taking notes and if there's anything you want to make a comment on and then we'll start our questioning. You don't have to but if there's anything?

Ms. ABRAHAM. I, perhaps, might thank all three of the other witnesses for the kind things they had to say about the work of the BLS, which I greatly appreciated. Why don't I, perhaps, leave it at that. There were some things that were brought up concerning areas in the——

Mr. SHAYS. I just wanted to give you the chance if you wanted——

Ms. ABRAHAM [continuing]. Boskin report that we hadn't yet publicly made commitments on and comments about our strategic plan, but rather than my commenting, perhaps I could——

Mr. SHAYS. OK, why don't we just start with the questioning, and I will start out, so we'll start the clock. We're going to do it one, 5 minutes, and if you'd just check your watch to make sure this thing is accurate because it seems to be, and then tip it over one time and we'll do 10 minutes and then go through.

First off, what I learned from the last hearing is as much as I may have some questions about the accuracy of the CPI, I felt fairly convinced after the hearing, not just from listening to BLS but from others, that a legislative solution would not be productive. In other words, just arbitrarily deciding what we want it to be would not be productive. And what I was also left with was, one, that BLS has some work cut out for itself, and also that we need to make sure that we are providing the resources to have that done.

So the first question I want to ask is, are you asking for the resources you need, and is the administration supporting you in that effort, and is Congress supporting you? And so I'll start with you Dr. Abraham.

Ms. ABRAHAM. Taking those three in turn, as part of the CPI improvement initiative, which we first proposed last year and have asked for a second installment of funding for fiscal year 1999, we have asked for resources to support, as I think I may have indicated in my opening statement, everything that we know how to do at this time to improve the CPI. The administration has been very supportive of our resource requests. The Congress supported us last year and I hope will support us this year.

Mr. SHAYS. Just so it doesn't get lost, I want to make sure that you contact this committee if you don't feel that that is happening in terms of Congress' response. The request has been made and you're satisfied with the request the administration has made for your budget?

Ms. ABRAHAM. Yes.

Mr. SHAYS. And I just need to make sure you stay in touch with the committee. I just wanted to make sure that's part of the record. I make an assumption that when the effect of the CPI is on both spending and the lasting image from my budget committee days has been that it affects 60 percent of spending and 40 percent revenue. Is that something you would be able to respond to, or should

I ask? So it's not just—in other words, a lowering of the CPI, for whatever reason, would reduce Government spending. And 60 percent of the impact is on spending and 40 percent is on increased taxes because we don't change the index for the tax rate so you don't arbitrarily go into the next tax rate. Is anyone prepared to tell me if that's accurate or not?

Ms. ABRAHAM. That's not something I can address. Clearly, slowing the rate of growth of the CPI would impact both but we don't——

Mr. SHAYS. You don't know the—OK.

Ms. ABRAHAM [continuing]. Produce estimates of the magnitude. The Congressional Budget Office——

Mr. SHAYS. OK.

Ms. ABRAHAM [continuing]. Has looked at that.

Mr. SHAYS. Yes, sir?

Mr. GORDON. There are figures on that in the commission report. It looks to me it's more like 35 percent on revenues, about 50 percent expenditures and the rest of it comes on reduced debt service, reduced interest.

Mr. SHAYS. OK, interesting.

Mr. GORDON. So I would say, it's 50, 35, and 15 is about right.

Mr. SHAYS. Great. I didn't even think of it in terms of debt service. In terms of your presentation, when you talk of the currency, you're talking of timeliness of the data?

Ms. ABRAHAM. I'm talking about the period of time to which the market basket that we're using to construct weights for the index applies.

Mr. SHAYS. We changed the bread basket, it was in the 1980's and you brought it up to the 1990's somewhat, 1993 to 1995.

Ms. ABRAHAM. 1993 to 1995.

Mr. SHAYS. What is the intention of BLS in terms of how often that bread basket gets changed?

Ms. ABRAHAM. We have not, at this point, made a specific determination. We have said that we will do it more often than every 10 years. I would guess that the most likely frequency of updating would probably be every 5 years, but we've not made a specific decision on that.

Mr. SHAYS. The recommendation of GAO, is that it be more like 5 years instead of every 10 years, is that correct?

Mr. UNGAR. Mr. Chairman, we said more frequently. We didn't have a specific number in mind. I believe the research isn't very definitive there. Many people believe that 5 years would be appropriate, but the data aren't really conclusive on this point.

Mr. SHAYS. When I refer to the bread basket, I do mean the market basket.

Mr. UNGAR. Right.

Mr. SHAYS. I saw some confused faces. I'd like all of you to respond to it because for me it seems like a "no-brainer." I guess because I don't know the extent to which it involves—I mean, to me it seems fairly simple. You just continually want to update that market basket.

Ms. ABRAHAM. If I could and then——

Mr. SHAYS. Yes.

Ms. ABRAHAM. I don't think it is actually a "no-brainer" that you would want to do it continuously. There are those who have suggested that perhaps you might want to update the market basket as frequently as every year. But there is research that suggests that doing that within the context of the kind of measure we currently produce might itself introduce an upward bias in the index, so it's not quite so simple as it might appear.

Mr. SHAYS. Let's hear from others as well, thank you.

Mr. GRAMLICH. Yes, in a way the notion of having the superlative index that has automatically adjustable weights might be a very sensible approach. If there were a procedure for automatically updating the weights in line with changes in spending patterns, or substitution, then the importance of going to surveys in shorter intervals is reduced.

Mr. SHAYS. Anybody else want to respond to that?

Mr. GORDON. There's a mention in the GAO statement of the fact that all the other G–7 countries update their weights more frequently than the United States has done so in the past. A typical pattern is Japan, where they update the weights every 5 years, and by January 1997, it already introduced 1995 weights.

Mr. SHAYS. You use a word that intuitively, I guess, what you're saying is it's not just what goes in the market basket, but how you weight it within the market basket?

Mr. GRAMLICH. Yes, it's what percentage is on home heating and how much——

Mr. SHAYS. I understand.

Mr. GRAMLICH [continuing]. Is on shelter. A minor issue is whether you would want to use a single year's weight on the most recent year as opposed to the current practice which is to average together 3 years, that is, 1993 to 1995. The only serious problem I can see about using a single year would be that the weather might be unusual and there might be an usually high or low weight or expenditure on home heating fuel but I think that could be handled separately. So, I support the commission's recommendation that there be a regular, annual updating of weights to the most recent year or 2 years for which data are available.

Mr. SHAYS. Now, explain to me why there is a lag period in terms of the data that goes into the formula? In other words, I don't quite understand why there's such a lag?

Ms. ABRAHAM. It is a lag in getting the weights in that we're talking about.

Mr. SHAYS. OK.

Ms. ABRAHAM. The updated weights. And the reason for that lag is that, at present, the size of our consumer expenditure survey sample, the survey we get the weighting information from——

Mr. SHAYS. But that consumer expenditure data is current?

Ms. ABRAHAM. No.

Mr. SHAYS. That's a lag as well?

Ms. ABRAHAM. It's collected quarterly but there is a lag in getting it. We won't, for example, have all of the information that applies to calendar year 1997 in our hands until sometime in the late summer or early fall. The last interviews aren't done until March and then, the Census Bureau processes the information and there is a bit of a lag.

Mr. SHAYS. So, is there about a year's lag in terms of the——

Ms. ABRAHAM. So, there's about a year's lag in us getting it, and then historically there has been a further lag given the nature of our processing systems, in getting it in place.

Mr. SHAYS. OK, so the answer is not, no, it's really, yes. I mean, there's a lag in terms, there's the issue of how you weight and but there's also an issue of the data that actually goes in, so once you have——

Ms. ABRAHAM. Right.

Mr. SHAYS [continuing]. And that's the point. And so you're saying it's about a 2-year lag?

Ms. ABRAHAM. Well, at present, we are getting the data in about 2 years after the most recent data we're using have been collected. But also, given the size of the survey, to ensure a sufficiently high degree of statistical accuracy in the estimates, we're currently using 3 years worth of data which is why, on average, the market basket is 3½ years old at the time we introduce it.

Mr. SHAYS. My time is really running out here, and we'll go around again. But would others comment to this issue?

Mr. GORDON. I think if there were a plan to do regular updates, the computer systems could be designed to simply plug in the new weights.

Ms. ABRAHAM. And we are doing that, we are doing that.

Mr. GORDON. Right, and, so, you know, in Japan they can do it. I'm sure there could be, in principle, some kind redesign of the procedures that would allow——

Ms. ABRAHAM. And that is part——

Mr. SHAYS. No, just let him finish, let him finish. I'll let you respond. I mean, my intention is not to have a big debate but to know the facts when we're done.

Mr. GORDON. So, I think there's agreement here——

Mr. SHAYS. Yes.

Mr. GORDON [continuing]. That it is feasible to do it faster. I don't think there's any clear sense that it makes a huge difference whether you do it every 5 years or every year. I think that's probably one of the least——

Mr. SHAYS. OK.

Mr. GORDON [continuing]. Important of the Boskin Commission——

Mr. SHAYS. Yes, what I want to make sure is in the end when we're done, when we think we're done, if we've missed the big issue so we need to have you just tell us and then I want to explore this. I don't want to end this hearing and find that we're on the edges of what we think is important.

Mr. Towns, and then we'll go right down through our members and then we'll just go through again.

Mr. TOWNS. Thank you, Mr. Chairman. Let me begin by thanking the witnesses too because this is something, as indicated, we need to really know more about. And I think the chairman sort of hit upon the fact that, are we giving it the kind of support that it really needs in order to be able to do the kind of things that we feel that it should do in terms of resources. And along those lines, I'd like to know if the Department could produce some kind of index on the average family budget, in other words, the average family?

Ms. ABRAHAM. The Bureau of Labor Statistics back nearly 20 years ago now, did have a program called the Family Budget Program that was designed to go out and collect information on actual expenditures by high-income intermediate income, and low-income families. So, in principle, were that something that the Congress were to decide it wished to fund us to do, would be something that we could do.

Mr. TOWNS. OK, fine. But in other words, you stopped it because the Congress would not fund you to do it?

Ms. ABRAHAM. There were——

Mr. TOWNS. Now, let me say, I'm very concerned about this whole thing, and I'm very nervous. You might even detect it in my questions, that as to where we're going here, and I think that's very important to the average family. So did you stop it because of the lack of funds or other reasons?

Ms. ABRAHAM. I should say that this program was discontinued a good long while before I came to the BLS, but my understanding is that it was discontinued because, first, the Bureau experienced large reductions in its budget in the early 1980's and second, because when it came to making choices about which programs would be kept and which programs were to be let go, there were some questions about the conceptual underpinnings of that program.

Mr. TOWNS. Let me ask the other members of the panel. Do you see a need for this?

Mr. GORDON. I would rather have the hypothetical funds for such a program go into a larger sample for the CES which in turn allow more frequent updating because their reason for using these 3 average years of data is the small sample size, so.

Mr. SHAYS. For the record, when you say, CES, it is the consumer expenditure——

Mr. GORDON. Expenditure survey.

Mr. TOWNS. So, I'm sort of detecting that maybe we're not spending enough to get what we're looking for here, you know.

Mr. GORDON. I think that's a reasonable conclusion.

Mr. TOWNS. I mean, I don't want to roll the dice. I don't shoot the crap here.

Mr. GORDON. One thing you should be asking today, I think, is whether the BLS' own plans and requests are ambitious enough because the implication of what I was saying is that there are still recommendations that, to be fair, they can't do everything all at once but they could have a 5- or 10-year plan with a ramping up of expenditure that would sort of set out before Congress in advance so that 5 years from now you could have some of these recommendations already implemented.

Mr. GRAMLICH. If I could enter in on this? This matter has been studied a little bit to the extent that the data are available and, frankly, you don't see enormous differences between the inflation of high and low income families. It may be that as a regular matter whoever made this decision back 20 years ago to discontinue the three or four indices was, that may have been a sensible decision. At the same time, that matter could be studied every now and then. I don't think you'd have to do it more than every 10 years, just to see if you get big differences. Right now those people who have studied the issue, don't seem to get big differences. But that is something that could be checked more carefully if you had—if the BLS, let say, on a one time basis, went back and did these high- and low-income families.

At the same time, I think we should all be mindful of the fact that we are balancing resources. And I have some sympathy with what Bob Gordon just said that there are other high priority issues out there and it may be that this isn't the highest. So it could certainly be on the table.

Mr. UNGAR. Mr. Towns, I'd just like to point out that one of the basic purposes of the Results Act is related to this discussion that we're having now. It's for the agencies to lay out for Congress, and others, what they see as important results they would like to achieve over, in a strategic plan over a 5- or 6-year period, how they're going to get there, what resources they're going to use, and how they're going to measure how they perform. It's to lay this information out as a proposal linked to its budget for the Congress to look at and decide whether it thinks the agency is going in a direction that it would feel comfortable with. If not, then Congress can raise those questions as you are now with the appropriate agency. So I think the Results Act does provide a useful mechanism for this type of discussion and you might want to pursue that at some point.

Mr. TOWNS. Thank you very much. How do you change the demographics that affect the CPI? As the population grows older, should the CPI devote more weight to maybe health care cost and less to shelter or less to something else? We're living longer.

Ms. ABRAHAM. This relates to the questions that Mr. Sanders was bringing up earlier as well. Perhaps I could just describe what the CPI is and then what it isn't. What the CPI is attempting to do is to track the cost of the market basket purchased by the average consumer. So we take all consumer expenditures, we look how those are allocated across categories and, based on those weights, we weight up the price increases in individual components. I think it is a quite legitimate question to ask, whether it would be useful for us to produce indexes for a broader array of groups, CPI's for the elderly, CPI's for people in different income groups. We have done some of that on an experimental basis, and I may not have been understanding your earlier question. We have an experimental CPI for the elderly. We've done some research on looking at CPI's for poor households as opposed to average households. Dr. Gramlich's comment that, at least with respect to the poor, our experimental measure didn't look a lot different than the average measure is correct. But I do want to draw a distinction between what we do and the array of measures that we might potentially produce and decisions that are really policy decisions about how those measures get used, and those are obviously distinct things.

Mr. TOWNS. I understand that the CPI makes certain economic assumptions. I am concerned about the effect of the CPI on the poor. Does the Department have a way to look at the relationship between anti-poverty programs and the CPI? Is there a separate index, inflation, and it's among this population upon which to determine whether certain things are working?

Ms. ABRAHAM. That would really be a policy evaluation exercise that we wouldn't be the agency working on, I think. Evaluating whether an anti-poverty policy is working is not something that we would look at. Others might use our data to look at that but perhaps others could comment on this?

Mr. TOWNS. You know, go ahead, Dr. Gramlich, because I want to come back to you.

Mr. GRAMLICH. Well, I think that Katharine just answered the question. Frankly, I wasn't, aware that the BLS had an experimental index on low-income consumers but that certainly gets close. You could certainly do that on a more extensive basis. You know, you could have poverty level consumers——

Mr. TOWNS. Yes.

Mr. GRAMLICH [continuing]. Which would be a little different from low-income consumers. But I repeat that to the extent people have done this kind of work they haven't observed large differences in the rate of inflation.

Mr. TOWNS. Could you tell me about some other studies where it's actually happened?

Mr. GRAMLICH. I can't sitting right here.

Mr. TOWNS. Right.

Mr. GRAMLICH. We'll, we could——

Mr. TOWNS. I'm not trying to, I'm really trying to educate myself.

Mr. GRAMLICH. We can supply you with what we have and I hope BLS will as well.

Mr. TOWNS. It's not a test. I'm not giving you a test. [Laughter.] Really, I'm trying to get some information for myself because this is. Who knows we might have to make a decision here. I need to have as much information as I possibly can to—yes? You want to comment on that too?

Mr. GORDON. I was only going to mention that the studies of the cost of living of the elderly have generally concluded that the only real factor that causes inflation that's different for the elderly is prescription drugs and medical care. Those conclusions are, therefore, sensitive to the research of a number of people in the last 5 years that have identified substantial overstatement of the cost of prescription drugs in the CPI by getting the actual original data from drug companies.

Mr. SANDERS. Can I just jump in?

Mr. GORDON. Sure.

Mr. SANDERS. Without arguing, without arguing your point what about the fact that senior citizens are much more dependent upon prescription drugs than younger people? Isn't that really the issue? That seniors spend a far higher percentage of their income on prescription drugs than the average person?

Mr. GORDON. That only matters if the rate of inflation for prescription drugs is dramatically different than the rate of inflation for everything else.

Mr. SANDERS. You're going to deny that? You're really, are you going to tell us now that prescription drug rates are not going up substantially higher than general inflation? Are you going to be the only person in America to make that claim? I'd love to hear it, I mean, that's so clearly untrue. But I'd like, if that's what you think.

Mr. GORDON. It depends what medical plan they're in.

Mr. SANDERS. Are you going to tell me here, in your judgment, the prescription drug rates are not going up higher than general inflation?

Mr. GORDON. That involves a question of what the consumer is actually paying. The CPI concept of medical care prices, I believe, is out of pocket expense by the consumer.

Mr. SANDERS. No. I am asking you——

Mr. SHAYS. Let me just interrupt the gentleman a second and just say, the gentleman's time, no, you're on, you get 10 minutes.

Mr. TOWNS. It's your time.

Mr. SANDERS. Oh, I thought I was using his time, it's not fair. [Laughter.]

Mr. SHAYS. No, no your time had run out, sir, but given that you are the ranking member, you can have as much as you want. Then what we're going to do is we're going to start the clock. He's a pussy cat so don't be intimidated by him. The bottom line is that the gentleman from Vermont has 5 minutes rolled over, another 5.

Mr. SANDERS. Thank you, Mr. Chairman. Mr. Chairman, I'd like to submit for the record an article in the Washington Post by Dean Baker who is an economist with Economic Policy Institute, Friday, October 6, 1995, and I would like to quote from that for a start, quote. He's talking about the Boskin Commission.

> While this commission was composed of distinguished economists, its conclusion should be viewed skeptically. First, there was absolutely no effort to create a balanced commission. All five members have previously testified that they believe the CPI substantially overstated inflation. Economists who had given contrary testimony to the committee, such as former Bureau of Labor Statistics commissioner, Janet Norwood, were excluded.

So I, for one—end of quote—I, for one, take with a grain of salt the conclusion of the Boskin Commission. I think we should not be separating what's going on, and I don't mean to say you, Mr. Chairman, but this attack on the cost of living increase from everything that's going on in this Congress, cuts in Medicare, cuts in Medicaid, cuts in programs for low-income people, tax breaks for the rich. I think, Mr. Gramlich, you worked for Alan Greenspan, is that correct? Mr. Greenspan is the——

[The information referred to follows:]

Washington Post

FRIDAY, OCTOBER 6, 1995

Dean Baker

Back-Door Attack on Social Security

In the drive to balance the budget, everyone from Newt Gingrich to Bill Clinton has repeatedly assured the public that Social Security cuts and tax increases were off the table. Two op-ed columns paired in The Post on Sept. 26—Daniel Patrick Moynihan's "The CPI: An Easy Fix . . ." and James K. Glassman's ". . . And an Ace in the Hole"—represent a determined effort to make Social Security cuts and tax increases central goals.

These columns do not directly propose cuts in benefits or tax increases. Rather, they hide behind the dubious technical argument that the consumer price index (CPI) overstates inflation. Therefore, benefits and tax brackets should be adjusted downward to take account this overstatement. This claim stems most mediately from a report issued by a commission appointed by the Senate Finance Committee to investigate the question.

While this commission was composed of distinguished economists, its conclusions should be viewed skeptically. First, there was absolutely no effort to create a balanced commission. All five members had previously testified that they believed the CPI substantially overstated inflation. Economists who had given contrary testimony to the committee, such as former Bureau of Labor Statistics (BLS) commissioner Janet Norwood, were excluded.

Second, the commission did not have adequate time to research the issue thoroughly. It

Taking Exception

was appointed in July and issued its interim report on Sept. 15. It did not try to do any original research during this brief period. Much additional research is needed to reach any conclusive judgments about any bias in the CPI. While many economists have been quick to claim that the CPI overstates inflation, this judgment is based on little actual research—a central point of the testimony of commissioner Zvi Griliches of Harvard.

Third, the commission had difficulty even summarizing the state of the existing research on the CPI. For example, one question raised is whether groups such as the elderly experience different rates of inflation from the population as a whole. The report cited an article co-authored by Dale Jorgenson, another Harvard member of the commission, to argue that they don't. In fact, Jorgenson's article explicitly states the opposite.

The report even includes significant arithmetic errors. It cites BLS research to claim that the bias in the CPI resulting from its failure to note consumers' substitution away from goods with rapidly rising prices is 0.3 percent to 0.4 percent annually. In fact, the BLS research shows this bias has averaged just over 0.1 percent for the past three years. According to the Congressional Budget Office, if policy were based on an arithmetic error of this magnitude, it would result in $63 billion in excess benefit cuts and taxes over 10 years.

In addition, the commission made no serious effort to examine any of the possible sources of understatement in the CPI. For example, the CPI would show no increase in insurance costs if premiums were to rise because the government mandated that insurers cover everyone, regardless of their health. The commission also made no effort to examine areas in which there is reason to believe the CPI has failed to pick up a deterioration in the quality of goods or services.

In short, the commission's report can hardly be taken as a conclusive judgment on the accuracy of the CPI. It would appear to be a politically driven document designed to provide a cover for politicians who want to cut Social Security and raise taxes without voting for it. If Congress is concerned about inaccuracies in the CPI, then it should instruct the BLS to do a thorough examination of all the sources of bias in the index, both high and low, and appropriate the funding needed to carry through the research. It should not be interfering with the independence of statistical agencies to get politically convenient numbers.

Actually, there is an irony in the use of the commission's findings as a justification for cutting Social Security. The reason we are supposed to be cutting the deficit is to help our children and grandchildren. If the commission's report is correct, then average real (inflation-adjusted) wages have been growing far more rapidly than we thought. They should double in approximately 35 years. The average annual wage in the year 2030 would be approximately $50,000 in today's dollars. The median household income for a family over 65 is now about $20,000. Based on the findings of this commission, Sen. Moynihan wants to cut Social Security benefits for elderly households with incomes of $20,000 in order to increase wages for people earning an average of $50,000. It is hard to see the generational equity in such an "easy fix."

The writer is an economist at the Economic Policy Institute. He is the author of the EPI report "Revising the Consumer Price Index: Correcting Bias or Biased Corrections?"

Mr. GRAMLICH. I am a Governor of the Federal Reserve. [Laughter.]

Mr. SHAYS. That's like saying——

Mr. GRAMLICH. He is another Governor.

Mr. SANDERS. He's another Governor, OK.

Mr. SHAYS. That's like saying, Mr. Sanders, that you work for me, just because I'm chairman. [Laughter.]

I don't think so.

Mr. SANDERS. And Mr. Greenspan has been going around the country for years telling us how we have to cut back on the cost of living for seniors for so forth and so on. Let me ask, Dr. Abraham a question, if I might. Dr. Abraham, my understanding is that a study conducted over several years by Nathan Amble, I may be pronouncing it wrong, Nathan Amble, and Ken Stewart of the BLS Division of Consumer Prices and Price Indexes found that since senior citizens spend disproportionately on health care and other goods with higher inflation rates, the CPI we use may actually be too low for senior citizens, not too high. Could you comment on that, on any other studies that you know that would indicate, in fact, that the CPI might be too low for senior citizens?

Ms. ABRAHAM. The study that you're referring to is a description of the experimental CPI for the elderly that I already mentioned. What the study concluded, what the calculation of this measure shows, is that if over a period of years you take the data that we collect for producing the regular CPI and reweight it in accord with how elderly consumers spend their dollars, because of the higher weight of medical care and prescription drugs the measure tended to go up a bit faster, three or four tenths of a percentage point per year faster than the overall CPI. But I have to say two things about that. First, we didn't, in putting this measure together, have the resources to go out and figure out where these individuals were actually shopping and what they were actually buying in the stores that they frequented. We just reweighted the data that we already had. So that may be an issue.

And, second, as Bob Gordon has already noted, the reason for the difference in the overall index is because of the higher weight on medical care and prescription drugs for those folks and there are serious questions about our ability to appropriately adjust for changes in the quality of medical care, and perhaps, prescription drugs as well. So that how you view those results depends on what you think about that matter.

Mr. SANDERS. I understand what you're saying and I would be the first to agree that the task that you are being given is a very difficult one. I mean, it really is. My purchasing patterns are different than your's and different than a 90-year-old person living in a 20-below-zero climate, correct? But let me get back to the point that you made. Would you agree with me that, in general, for senior citizens, they are more dependent on health care and prescription drugs than the average person?

Ms. ABRAHAM. Yes, the data that we have shows they spend a higher share of their consumer dollars on those things.

Mr. SANDERS. And would you agree, perhaps, unlike the gentleman there who's name, unfortunately his name, now it's on backward, let's see if it works here, all right, Dr. Gordon, that the statistics are pretty clear that prescription drug costs are going up a lot faster than general inflation?

Ms. ABRAHAM. If you look at our measures over the past 10 years or so, on average medical care as a whole, and I'm afraid I don't know off the top of my head about prescription drugs specifically, has gone up at a faster rate than overall inflation as captured by our measures. And the question is whether you agree that the way we're constructing those measures is appropriate and I have to acknowledge that appropriately adjusting for changes in quality in that area is particularly difficult.

Mr. SANDERS. It's a difficult issue. I kind of think that in the real world, I mean this is honestly, people, the senior citizens of Vermont, you talk about MediGap going up 30 percent this year in my own State. Prescription drugs going up higher. People do not have the slightest doubt that their health care costs are going up a lot faster than inflation.

My question, and I think you touched on this, we understand that the CPI affects a whole cross-section of our population, and I think we can agree from a commonsense point of view we don't want 50 different categories, right? If you're 23 years old and living in Los Angeles and 80 years old living in Vermont, you know, it would drive us all crazy. But on the other hand, why aren't we not looking more seriously at a CPI for seniors who are on social security and take a look at their costs as opposed to a lot of younger people whose inflationary needs may be lower than seniors?

Ms. ABRAHAM. This question has come up in the Congress a number of times. Back in the late 1980's there was congressional interest in the possibility of the Bureau of Labor Statistics producing an official CPI for the elderly and there was an exercise carried out to look at the issues we confront and try to come up with some estimates of the cost of doing that, and in the end there was no decision by Congress to provide the resources to pursue that.

Mr. SANDERS. How much would something like that cost, you guess, I know it's——

Ms. ABRAHAM. I would guess that it would cost at least as much as producing the CPI itself. It would be that kind of ballpark figure because you'd have to go out and collect for the elderly information on prices in the stores where they shop of the items they purchase. So you'd really be talking about duplicating what we do now for the overall population. There would be a little overlap in the sample because we do have elderly folks included but the extra cost would be substantial.

Mr. SANDERS. No, I recognize, as we've all heard, Mr. Chairman, as you have said, the CPI affects a lot more than senior citizens but we have how many Social Security recipients in this country, does anybody know offhand?

Ms. ABRAHAM. Forty million.

Mr. SANDERS. Forty million folks. I kind of think when 45 million people are going to be effected by the decisions that you are contemplating right now, I think that the amount of money that it would take to come up with a good and fair study is well worth it, is well worth it. Is that something that you would like the Congress to do?

Ms. ABRAHAM. My concern here is what technically it would be feasible for us to do if requested. And I think there would be a lot of difficult issues associated with trying to figure out how to do this right.

Mr. SANDERS. Whoa, whoa, whoa, 1 second. Everything that we're talking about is difficult.

Ms. ABRAHAM. Right.

Mr. SANDERS. But you will agree with me, and I trust everybody will agree with me, that we want the best statistics that we can get. What we all know, and common sense dictates, and you tell me if you disagree with me, that a young person in a warm climate, or forget the warm climate, a 20-year-old has different purchasing needs than an 80-year-old person, right?

Ms. ABRAHAM. The purchasing patterns clearly are different.

Mr. SANDERS. So it would seem to me elementary that we would want to, if 40 million people are receiving Social Security, and by the way it's half of the folks have incomes, I believe, under $15,000 a year, so this is important whether they get that extra $200 or not, OK? I don't, and to say that it would be difficult, I'm sure that it would be difficult but that's what you and your agency are paid to do. Why—you could do it, I mean, you're not suggesting to us that you can't?

Ms. ABRAHAM. I can tell you what specific thing I think would be difficult and I don't know quite how we'd deal with it. The way that we put the index together now when we go into stores, we're trying to pick items that are representative of what people buy in those stores and I don't know how we'd figure out if we went into a store which items the older people are buying as compared to what the average——

Mr. SANDERS. Why can't you figure that out? I mean, that's what you would be asked, senior citizens have, so you have to study that. That's what we would be asking you to do. Senior citizens do not usually buy $5,000 computers, right? At least in my State they don't. Senior citizens would not buy too many, you know, rock and roll records and so forth. They don't have records any more, discs, you know, and so forth. But senior citizens do buy prescription drugs and they do have to heat their homes warmer than other people. You could do that. I mean, it's not, sure, it would be a challenge. But if you can't do that then what the heck do we have the Bureau of Labor Statistics for? That's what your job is, isn't it?

Ms. ABRAHAM. Well, we could certainly work on it. I do want to say again, that I think there is a distinction between what from a policy perspective is the right thing to be doing and what kind of information we're——

Mr. SANDERS. But I'm not talking about policy. I'm talking about getting the chairman, I think misunderstood me before in the sense that I am not saying raise the CPI because you have a lot of low-income senior citizens. That is not what I'm saying. That is a policy decision that we should debate. I agree with you, what you want these folks to do is give us the facts right? And I agree and then we will go with the facts. But I'm suggesting to you, and I don't think you're strenuously disagreeing that the facts for senior citizens may be different than they are for other people in the population?

Ms. ABRAHAM. Put that way, I can't disagree.

Mr. SANDERS. All right. And it should be studied. When you have 40 million people who are dependent, many of them lower-income seniors. Now, my other question, having said that, Mr. Chairman, I hope you will work with me to see if we can move in that direction, is what kind of political pressure is being put on you to drive down the CPI? When you read in the papers every day that Mr. Greenspan is talking the need to lower this, when you're talking about people saying Social Security is going broke despite the fact it's going to pay out all of its payments for the next 33 years, do you feel the pressure that you're going to have to come in with results that are close to the Boskin Commission?

Ms. ABRAHAM. No.

Mr. GORDON. I agree, there's no reason for, that——

Mr. SHAYS. And I—if the gentleman will yield?

Mr. SANDERS. Yes.

Mr. SHAYS. Based on our hearings last year, I really felt comfortable that there wasn't pressure on BLS and I felt that Dr. Abraham was up to the task of resisting the pressure, frankly.

Mr. GRAMLICH. Could I comment on that?

Mr. SANDERS. Please.

Mr. GRAMLICH. I have the complete list of the chairman's testimony on this and the last one I have is January 30, 1997, and so I don't think that he is talking a lot about this issue, at least recently.

Mr. SANDERS. I would respectfully disagree. You may have a statement that he made but would you disagree that Mr. Greenspan has on numerous occasions talked about his belief that the CPI should be lowered?

Mr. GRAMLICH. I think his statement is that the index ought to be made as correct as possible, just what everybody up here is saying.

Mr. SANDERS. I think he has made, unless I'm very mistaken, and I don't think I am, I think he has made it very clear that he expects, in making it correct, that it will be lower and that it can save the Government substantial sums of money.

Mr. SHAYS. If I could claim the committee's time and just, we're going to go through another round here. I do want to say since I characterized last year, I would also say that I think there was consensus on the part of both Mr. Towns and myself that we need to make sure you were being provided the resources to be more aggressive in looking at some very legitimate issues that were being raised about how we deal with substitution and so on. But we felt that it needed to be done in the context of your agency, in your Bureau, rather than in the context of Mr. Towns or I recommending to Congress that we should just arbitrarily change the CPI, is that fair?

Mr. GRAMLICH. Yes, that's correct.

Mr. SHAYS. If I could—do you want to make one last comment?

Mr. SANDERS. Yes, just for the record let me quote New York Times, May 3, 1997, second paragraph, "Some of the Nation's most powerful figures, including Alan Greenspan, Chairman of the Federal Reserve, had embraced the view that the index overstates inflation by more than a percentage point." Would you like to comment on that Dr. Gramlich?

Mr. GRAMLICH. Sure, that was based on analysis of the index. I mean, just the same kind of thing the Boskin Commission did. It didn't reflect any ideas about cutting the budget, it just reflected a statement that this is how he, what he and staff at the Federal Reserve felt the bias was.

Mr. SANDERS. In other words, all that I'm saying, that's what I said. That he has been public in saying that he thought that the CPI was too high and that it should, and that he thought it was too high, and that it should eventually be cut.

Mr. GRAMLICH. In perfect agreement with the Boskin Commission——

Mr. SANDERS. Yes.

Mr. GRAMLICH [continuing]. That had studied this, and is not really dissented from by the BLS.

Mr. SHAYS. Would the gentleman mind me just asking Dr. Abraham——

Ms. ABRAHAM. No, just on that point, I do want to be clear that this 1.1 percent, or 1 percent, or whatever, is not a figure that the Bureau of Labor Statistics has endorsed. I personally am skeptical, I have to say, of any quantitative estimate of bias in the CPI, mainly because the evidence in so many of the areas is, in my opinion, sketchy. So we sort of agreed to disagree on that. But what we are trying to do is work in every way we can to make technical improvements in the measure, whether those raise the measure or lower the measure. And I feel that's been respected and understood and we've been left alone to do that.

Mr. SANDERS. Can I get 14 seconds?

Mr. SHAYS. You can, and then I'm going to make a comment and give it to Mr. Kucinich.

Mr. SANDERS. OK. Dr. Abraham, would you comment on what Dean Baker said that "all five members of the Boskin Commission have previously testified that they believe the CPI substantially overstated inflation?" In other words, was that a balanced commission or was that already a stacked deck?

Ms. ABRAHAM. Well, I think you would have to say that every one of the people on the Boskin Commission was a well-respected, if not, distinguished economist. So I'm certainly not going to criticize——

Mr. SANDERS. Not a problem——

Ms. ABRAHAM [continuing]. The Boskin group on the basis of their credentials.

Mr. SANDERS. Thank you.

Mr. SHAYS. And for the record, I would make an assumption, but I guess I want to ask. Dr. Greenspan wouldn't be calling you up and asking you to lower the—[laughter]—and I mean this seriously, would not be asking you to change the index either up or down. Is that a correct assumption?

Ms. ABRAHAM. Yes.

Mr. SHAYS. But this is an important issue and we're going to pursue it. I mean the whole concept. And I'm really happy that the members are patient. Yes, sir, and then?

Mr. GORDON. I wanted to make a couple of comments on the general line of questioning. First of all, you don't necessarily have to index Social Security by the CPI. Several of our commission members actually have suggested in public that a more appropriate measure for indexation would be wages so that the income of the retired kept pace with the income of the working people. What index of wages and whether that's a correct measure is a whole different issue. That might be a more useful way to go than spending all the money to do a separate CPI for the elderly.

Everybody agrees that the main reason why inflation for the elderly might differ has to do with medical care inflation and inflation of prescription drugs. As a matter of fact, there has been a huge change in this country over the last 6 years from a time in 1992, when medical care inflation was running 3 whole percentage points faster than overall inflation to 1997, when general inflation and medical care inflation had converged to the same low rate. So you would get a different answer to this question about inflation for the elderly depending on what point in time you looked at it.

Mr. SHAYS. Mr. Kucinich, you are a very gracious man, and very patient, but you knew that you would have your time and some.

Mr. KUCINICH. No one's heard my questions yet, so.

Mr. SHAYS. OK, you have the floor.

Mr. KUCINICH. Thank you very much, Mr. Chairman, for your kindness for holding these hearings. So much of this discussion appears to be very clinical and oh so apolitical. For a moment I would think that we were transported in time and space and we weren't in Washington, DC. [Laughter.]

That I was in some rarified Ivy League tower having some dispassionate discussion about the mating habits of the tsetse fly. I mean, let's get real here. Social Security is a big issue right now. There's speculation, there are some people who want to privatize it. There are others who will say that it's going to run out of money in the year 2029, or have 75 percent of its capability. It would seem to me perfectly logical, given the hysteria that's been raised, that some mysterious process would be at work to get the CPI lowered so you don't have to pay out as much. I mean, wow, big surprise but we're in Washington, things like that could never happen. I mean there's, I mean, we need to puncture this unreality that comes up here, Mr. Chairman. Frankly, with all due respect, I assume that you're all fine public servants and I thank you, and I want that noted in the record. But really to come here in front of this committee, at least in front me, I believe I have a different view of the way the world works, I have to tell you something. It's not real for you to tell us that this is all divorced from politics. Now, I mean, please, you know, please.

The thing that I'm wondering, you know, I've been looking at this, there's a formula here somewhere, OK. This is the formula, you have a, the old formula was an arithmetic mean and the new formula is a geometric mean. I'm sure all of you are familiar with that, right? I have, I've been looking at this and listening to this real hard, and because the real issue in this country is how the wealth is redistributed, and I'm going to get into a few questions about the impact of that on your deliberations. But, let's see, the, here it is, I've got the old formula for the redistribution of wealth is you have a certain amount of wealth and if the system works right you have a little more wealth. That's the old formula. [Laughter.]

Now, the new formula, given the CPI changes with your geometric mean means that wealth accelerates quickly to the top so you have a little bit of wealth and you have even greater wealth. So my question to you is this. I listened to your testimony. It seems to me you haven't quite analyzed the impact of the substitution effect of outlet, substitution effect and the quality effect as a responsive mechanism in the redistribution of the wealth. And since you haven't really done that, how could you be sure that a downward revision of the CPI would not have a direct result of redistributing the wealth even further? Any one want to try that? That's this formula.

Mr. GORDON. If we were in a different room, in a different committee, on a different topic, I would tell you that I agree with both of you two gentlemen. We do not tax the rich nearly enough and the Michael Eisners, the Michael Jordans of the world would still be doing exactly the same thing they are doing today if you added a marginal tax rate at the top of 50 or 60 percent instead of 39. But that's not what we're here to talk about. We're here to talk about the most accurate possible measure of the cost of living.

Mr. KUCINICH. That's what you're here to talk about.

Mr. SHAYS. No, you're free to talk about whatever you want but this hearing is about the accuracy of the CPI.

Mr. KUCINICH. But, please, I have a great respect for the Chair, but I just want to make sure that I understand what, and you're talking about it very well, thank you, I will assert that and give the gentleman his due, you're talking about it very well. But what I'm stating is, permit me the liberty, as a Member of Congress, to shift the context if I might because there is a larger context here. There is, when the stock market goes above 9,000, there's wealth that's being redistributed upward and I'm happy for my constituents who are part of that. But I also recognize there's some who aren't. So you draw up your presumption, your modeling is based on certain economic conditions, market baskets, et cetera.

My question to you is where do you take into account the climate where wealth is being accelerated to the top much more quickly and there's greater disparity between the rich and the poor, so much so we know you change the CPI, it impacts on the middle class. We know that. And so if you're going to do that, and you're not doing it in response to these questions, do you even think about those things?

Ms. ABRAHAM. No, we don't, and I believe we shouldn't. Our goal is to produce the most accurate measure we possibly can. How people use that, what decisions you as policymakers make about how that measure is, or isn't, going to be used are really not questions we appropriately could address. And I think that if we were to start getting into those kinds of questions you would quite appropriately have concern about our objectivity.

Mr. KUCINICH. I'm glad, I'm glad you clarified that because when I go back to senior citizens in my district who are concerned that a downward revision in the CPI will result in lower Social Security checks and them not being able to keep up with the cost of living, I have to tell them that this is just all, you know, a mathematical model they're using. And what I'm telling you is that you have really confirmed for me the importance of Congress looking at the implications of your purely mathematical calculations because if, you know, I note that you're taking——

Ms. ABRAHAM. That sounds right.

Mr. KUCINICH. Right, I understand that, I note that you're taking computers and modems and other things into some of the calculations. Well, you know, I can appreciate all that but at the same time I started off my remarks, Mr. Chairman, by talking about the human context here, and the human dimension and while I can appreciate the technical expertise of everyone sitting in front of me, and I do, I also want it said that you're not divorced from politics and you may try to be and I appreciate your conducting yourself in that way, but you're not because your conclusions are not.

Mr. GORDON. Let me address something that is a legitimate, possible concern, and this has to do with the distribution of income. We all know that the mean is different than the median. As I understand it, the BLS consumer expenditure survey weights these different categories by total expenditure, and that means that rich people have a bigger vote in dollars than the poor people in determining the weights within the CPI. You could urge or require the BLS to adopt a different concept which is to have a survey that is focused on the median-income family and their patterns of expenditures and you would get a slightly different answer. I don't think it would make any difference in the rate of inflation but it would be a slightly different set of weights.

Mr. KUCINICH. But wouldn't you agree, sir, that you look at the, that with tax brackets and so-called deductions currently indexed to the CPI, a lower measured rate of inflation would lower the bracket cutoff point relative to where they would have been with the current CPI and lowered the size of the standard deduction relative to where it would have been and both of these factors expose more of a person's income to higher tax and this would——

Mr. GORDON. That's correct, that——

Mr. KUCINICH [continuing]. Essentially, thank you——

Mr. GORDON [continuing]. Thirty-five percent——

Mr. KUCINICH. Well, it would especially affect the middle-class where there are more tax bracket distinctions and they use standard deductions probably more frequently than high income earners who itemize. So that's why I raise this issue.

Mr. GORDON. Sure, we all agree with that.

Mr. KUCINICH. OK, thank you. Mr. Chairman.

Mr. SHAYS. Thank you. I'm going to recognize——

Mr. TOWNS. I just want to make a brief comment. Basically, Mr. Chairman, I know that when we talk about changes, generally we talk about more resources. You know, I'm not sure that we should be involved here in any kind of legislative recommendations or changes or involvement in this point in time. However, I must admit that I'm uncomfortable over the fact that some pilot projects are not going on to sort of answer some of the specific kinds of questions that we have. And I think that if that requires additional resources to do it, then there's some things that we need to do. I'm concerned about our senior citizens. And I'm concerned about the middle class. I think there's some things that we could do to get information maybe to bring about answers to those kind of questions, and I think that, to me, this is very, very serious because when you're talking about somebody in terms of buying, being able to buy a VCR, somebody else will not be able to buy food. And I think that's what we're talking about here. And I come from an area that when we talk about the discounts in the stores and all that, I come from an area where they're not there. And that's a concern. And I think information like this when we look—I would like to have some additional kinds of information on those kinds of questions. And I think that it's only fair to request that. And we're not talking about an ongoing thing but I think there's some things that you could do, at this particular point, to give an answer. I think in terms of the middle class, I think that's just there, that we have that kind of project in place to be able to answer those kinds of questions. I think that that's reasonable, you know, if it costs a few more dollars then let's spend it because I think that when it comes to credibility, I think that's also an issue here, and I'm not questioning yours at all. For instance, I want to let you know, I like you.

Ms. ABRAHAM. Thank you. I would be happy to come talk with you privately about what we're currently doing and what other things might be feasible to do at what cost.

Mr. TOWNS. Let me ask you, and then I'm going to close, Mr. Chairman. You know, I think about when the VCR's that came out initially. First of all, we had the Beta, and after, VHS first, and then after that the Beta. And then the question is, is this included in the calculations that would change the price as a result. I think that when you first got involved it was only the one and then after that, no one had any idea as to where the price was really going to go and then after that point, there was a change and I don't see whether that would be reflected. I don't see how you could reflect that. And those are the kinds of things that I think that I'm concerned about. And if I'm wrong, tell me I'm wrong. I mean, I've been wrong once before, a long time ago though. [Laughter.]

Mr. GORDON. We, I think the BLS agrees with the basic proposition that unfortunately some products were introduced late into the CPI relative to the time they were introduced into the marketplace. This is a longstanding problem. The automobile wasn't introduced into the CPI until 1935 and yet people were driving them in 1906. So I think the——

Mr. TOWNS. I think you're agreeing with me.

Mr. GORDON. I think the recommendations that the market basket be updated as often as possible handles this problem because as you update the market basket, you're going to capture these new more modern products earlier in their cycle.

Mr. TOWNS. Yes, and I'm not sure I'm making myself clear, that they introduce after the price comes down that's what I'm really trying to say here and that's the concern I have. For instance, you know——

Mr. GORDON. That was our point in the report.

Mr. TOWNS. Yes.

Mr. GORDON. That we're missing some of the price declines the later we introduce these things.

Mr. TOWNS. So——

Mr. GORDON. Same with the cell phone.

Mr. TOWNS. So what should we do then? Let me, maybe I can, what should we do then in order to get accuracy here? Maybe I'm asking the question wrong.

Mr. GORDON. Well, let me just turn this to Katharine and ask what specific things the BLS is doing to ensure an earlier introduction of new products?

Mr. TOWNS. Before that, and also, I'm going to recognize you, I saw your hand. I recognize you, yes, go ahead Dr. Abraham.

Ms. ABRAHAM. We're doing a couple of things. We have introduced plans to ensure, in a targeted way, that if a new item appears on the market that we start collecting the price promptly rather than what has sometimes occurred, after a substantial lag, so that we would capture that initial decline in price.

And, second, this more generally, we're taking steps to ensure that in market segments where there's a lot of change going on that we're updating the samples of specific items that we're pricing more frequently than the roughly every 5 years that updating of specific price items currently occurs. So we're taking steps to try to get things in more promptly, response if that's responsive to your question.

Mr. TOWNS. Yes.

Ms. ABRAHAM. And we agree that it's something that it's important to be doing.

Mr. TOWNS. Yes, I think you had your hand? Thank you.

Ms. SCHOLL. I just want to make the point that when these particular products were introduced. These were introduced at the time of major revisions and that was the point that we're making in our report—the weights of the market basket items should be updated more frequently. That would allow the introduction of some of these things that have in the past not been included for 10 years or so. It's because the weights were not updated for such a long period of time. When the item was introduced in between these revisions, it was not included in the market basket.

Mr. TOWNS. Thank you very much. But let me just say that, in closing, I come from Brooklyn, where there are 2.5 million people. And I'm just trying to think of—I think I can come up with like one major discount store. I'm trying to think and I've been sitting here, and I'm back there every week. I can only think of just one and there's 2.5 million folks that live in Brooklyn, you know——

Mr. SHAYS. Can I make an assumption that people in Brooklyn go into other parts of New York City? [Laughter.]

I mean, with all due respect——

Mr. TOWNS. Well, no, but you have to understand that generally, if you have to—that's another factor, you just raised that issue. If you have to go away somewhere else to do it, then is that cost included? I mean, I don't know. I mean, you just raised another issue. And then can senior citizens do that? I mean, these are issues that I need to have more on. I mean, and I understand that Dr. Abraham cannot do everything but I just think some of these things are just so important that they must be done. I mean, that's my view of my feelings.

Mr. SHAYS. I'm beginning to, thank you, gentlemen, I'm beginning to—yield?

Mr. TOWNS. I'm done. [Laughter.]

Mr. SHAYS. I'm beginning to think that we may need three hearings and we're all trying to combine too much into one hearing, and I appreciate the patience of the panel. I note, Dr. Gramlich, that you were looking at your watch, and I know we're going pretty long here, but, I'm concerned that we haven't established some basic points here that I feel that the committee would be derelict if we didn't establish. One of them is going to be what in the Boskin Commission should BLS be concerned about? And what aren't they doing what they should be doing? I mean, that's one, and I'm not going to ask that right away.

First, I want to know what are the known potential sources of downward CPI bias in the current structure? And rather than starting with Dr. Abraham, I'm going to start with Dr. Gordon or Dr. Gramlich. What are the known downward biases that exist?

Mr. GORDON. There is literature on downward biases that were important in the past, and that the BLS discovered on its own and largely addressed. Particularly, for rental housing and apparel.

Mr. SHAYS. Rental housing and apparel?

Mr. GORDON. And I believe both of those were basically fixed in the late 1980's. I'm not aware that there is an important category where there's any kind of consensus that there's a downward bias.

Mr. SHAYS. Well, I think in our next panel we're going to have some dialog about that so I wanted to make sure it was covered here. Dr. Gramlich?

Mr. GRAMLICH. I'm going to have to pass on that one, Mr. Chairman.

Mr. SHAYS. OK.

Mr. GRAMLICH. I am not aware, that doesn't mean there aren't any.

Mr. SHAYS. Is anyone from GAO able to respond? Are there any potential downward biases in the CPI?

Mr. UNGAR. I don't think we have any.

Mr. SHAYS. Dr. Abraham?

Ms. ABRAHAM. There are places where people have suggested that if you look you might find evidence of downward bias. The thing that comes most to mind is the quality of service in retail and other services establishments generally, but as is true with many aspects of bias associated with changes in the quality of goods and services, the evidence is sparse to non-existent.

Mr. SHAYS. Now, we talked about the so-called "low-hanging fruit" of the Boskin Commission. I want you to define what that low-hanging fruit is, and, Dr. Gordon, what you thought it was and what you think BLS has done to date to deal with the low-hanging—the so-called easier issues to deal with?

Mr. GORDON. We have these four categories: upper-level, lower-level, substitution bias——

Mr. SHAYS. Right.

Mr. GORDON [continuing]. Outlay substitution bias, and the big area of quality change in new products. The low-hanging fruit, No. 1, was the geometric mean solution to lower-level substitution bias.

Mr. SHAYS. That was the 0.2 percent change in the CPI?

Mr. GORDON. And I might add that the BLS is already on to that, and before the Boskin Commission was established, they did the research on it and they are—they have now announced their intention to fix it. So that's the lowest hanging. So the next step would be an announcement by the BLS of a specific plan to introduce more frequent updating of the upper-level weights. That's one of our major recommendations.

Mr. SHAYS. And that's the transfer from one category to—the substitution from one category to the other.

Mr. GORDON. And the fact that——

Mr. SHAYS. Give me an example of that just so we give——

Mr. GORDON. Well, the most obvious is that in the whole area of TV, video, and personal computers, until this year, they were using 1983 to 1985 weights when the consumers weren't buying personal computers.

Mr. SHAYS. Yes.

Mr. GORDON. So that particular source of price decline and we all know how dramatic that has been was just left out of the index entirely. So more frequent updating tends to bring in more rapidly and with a larger weight the most modern products which often tend to experience price declines instead of price increases and for that reason the upper-level weights are important in the overall bias that turns out.

As I mentioned in my remarks, outlet substitution bias is a tough problem because you have to figure out what fraction of the difference between a discount store and a full-service store represents service, represents something the consumer wants. And we've had debates back and forth on that. I think that's not something that BLS should be prepared to do right now. They should be thinking about research initiatives that would help inform everyone on that question.

And then, finally, on the quality change, as I said, we need a second research-based index. And it's too big a task for the BLS. I think they should do it in collaboration with private agencies in the economy whose business it is to measure quality over time.

Mr. SHAYS. And Dr. Yager, excuse me, Dr. Ungar, Mr. Ungar, I'm sorry, you know who I mean.

Mr. UNGAR. Yes. [Laughter.]

Mr. SHAYS. Mr. Ungar, in your statement to the committee, and Dr. Scholl and Dr. Yager, I'm sure, participated in your statement, you talk about what BLS has not done in terms of the Boskin Commission. Now, the gentleman from Vermont may be just as happy that they totally ignore the report. [Laughter.]

But I want to make an assumption that there are some important elements there that should be dealt with and then I would like, Dr. Abraham, for you to tell me why it's not in your, and have you, you've looked at their report and you're aware, so, just pick one of the—there were 13 recommendations?

Mr. UNGAR. Yes, 13 to BLS, that's correct.

Mr. SHAYS. Right, and to BLS, I'm sorry, or 12, were there 12?

Mr. UNGAR. Well, there were 12 in the original Boskin Commission report.

Mr. SHAYS. Right.

Mr. UNGAR. But subsequently there was a matter discussed that wasn't labeled a recommendation that the commission said should have been.

Mr. SHAYS. OK, well, one is the general overview and then you had the short-run and then you had the intermediate-run, and then you had the long-run?

Mr. UNGAR. Right.

Mr. SHAYS. And when we get into the intermediate-run and the long-run, there really don't seem to be any BLS performance goals and therefore no ability to assess whether—now just pick out one as an example and let's see if we can learn something from this?

Mr. UNGAR. I'll do that, Mr. Chairman, now let's say if we could pick No. 5 for example——

Mr. SHAYS. OK.

Mr. UNGAR. I just wanted to clarify, I'm sorry five——

Mr. SHAYS. Do you want to clarify first or do you want?

Mr. UNGAR. I just want to clarify the table. What the table is really portraying is the linkage between what's in BLS' strategic plan in terms of performance goals in the commission's report. It doesn't necessarily mean that they're not doing anything in BLS in some of these areas.

Mr. SHAYS. OK.

Mr. UNGAR. And what we found was that——

Mr. SHAYS. So, let me be sure, Dr. Gramlich, that we're not, that you're able to hear so you're able to respond. The bottom line is that Congress intends for all the bureaus, divisions, and departments to have strategic plans, and then for Congress and GAO to be able to assess how well we're doing, and so you're saying under intermediate run, and let me read it. No. 5 is:

> BLS should study the behavior of the individual components of the index to ascertain which components provide most information on the future long-term movements in the index, and which items have fluctuations that are largely unrelated to the total and emphasize the former in its data collection activities.

Boy, that is a mouthful.

Mr. UNGAR. Right. Now, as I indicated, there were eight here in total that we didn't see a linkage for. This No. 5 happens to be one that BLS disagrees with. And there are two others like that. So, therefore, BLS told us it really didn't have anything underway with respect to that No. 5 plus two others.

Mr. SHAYS. Excuse me, let me just interrupt a second. There's so much movement here. Dr. Gramlich, do you have a time problem or anything that we need to be aware of? Pardon me?

Mr. GRAMLICH. I'm all right for a while.

Mr. SHAYS. OK, I want to be respectful. You've been here a while, and Dr. Gordon do you have any time problem?

Mr. GORDON. I'd like us to be done in 10 or 15 minutes.

Mr. SHAYS. OK, well, we'll see if we can accommodate that.

Mr. TOWNS. Otherwise or you'd like to leave. [Laughter.]

Mr. SHAYS. OK. Let me just say if we get cooperation from the subcommittee, I have no long speeches. We can be done in 15 minutes. Would you continue?

Mr. UNGAR. Sure, I think recommendations Nos. 5, 10, and 12 are those with which BLS said it really rejected, and, therefore, it disagreed with and doesn't have anything ongoing. Although, I would point out on 12 that it, you know, it said it rejected it but it partially agreed with at least some aspect of the recommendation according to the information BLS provided us. For the other eight, excuse me, for the other five for which you don't see anything in our columns there, those are ones for which BLS has said it does have activity under way, or research ongoing, but it did not include those activities as part of its plan or performance goal, and it's not required to, by the way.

Mr. SHAYS. Right, OK, fair enough. OK, so, but what should I conclude from that?

Mr. UNGAR. Well, I think that you would conclude a couple of things. First of all, one of the things you should conclude is that a stakeholder in BLS' efforts cannot tell from its strategic plan to what extent it is addressing Boskin Commission recommendations, and to what extent it isn't, or if a linkage is there.

Mr. SHAYS. Let me just, Dr. Abraham, I think it would be helpful for the subcommittee, and I've given the time and issues here for you to outline which recommendations you feel are important to pursue and which ones you totally discount and reject and we can have a dialog about that. And I think that would be a good way to go, and I can leave it at that, unless you want to make some general comments?

Ms. ABRAHAM. Perhaps, I could with due respect to other panel members' desire to conclude the conversation, just make a couple of quick comments.

Mr. SHAYS. Sure.

Ms. ABRAHAM. Bob Gordon, in his opening statement, identified some areas where we hadn't yet made public comments that he was aware of. On some of the things he talked about we have made public commitments to do something and we can specify that to you in writing. On others, we have ongoing research that is looking into the issue. Some things, as has already been indicated, we just don't agree with. One thing that he talked about was modifying the allocation of our data collection resources to optimize what we're getting out of those resources, and we feel we're doing that already so we really don't agree with the recommendation.

I think there also is a separate issue here about the role of our strategic plan in addressing all of this. Both the Secretary of Labor and I feel it would not be appropriate to include in our strategic plan the recommendations of each and every advisory committee, no matter how distinguished, that might give us advice. What the strategic plan includes are specific things that we have figured out we can do and have made a commitment to do. That doesn't indicate that there aren't other things that we're doing. I don't know how to put——

Mr. SHAYS. OK——

Ms. ABRAHAM [continuing]. Research that we're doing into our plans and if there's some different thing that we should be doing in that regard, we're open to any thoughts on that.

Mr. SHAYS. Well, let me just tell you what the request of the subcommittee would be, and we will follow it up. I think separate from any strategic plan, performance plan, I would like to know what items a particular commission, it happens in this case to be the Boskin Commission, what you, what BLS' reaction is to those recommendations? Which ones you feel you should respond to, excuse me, the Department should implement, which one's they think they shouldn't, and give us a sense of how you're doing?

Ms. ABRAHAM. We have prepared a report that was submitted to the Joint Economic Committee last June in response to a request from Representative Saxton of New Jersey.

Mr. SHAYS. If you would just update that.

Ms. ABRAHAM. I don't think that our views on these things have changed. We could take a look through it and see whether it requires——

Mr. SHAYS. I would like a letter to say that, if you want to have a covering letter that just, there has to be some change in the year because all good men and women learn new information and respond to it.

Ms. ABRAHAM. We'll take a look at——

Mr. SHAYS. I would like that, and I'm going to end this question. I want to know what the CPI truly tells me. I want to know how up-to-date it is, and I'm going to really start with you, with Dr. Scholl, I'm not saying your name, Scholl?

Ms. SCHOLL. "Scholl."

Mr. SHAYS. Dr. Scholl, excuse me. I'd like to start with you and go all the way down. I want to know if it is an up-to-date measure of the cost of living, or whether it's a 2-year? I want to have a sense of what you think it tells me and tells the country. And, you know, just some general comments about that. So, I'll start with you.

Ms. SCHOLL. Well, on the record, for GAO, we have not done that much work about the cost-of-living aspects of the Consumer Price Index. We've only issued a couple of reports. The only recommendation that we have is that it be updated more frequently which BLS is basically addressing. Currently, they have just gone through a major revision that occurred in January so it is pretty much closely up to date as——

Mr. SHAYS. Yes, but what does closely up to date mean? That's what I want to know. When the CPI changes, is it really based on data that's 3 years old? Or is it really based on data that's current and tells me what truly happened last year?

Ms. SCHOLL. They use many different sources of data. The consumer expenditure survey, which determines the weighting of how much weight each item is going to have is based upon 1993–1995 data. It's an average of those years that they use for weighting. They use another set of data that they call a point-of-purchase survey, which is another aspect that's fed into the index. They also collect prices monthly of the items themselves. So it's a grouping of data from all sorts of different places in the economy or in the United States that they compiled to produce the Consumer Price Index. And like I said, for right now, since they just did a major revision, it's pretty correct.

Mr. SHAYS. I realize that you weren't the person testifying, but what's instructive to me is that you're telling me how it's put together, I'm asking you your opinion?

Ms. SCHOLL. I do not have a—GAO does not have an opinion.

Mr. GORDON. I do.

Mr. SHAYS. OK, I'd like it. You know, I welcome opinions especially at the end.

Mr. GORDON. The BLS data on inflation is very timely.

Mr. SHAYS. OK.

Mr. GORDON. It comes out a month or so after the prices are collected in the field. The weights with which those individual price changes are put together, since there are thousands of them, are less up to date than would be desirable because they're based on 1993–1995 and that's now 4, on average, roughly 4 years old. It doesn't make——

Mr. SHAYS. And what do you think——

Mr. GORDON [continuing]. That much difference.

Mr. SHAYS. OK, that's fair to know. And it doesn't make that much difference because the weights aren't as important?

Mr. GORDON. Because the weights don't change that much, because——

Mr. SHAYS. OK.

Mr. GORDON [continuing]. The big items like food, shelter, insurance are not either changing as a huge percent of the consumer budget from one decade to another nor are the rates of inflation for those items so radically different from each other that the weighting matters. Where it matters are items that have very atypical patterns of price change, especially things like computers, cell phones, long distance phone service.

You, the front page of the Wall Street Journal last week, had a story on the competitive battle for cellular phones in Jacksonville, FL, with six companies fighting it out and the price over the last year has gone down 46 percent according to that story. That's the kind of items where you need accurate up-to-date weights. One strategy that the BLS could take, and it sounds as if they are sympathetic to this idea, is maybe you don't have to update all the weights every year, but maybe there is a subset of the consumer market basket where there is dynamic change going on and you allocate more resources to that, collect data for the larger sample more frequently, and achieve a greater level of accuracy.

Mr. SHAYS. That seems like a sensible, you know, idea. I noticed that you were nodding your head, Dr. Abraham. You'll get your chance to translate your nodding of your head. Dr. Gramlich.

Mr. GRAMLICH. It is clearly a timely index but in terms of its quality I think it didn't used to be a very, particularly good index, or particularly updated index, but I think the BLS has made a lot of changes that makes it much better and more current. As I said in my testimony, another big step in that direction would be to get a revisable index that changes the weight for this upper level problem that we think the BLS could do fairly soon. It would entail revising the index and we think that probably ought to happen and could be dealt with. There are a number of other issues that Bob mentioned that are farther down the road, and I think we would all like to see the BLS study those carefully and presumably make some changes, but these are more complicated, would take more study. So I would like to see the BLS keep at it. But I do think the step of getting a revisable index dealing with upper level substitution bias would be something that would be a welcome change fairly soon.

Mr. SHAYS. Thank you, Dr. Gramlich. Dr. Abraham.

Ms. ABRAHAM. I, perhaps to my surprise, find myself thinking that you put this about as well as I could.

Mr. SHAYS. "You" being who?

Ms. ABRAHAM. Bob Gordon. The CPI is a very timely measure. The weights that we use in deciding how much importance to attach to different prices have not been as current in the past as they will be going forward. I'm in sympathy with, and we have indeed said that we are pursuing, some of the things that we have talked about in terms of updating rapidly changing segments of the index more rapidly. I would hope, however, that the committee would not lose sight of the fact that even before the recent round of changes that were made in the CPI, this was a very good measure. There is a lot of work that goes into ensuring that the prices we collect are representative of what people are purchasing, that new items and outlets are brought into the index and, again, even prior to the changes that we introduced recently, I think the U.S. CPI would compare very, very favorably to the CPI produced by any other country. We obviously always can work to improve what we're doing. We've done that and we'll continue to do it.

Mr. SHAYS. Yes, yes, Dr. Ungar, I'm sorry?

Mr. UNGAR. Just not to be left out, Mr. Chairman, I will speak on behalf of GAO. I think I would agree with Dr. Gordon and Dr. Abraham that on the price issue that is done monthly that the current, the weights again, as we pointed out, and everybody has pointed out, we do believe that they could be more current. Right now, they were just adjusted. However, in the future, we would certainly urge that more frequent updates than every 10 years would be appropriate.

Mr. SHAYS. OK, thank you. I'm just going to conclude, and I'll just skip to Mr. Towns. I represent a district of the wealthiest of wealthy. I mean, truly, the wealthiest of the wealthy, and the poorest of the poor in that I represent three urban areas and so I have a tremendous contrast. I take tremendous pride in what Congress on both sides of the aisle, and the President, have been able to do to get our country's financial house in order. We're moving in the right direction. And I see that as a tremendous beneficial effect on interest rates, the retirement funds of our workers, so I see a lot of good things benefiting the American people in what's happened. And I do want to say to you, I know a lot of people have played a role in that, but obviously the American people have played the biggest role in terms of their energy and the progress we've made with productivity as well. So, I know this is a very dynamic economy. I know it's hard to keep up with, but we obviously need to educate ourselves better on this side of the table, and that's what we're attempting to do.

Mr. Towns.

Mr. TOWNS. So, Mr. Chairman, you're not against the stock market going up? [Laughter.]

Mr. SHAYS. I am thrilled that Americans are—I realize that we need to be very cautious about its ultimate implications and make sure that the enthusiasm doesn't cloud our good judgment.

Mr. TOWNS. I agree with you, Mr. Chairman, and no question about it. Let me, again, thank the members of the panel for coming and sharing with us. I think that you have been very, very helpful but, Mr. Chairman, I think that maybe we might need to have further discussion to get some other information. So maybe we might have to look at, at some point in time, having a third hearing on this issue.

So, thank you very, very much, for coming and sharing.

Mr. SHAYS. My staff member said next April when you're chairman. [Laughter.]

He didn't say that last part. Strike that from the record. [Laughter.]

Mr. TOWNS. I like the idea. [Laughter.]

Mr. SHAYS. But I didn't say though as you became a Republican. [Laughter.]

Let me thank all of you and also thank the second panel that has been waiting. Dr. Abraham, one of the ways we're going to deal with this issue is our committee is going to stay in closer contact with you, and to be more up to date, just on the staff level, as well, and we appreciate your cooperation. We thank all of you for participating in this first panel. You have been more than patient in listening to our questions.

We'll call our second and last panel. Dr. Jack Triplett, visiting fellow, Economic Studies Department, the Brookings Institution; Dr. Mark Wilson, labor economist, the Heritage Foundation; Dr. Joel Popkin, president, Joel Popkin and Co. We invite all three to come to the dais, excuse me, to the table and we'll swear you in.

If the three of you would remain standing. Dr. Popkin, and Mr. Triplett, why don't you—Dr. Triplett should be put in the middle, excuse me. We'll slide you over. Can you move those places over, please? OK, here we go.

[Witnesses sworn.]

Mr. SHAYS. We swear in all of our witnesses, it's an investigative subcommittee, including Members of Congress, candidly, when they come and seek to give testimony. I would really welcome your testimony, and obviously it will be, your written testimony will be submitted in the record. I would be happy to have you respond to what you've already heard as well, and not have to wait for the questions on that. And, frankly, I'm happy to have you tell us if we've focused on some issues we shouldn't have and should have been focusing on some other issues. Neither the ranking member nor I will be offended by your critiquing what we need to focus in on.

I called you in the order of Dr. Triplett then Dr.—Mr. Wilson, and Dr. Popkin, and I'll go in that order, OK. Dr. Triplet.

STATEMENTS OF JACK TRIPLETT, VISITING FELLOW—ECONOMIC STUDIES, THE BROOKINGS INSTITUTION; D. MARK WILSON, LABOR ECONOMIST, THE HERITAGE FOUNDATION; AND JOEL POPKIN, PRESIDENT, JOEL POPKIN AND CO.

Mr. TRIPLETT. Thank you. I appreciate the opportunity to appear before this subcommittee and discuss CPI measurement issues. As the subcommittee recognizes, the CPI is important. Price measurement issues are difficult ones, even for professional economists, and they're certainly issues that are of vital concerns to all users of the CPI, both public and private.

The committee has requested discussion of three issues: the 1998 changes to the CPI, which is primarily, I think, the weighting changes; the proposed 1999 change to the geometric mean, for the lower level indexes; and long-run changes to improve the CPI. I want to summarize my reaction to all three of those. More details are in my prepared statement.

First, the updating of the weights. That's clearly an improvement in the CPI. The old weights were 1982–1984 average. The new ones are 1993–1995 average. That updates the weights, makes them more nearly current, let's put it that way. And it's clearly an improved measure and so that's an improvement in the CPI as of 1998. As part of that the BLS has indicated that it would cut the reweighting cycle in the future, which has been roughly 10 or 11 years in the past, to, we've heard this morning, something in the order of maybe half of that. Cutting in half that reweighting cycle would also, I believe, improve the CPI because, again, it would make the weights more nearly current. When the old weights were replaced this year they were roughly 14 years old, and the new proposal would mean they would grow to perhaps a maximum of 7 years old and that's clearly an improvement to the CPI. So I think both the 1998 changes and the announced future changes are definitely in the right direction.

Second, the proposed 1999 change to the geometric mean. The geometric mean replaces, the member of the subcommittee had this formula that he was showing us, replaces the old arithmetic mean. It's been demonstrated clearly that the arithmetic mean has substantial flaws, and so I support moving to the geometric mean as a way to get around some of those flaws.

In my prepared testimony, I talk about some technical matters that I think are not quite resolved yet. But that's a call for more research, and I think this issue might need to be revisited in the future. But, clearly, as an interim step, I think this is a step forward, to move to the geometric mean.

Now, on long-run changes to improve the CPI. First, let me talk a little bit about this issue of the substitution bias. We've had a lot of talk this morning about the substitution bias.

In the first place, the Boskin Commission estimated it at 0.15 percent annually. This is not a huge number, 0.15. So I think that's the context in which we're talking about substitution bias. It is true, however, that some of the research shows that in some years—that was an average number across this whole period in which the weights are fixed—for some years it has been considerably larger. My reading of the evidence suggests there are some years in which it reached roughly half a point, 0.5. And that's a little bit more concern, it seems to me, for everyone.

I think I'd also like to emphasize how you get this estimate of substitution bias. The way you get it is to compute the formula that the CPI now uses to aggregate those upper level components, those 211 components. You compute the CPI's formula, which is technically known as the Laspeyres index, and then you compute another formula which allows for substitution. So the way you do it is you compare two index number formulas, both of which have weights, and they have different weights. And it's looking at the difference between those indexes that gives you this estimate of the substitution bias. So they both are weighted index numbers.

Now, ideally, if you just talked about the CPI system, what weights would you really want in the Laspeyres index to produce a price index for 1998? Well, the whole framework suggests that what you'd really want, to be up to date, is 1997 weights. To do the superlative index number people are talking about, what you'd really want to do the price change between 1997–1998 is 1997 and 1998 weights combined.

The point I'm making here is that to do both the Laspeyres formula that traditionally has been used in the CPI accurately and to do the superlative index accurately, you ought to have weights that are both accurate and up to date. Otherwise it's not quite clear what this substitution bias measure means. So, whether we're talking about a superlative index, or just updating the CPI, both accuracy and currency of the weights matters.

And that focuses some attention, I think, on the consumer expenditure survey. The reason we use 3 years' weights for the consumer expenditure survey, the weights are now 1993–1995, the average of 1993–1995. The reason we do that is it's quite a small survey. It's only 5,000—the BLS says consumer units, but let's say, households, it's roughly the same thing; 5,000 households and that's not big enough to weight the CPI so we use an average of 3 years. The BLS is proposing to increase that to 7,500 households which would permit taking an average of 2 years.

One of the problems with an average of 3 years, we heard this morning, is that it takes time to get the weights in. An average of 2 years also creates a lag. You probably could not ever eliminate the lag for the reasons that Katharine Abraham indicated—it takes a while to get the data in, takes a while to analyze the data—but you could certainly shorten the lag if we were talking about producing a CPI that is based on 1 year's consumer expenditure survey. That would involve a larger expenditure survey, yes, in order to get accurate weights. And I think there are some good reasons why we should consider doing that.

Now, I also want to go back to put that proposal in context. We're talking about 0.15 average bias here, and increasing the consumer expenditure survey, say doubling it again, would cost money. You obviously don't want to spend a fortune to protect pennies. But there's a tradeoff here between accuracy and the expense of producing the index.

And I want to point out that in the BLS proposal, if you cut the reweighting cycle in half, by 2002 those weights would be 7 years old. The maximum estimate of substitution bias that I've seen actually occurred in the old index when the weights were just about 7 years old. So cutting this timing lag, getting the weights even more current, does have implications for the accuracy of the index. And it does have implications for the accuracy of doing a superlative index, which I support, or some of the other proposals that have been made to get more complicated, let's say, ways of estimating the cost of living index carried out in the index.

Finally, this is again, on the future. I'd like to call attention to the fact that all of the information that we have, almost all the information that we have, on upper level substitution bias, and all the information we have on this lower level problem, has been produced by BLS researchers. Researchers inside BLS have produced all of the information that we really have. And, therefore, an implication for improving the index, in the long run, it seems to me, is that one of the most important ways we can assure continued excellence in the CPI, and improvement in the CPI, is to support that research program that has developed so much information that now helps us assess the accuracy and comprehensiveness of the measure.

Thank you.

[The prepared statement of Mr. Triplett follows:]

Statement before the House Subcommittee on Human Resources, Committee on Government Reform and Oversight

Hearing on: "The Bureau of Labor Statistics: Fixing the Consumer Price Index" April 29, 1998

Jack E. Triplett[1]
Brookings Institution

I appreciate the opportunity to discuss CPI measurement issues. An accurate CPI is important. The subcommittee performs a valuable service by focussing attention on issues that are at once technically difficult even for professional economists and of vital concern for users of the index, including those in both public and private sectors. I have worked on CPI measurement issues as a researcher, and in my former capacities as Chief of the Price Index Research Division and Associate Commissioner for Research and Evaluation, both in the Bureau of Labor Statistics, and as Chief Economist in the Bureau of Economic Analysis.

January, 1998 CPI Weight Updating

In January, the Bureau of Labor Statistics (BLS) updated the Consumer Price Index (CPI) weights. They are now derived from consumption patterns for 1993-95. That clearly improves the CPI, because the weights are now more nearly current, compared with the pre-January index that used weights for 1982-84.

Moreover, BLS has indicated that in the future weights will be updated more frequently than the ten to twelve year intervals of the past. Again, that is a positive step that will improve the CPI.

More could be done to reduce weighting effects, often called "substitution bias," in the CPI. Although the average substitution bias has not been large in the past (about 0.15 percentage points annually), in some years it has gone as high as half a point (0.5). CPI changes to minimize bias from out-of-date weights, discussed in the following paragraphs, may be worth their additional cost.

BLS uses a fixed-basket formula (known as the Laspeyres formula) to aggregate 211 "strata indexes," such as the price index for "bananas" and the price index for "computer software and accessories," into the overall CPI. The fixed-basket formula takes no account of consumer substitution--consumers shift spending toward those commodities that become relatively cheaper (whose prices either fall, or rise less than average) and away from commodities whose prices rise more rapidly. A price index formula that allows for consumer substitution provides a better measure of the change in the cost of attaining a constant standard of living. Such a measure is known as a "cost-of-living index."

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[1] The views expressed are solely my own and not necessarily those of the trustees, officers and staff of the Brookings Institution.

The Boskin Commission defined "upper level substitution bias" as the difference between the Laspeyres formula and a formula that estimates a cost-of-living index. It estimated upper level substitution bias at 0.15 percentage points, annually. I concur with this estimate, which is based entirely on empirical work conducted by BLS staff (when I was at BLS from 1971 to 1985, I directed the early BLS research on substitution bias).

As the Boskin Commission noted, upper level substitution bias could be eliminated by using a "superlative" index number formula for the CPI. The Fisher index now used by the Bureau of Economic Analysis to measure Personal Consumption Expenditures (and consumption prices) in the national accounts is an example of a superlative index.

Even with the CPI's traditional Laspeyres formula, substitution bias would be minimized if weights were updated frequently, and were kept current. Though the Laspeyres formula will always be subject to *some* substitution bias, when the weight year is very close to the current year, the bias will normally be small.

The new, updated CPI weights are a positive step that improves the CPI. However, the weights are already roughly four years out of date (the mid-point of the new weighting period is 1994). Even if the CPI weighting cycle is cut in half in the future, so weights are replaced every five years, by 2003 the weights will be approximately nine years old. In today's heightened concern for CPI accuracy, nine year old weights may be unacceptable. Few other countries tolerate CPI weights that grow so old before replacement. For example, in the new "harmonized" CPI for Europe, the maximum age for any country's weights is seven years, and the average weight age across European countries will be less.

As an additional consideration, upper level substitution bias may not always remain small. If shocks such as the oil and energy shocks of the 1970's occur, resulting in substantial changes in consumption patterns, substitution bias might be larger in the future than in the past. If it takes several years to get new weights into the CPI, an unanticipated shock might distort the CPI for an unacceptably long period. <u>A regular program for introducing up-dated CPI weights that are as current as possible would avoid potential deterioration in the quality of the CPI caused by unforeseen events.</u>

Further reduction of weighting effects in the CPI could be accomplished by improving the Consumer Expenditure Survey so that the CPI would have: (1) annual weights (a single year, not three years' average, as now, or two years' average, as BLS has proposed), (2) weights that are introduced not only more frequently but also more expeditiously (so they would be more up to date), and (3) weights that are more accurate than those in the present index. What matters is not just the frequency of re-weighting. The currency and the accuracy of the weights matter as well. Improving the currency and accuracy of CPI weights requires improving the Consumer Expenditure Survey.

The Consumer Expenditure Survey

The Consumer Expenditure Survey provides weights for the CPI. At present, it is too small (approximately 5000 "consumer units" or households) to obtain CPI weights from one year's data, so three years' data (1993-95) are used to determine the weights. This three-year averaging process necessarily delays the availability of CPI weights and retards their introduction into the index.

BLS proposes to increase the size of the Consumer Expenditure Survey from its present approximately 5000 consumer units to approximately 7500 units. The intention, as I understand it, is to average two years' consumption data (instead of three years, as now) to obtain the same level of reliability or accuracy in CPI weights. The change is in the right direction, and deserves support. But the survey ought to be larger than 7500 households, because it ought to be large enough to permit CPI weights to be calculated from a single year's expenditure data.

The ideal for a Laspeyres index would have the 1998 CPI weighted by consumer expenditure for 1997. That may not be practical, because of processing time for the expenditure survey data and the time required for analyzing the expenditure data before CPI weights can be estimated. But if the Consumer Expenditure Survey were expanded so it became large enough to use a single year's survey data for CPI weights, it ought to be possible to cut a year and possibly more from the present lag between the weighting period and the date at which new weights are introduced into the index. It would also then be possible to re-weight the CPI annually, which would keep the weights current and minimize upper level substitution bias.

Expansion of the Consumer Expenditure Survey ought also to aim for increased accuracy of the CPI weights (not just maintaining the present accuracy). In a paper published in the St. Louis Federal Reserve Bank *Review*, I pointed out, as have others, that the Consumer Expenditure Survey does not give compatible results--either in levels or in trends--to the Personal Consumption Expenditures component of the national accounts. This is true for major consumption components like motor vehicle purchases and food at home. When the two data sources on consumption expenditures disagree, that does not necessarily imply that the national accounts consumption data are always right and the Consumer Expenditure Survey information is always wrong. Nevertheless, it does raise questions about the accuracy of CPI weights. Analysts of consumption data, including policy analysts in the Executive branch and in Congressional agencies, have long felt that the Consumer Expenditure Survey data need attention. A conference involving BLS staff and users of Consumer Expenditure Survey data will take place in May. A comprehensive review of the Consumer Expenditure Survey data and methodology deserves high priority, and the review should consider both CPI weighting uses of the survey and the other uses for consumer expenditure data, particularly research and policy analysis uses.

The Boskin Commission did not emphasize the accuracy of Consumer Expenditure Survey data in its review of the CPI, or propose additional expansion of the survey. It is hard to understand how the CPI can be accurate without accurate weights. And the U.S. Consumer Expenditure

Survey is small by international standards. Canada, for example, includes about 36,000 households in its consumer expenditure survey (though the data collected in the Canadian survey are not as detailed in some cases as in the U.S.)

Even estimates of substitution bias require accurate weights. Substitution bias is often estimated by comparing the Laspeyres index formula used in the CPI with the results of another formula, such as the Fisher index. The Fisher index uses weights for two periods, rather than one. An accurate measure of the *true* difference between Fisher and Laspeyres indexes requires accurate weights for both indexes. When weights are inaccurate, the difference between Fisher and Laspeyres indexes may just measure statistical "noise."

The BLS Change to the Geometric Mean for Lower Level (Item Strata) Indexes

BLS recently announced that the statistical estimator used for most lower level indexes, or item strata indexes, will be changed to a geometric mean estimator in January, 1999. Examples of item strata indexes are "bananas," "sugar and artificial sweeteners," and "college tuition and fees." The change to the geometric mean was recommended by the Boskin Commission.

I support the change to a geometric mean as an interim step to improve the accuracy of the CPI. However, I believe that this issue needs more research and might need to be revisited in the future.

Almost all of our knowledge about the lower level index number problem in the U.S. CPI comes from research by BLS staff, who were seeking to improve the index. Outside reviews, including the Boskin Commission, have added mostly interpretations of the BLS research. But some aspects of the interpretation are still in doubt.

What we know at this stage is that the old BLS estimator for strata indexes (sometimes called an "arithmetic mean") is seriously flawed, and that the geometric mean gives a different answer. The size of the difference between arithmetic and geometric mean estimators depends on the year for which the difference is estimated, and on the exact comparison that is made, but it is somewhere in the neighborhood of 0.2 percentage points per year.

The Boskin Commission labeled the difference between arithmetic and geometric mean estimators "lower level substitution bias." In my opinion, "lower level substitution bias" is part of the interpretation of the research findings, but it is an interpretation that is incomplete. The geometric and arithmetic mean estimators for the price index for bananas, for example, are different, but there is no consumer substitution among different kinds of bananas because bananas in the United States are as close to a homogeneous commodity as can be found. We need more research on how consumer shopping, search, response to store sales, and so forth should be handled in a cost-of-living index. I have recently written on this, as has Prof. Robert Pollak, of Washington University. The lower level substitution bias interpretation of BLS research emphasized by the Boskin Commission is not wrong, but it is not a complete interpretation.

Having said this, I emphasize that I support the BLS move to geometric means as an interim improvement to the CPI. It is an interim step because the "lower level" index number problem is one that has emerged only recently and the issues are still not fully understood. In contrast, the "upper level" substitution problem is one where theoretical and empirical economic research has a long history and the issues are well settled,

Other Points on Substitution Bias

Other options for moving the CPI weighting closer to a cost-of-living index have been discussed. One is to change the index from its traditional Laspeyres formula to a superlative formula, such as the Fisher index. Superlative formulas require weights for the current year (for example, a measure of price change for 1997-98 would require weights for both 1997 and 1998), but current year weights are not available until after the publication month. Superlative index number formulas could only be used in the CPI if the index were routinely revised, retrospectively, as the new information becomes available.

Revisions to economic time series are never liked, no matter what series is revised, and the CPI has no tradition of revision. Yet, there is no particular reason why we tolerate revisions to national accounts when the revisions improve the accuracy of the information and do not tolerate them in the CPI. Many escalation arrangements that use national accounts information exist in the United States, and users have evolved methods for escalation with indexes that are revised. Accordingly, the escalation uses of the CPI do not seem an overwhelming reason to reject revisions, provided assistance is provided to users who may be unfamiliar with escalation contracts where the escalating index is revised.

Another proposal is to estimate or forecast the change in a superlative index number, using Consumer Expenditure Survey information and some form of weighted geometric mean index at the upper level. That is, one could combine the 211 strata of the CPI (most of which will be computed from geometric means, after 1999) with an expenditure-weighted geometric mean index. The intention, here, is to reduce the difference between the Laspeyres formula and the superlative formula, thereby reducing potential CPI revisions (from the first option discussed above) and/or surmount the problem that current-period expenditure data are not available to compute the superlative index.

Both these proposals deserve consideration. Whether or not the official CPI is converted to a superlative index on a current basis, an alternative or research superlative index should be published as an analytic aid in evaluating the official index.

However, these proposals imply that CPI weighting information is available on a more current basis than is presently the case. The proposals, in other words, require an expanded and improved Consumer Expenditure Survey, so that weights could be incorporated on a timely basis. If the expenditure survey were improved, as suggested in the section on the expenditure survey, above, it is likely that a frequently re-weighted Laspeyres index would also have very low substitution bias (this seems likely from evaluation of alternative index number formulas for the Personal Consumption Expenditures component of the national accounts). Thus, improvements in the Consumer Expenditure Survey are necessary to implement effectively any option for reducing CPI weighting effects and substitution bias.

BLS Research

Congressman Shays' letter asked for suggestions for how Congress and the Administration could work to improve the index. In responding to this very positive request, I emphasize that researchers inside the BLS have developed most of the information that is now available on upper level substitution bias and on the lower level index problem. Without the very active and very professional research staff that exists inside BLS, economists would lack firm knowledge of the sizes of potential biases in past CPI's and what to do about them. I recall that when BLS economists first began work on estimating substitution bias in the CPI, more than twenty years ago, many economists were willing to "guesstimate" that the CPI substitution bias amounted to 2 to 3 percentage points per year. That we now have numbers, rather than guesstimates, facilitates an informed debate on CPI measurement issues, and demonstrates the value of the BLS research program.

BLS researchers have also demonstrated that they can make substantial contributions to better methods for handling quality change in goods and services priced for the CPI. Quality change was, rightly, emphasized by the Boskin Commission as a serious measurement problem in the CPI, and it is recognized as a difficult problem. Improving quality change methods is probably the most pressing need for moving the CPI closer to a measure of the cost of living, and additional research on quality change promises a very great payout for improving the index.

Accordingly, assuring resources for continued research on measurement issues in the BLS is one of the greatest contributions that can be made to long-run improvement of the CPI.

Summary

The BLS has made three recent positive changes that improve the CPI and move it closer to a cost-of-living index.

First, it has updated the weights to a 1993-95 reference period, which means they are more current than the former 1982-84 weights. That should reduce the size of the upper level substitution bias, at least for the next few years.

Second, it has announced that the CPI re-weighting cycle, which has been ten to twelve years in the past, will be shortened in the future. That means that CPI weights will never again become as far out of date as they were before January, 1998, when they were roughly 14 years old.

Third, it has announced that most lower level indexes will be computed in the future by the geometric mean method. This replaces the old arithmetic mean method for lower level indexes, which has been shown to have serious faults.

Additional reduction of weighting effects, and substitution bias, in the CPI can be accomplished by expanding the Consumer Expenditure Survey, and improving its data. An expanded expenditure survey will permit CPI weights drawn from one year's survey data, instead of the average of three years' data, as now. It will also make it possible to reduce substantially the time it takes to bring new weights into the index, so in the future the weights can be more nearly current than they are at present, where the new weights are already roughly four years out of date.

BLS research has led to most of the knowledge about substitution bias and lower level index number problems in the CPI. Because the payoff to resources devoted to research has been so high, assuring continued resources to the BLS research function is possibly the most valuable step that can be taken to assure future improvements to the CPI.

Mr. SHAYS. Thank you very much, Dr. Triplett.

Mr. Wilson.

Mr. WILSON. Thank you, Mr. Chairman, members of the subcommittee. In the interest of time, I'd like to submit my written testimony for the record, but I'd like to also point out that——

Mr. SHAYS. Let me just say something, sir. You had to wait a while so you feel free to make——

Mr. WILSON. That's fine.

Mr. SHAYS [continuing]. I'm happy to have you summarize but I——

Mr. WILSON. I think there's a lot of things that have been discussed. There's no reason to go over a lot of the points——

Mr. SHAYS. OK.

Mr. WILSON [continuing]. That have already been made——

Mr. SHAYS. Sure.

Mr. WILSON [continuing]. So I'd like to just touch on briefly——

Mr. SHAYS. Sure.

Mr. WILSON [continuing]. The points that I think probably haven't been touched on sufficiently so far today. Well, we all are aware that the Consumer Price Index is one of the two most important economic statistics produced by the BLS. The other one, of course, being the unemployment rate. It's important because it is a central target of monetary policy, and that's why Chairman Greenspan is so interested in it. But it also is important because it significantly affects a wide variety of other Government data, and, heretofore, the public policy debates that surround such things as real wages and income growth. To give one example, if you believe the previous formulation of the CPI overstated inflation by approximately 1 percent a year from 1973 to 1975, real hourly wages would have actually increased over that period of time rather than having decreased as currently reported. So getting the Consumer Price Index as accurate as possible is important not only because it plays a significant role in monetary policy and has significant implications for the Federal budget, but also because it would significantly and substantially affect the public policy debate in this country.

Since 1990, the BLS has implemented a variety of improvements in addition to its 6-year CPI revision program. And many of those have been touched on by Dr. Abraham this morning. The effect of these improvements, combined with the major CPI revision, will effectively reduce the rate of increase in the CPI by almost 0.7 percentage points per year and will save taxpayers about $100 billion a year in Federal outlays and interest payments between now and fiscal year 2003.

In fiscal year 1998, I'd like to point out the BLS——

Mr. SHAYS. Let me just interrupt you. The interest payments are the result of what in terms of the index? What comes down?

Mr. WILSON. There is the interest rate premium obviously, excuse me, there's an inflation premium on all interest rates, even Government bonds, to the degree that the public and the markets perceive measured inflation as being the bulwark of interest rates.

Mr. SHAYS. But that's determined by the market, that's not——

Mr. WILSON. Right.

Mr. SHAYS. That's not determined by the CPI?

Mr. WILSON. Well, to the degree that the CPI and the measured inflation influences inflation expectations as well as the market's perception of inflation, that will then affect both Government as well as private interest rates.

To go on, to touch on here, I think that it's important to note that the BLS received in this fiscal year $2.1 million to, as first year of their CPI Improvement Initiative Program, and they've asked for $9.1 million in fiscal year 1999, a substantial amount of money. These funds will be used to expand the consumer expenditure survey, to facilitate more timely CPI market basket updates that have been touched on, and also to begin the production of an official superlative index, which I think are both positive steps, but certainly long overdue.

I think we all agree that congressional action is certainly not necessary but oversight such as this hearing and other hearings are critical. I would strongly encourage at least annual oversight hearings. The Secretary, I believe, the Secretary of Labor should establish a permanent and rotating independent commission of experts that's focused specifically on the Consumer Price Index. There are advisory panels at the BLS, but I think one that focuses exclusively on the CPI would be productive.

I think that it's important that the BLS establish a new index that's published and updated annually and revised historically as far as possible. The index would take immediately into account all changes made to the CPI since 1990, and any further improvements that are made to the official CPI. This new index could then be used much like the current CPI UX–1, that's published in the Economic Report of the President, is used as a deflator in economic research.

This morning there was some discussion, of the average family income concept CPI. I think the solution there, to touch on those issues, is certainly an expansion and improvement of the consumer expenditure survey, with that I think such an experimental measure could be developed. I think that expanding the point-of-purchase survey and improving that survey would help facilitate an experimental elderly index. And I think it was also very good to have GAO's views on how well the BLS meet the requirements of GEPRA.

Thank you.

[The prepared statement of Mr. Wilson follows:]

Mr. Chairman, Members of the Subcommittee, thank you for inviting me to testify on improving the Consumer Price Index. Please accept my written testimony and enter it into the record. It should also be noted that the following testimony is my own view and does not necessarily reflect that of The Heritage Foundation.

The Consumer Price Index (CPI), along with the unemployment rate, is one of the two most important economic statistics produced by the Bureau of Labor Statistics (BLS). The CPI is a weighted measure of the average change in the prices of a fixed market basket of goods and services.[1] It is important because it not only is a central target of monetary policy, but also because it significantly affects government data and therefore the public policy debates surrounding such things as real wage and income growth.[2] For example, the implication of overstating inflation by 1.1 percentage points per year from 1973 to 1995 means that real hourly wages have actually increased 13 percent instead of falling by 13 percent as currently reported.[3]

The CPI is also important because it has major federal budget implications. In the current fiscal year, roughly 30 percent of total federal outlays are indexed to movements in consumer prices. Social Security, SSI, veterans' pensions, military retirement, and civilian pensions account for the bulk of this spending. Tax receipts are affected because individual income tax brackets, personal exemptions, and standard deduction are adjusted -- that is indexed – according to the CPI.[4] Individual income taxes account for about 45 percent of federal receipts.

There is widespread consensus that the CPI significantly overstates the rate of increase in the cost-of-living. This problem received even more attention with the release of the 1996 Boskin Commission Report.[5] The weight of evidence from the academic community, the Federal Reserve, the Congressional Budget Office (CBO), and even the BLS is overwhelming.[6] This upward bias in the CPI has and will continue to have significant implications for public policy decisions. Even after the next set of revisions to the CPI is completed in 1999, significant upward bias will remain.

There are a variety of methodological problems that, when combined, result in a significant overestimate of the increase in the cost-of-living.[7] To their credit, the BLS has a

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[1] Despite the best efforts of the BLS, many people mistakenly refer to the CPI as a "cost-of-living" index. As BLS-published descriptions make clear, the CPI as currently constructed will tend to rise more rapidly than a true cost-of-living measure.

[2] The CPI also effects among other things the real rate of economic growth, productivity, and the poverty rate.

[3] Michael J. Boskin, "Prisoners of Faulty Statistics," *Wall Street Journal*, December 5, 1996, A20.

[4] The CPI also affects around 28 other Internal Revenue Code sections. See Bureau of National Affairs, *Daily Labor Report*, December 5, 1996.

[5] Final Report of the Advisory Commission to Study the Consumer Price Index, *Toward a More Accurate Measure of the Cost of Living*, Committee on Finance, U.S. Senate, 104th Cong., 2nd Sess., December 5, 1996. Also known as the Boskin Commission after its Chairman Michael J. Boskin.

[6] Michael J. Boskin, Ellen R. Dulberger, Robert J. Gordon, Zvi Griliches, and Dale W. Jorgenson, "Consumer Prices, the Consumer Price Index and the Cost of Living," The Journal of Economic Perspectives, Vol. 12, No. 1, Winter 1998.

[7] The four major problems are: 1) lower-level and upper-level product substitution bias (when the price of beef goes up people buy more chicken); 2) an outlet substitution bias (as prices rise consumers may switch to new discount stores not sampled by the BLS); 3) a new product bias (new products are not introduced into the CPI, or included

program of research and development activities aimed at improving the CPI. Since 1990, the BLS has implemented a number of improvements in addition to the soon to be completed six-year CPI revision program.[8] The effect of these improvements, combined with the major CPI revision program, will effectively reduce the rate of increase in the CPI by almost 0.7 percentage points per year.[9] These changes alone will save taxpayers approximately $100 billion in federal outlays and interest payments between now and FY 2003.[10]

As a result of the increased focus on the CPI caused by the Boskin Commission report, the BLS has also begun a new multi-year CPI Improvement Initiative. In FY 1998, the BLS received $2.1 million for the first year of the Initiative and has asked for $9.1 million in FY 1999. According to the BLS, these funds will expand the Consumer Expenditure Survey to facilitate more timely CPI market basket updates and the production of an official superlative index that is more accurate than the current CPI. The new funding will also enable the BLS to significantly expand the use of hedonic quality adjustment methods and reduce the CPI's reliance on linking methods for new products.

Recommendations:

Congressional action is not immediately necessary, but oversight is critical. The President and Secretary of Labor have authority to direct the BLS to correct the CPI as part of the current Improvement Initiative. Funding for this important project should be found within the existing discretionary budget.

The Secretary of Labor should establish a cost-of-living index as the BLS's objective in measuring consumer prices. A perfect cost-of-living index may not be possible in a complex economy, but the BLS should continually strive for that goal.

The Secretary of Labor should establish a permanent and rotating independent commission of experts to review progress, conduct research, and make recommendations to further improve to the CPI. The commission should be appointed by either the National Bureau of Economic Research or the National Academy of Sciences and report the Congress once a year. If the Secretary of Labor does not establish such a commission this year, Congress should implement one through the appropriation process with the reprioritization of existing resources. Thirty years between the Stilger and Boskin commissions is far to long.

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only with a long lag); 4) a quality change bias (the price increases related to medical services are not adjusted for increases in the quality of care). There is also a temporal substitution bias (consumers purchase items on the weekends when products are on sale).

[8] The BLS has revised its methods for making seasonal adjustments; introduced procedures to capture the effect of generic drugs in reducing prices; changed the way shelter prices are estimated for renters and homeowners; corrected a flaw in the weights attached to new items in the CPI sample; and reclassified the services provided to hospitals to capture patterns of treatment better.

[9] Max R. Lyons, "Employment Policy Based on The Consumer Price Index: Roughly Right or Precisely Wrong?" Employment Policy Foundation *Fact & Fallacy*, Volume IV, No. 4, April 1998.

[10] Heritage Foundation calculation based on: Scott A. Hodge, "Ending the Era of Big Government: Balancing America's Budget," The Heritage Foundation, 1997.

The BLS should establish a new index that is published and updated annually, and revised historically as far back as possible. The index should immediately take into account all of the changes made to the CPI since 1990 and any future improvements that are made to the official CPI. This new index could then be used -- much like the current CPI-U-X1 index --as a deflator in economic research.

Conclusion:

A major problem is not the CPI itself, but what it is used for. Although Congress explicitly intended to automatically insulate program beneficiaries and taxpayers from the effects of inflation, they chose a mechanical process that does not accurately account for changes in the true cost-of-living. The Secretary of Labor and the BLS can and should make improvements to the CPI. Congress must conduct effective oversight and make it a priority to keep such an index up to date. Even if the upward bias in the CPI is only a fraction of a percentage point per year, the relentless compounding of such a bias ultimately has significant budgetary consequences.

Thank you very much for your time. I will be happy to answer any questions that you may have.

D. MARK WILSON

Labor Economist
The Heritage Foundation

Since February 1995, Mr. Wilson has been the Labor Economist at The Heritage Foundation.

Mr. Wilson specializes in workplace policy issues, examines the impact of labor market mandates and regulations, and the role of government in labor-management relations. His most recent work involves the minimum wage, reforming the Employment Security System, analysis of the ineffectiveness of federal job training programs, flex-time for private sector workers, and the impact of private sector mandates on wages and job opportunities.

Other Recent Issues Include:

- The 21st workplace, wage growth and income inequality, union activities and workplace democracy, Labor Department appropriations, and OSHA Reform.
- Development of The Labor Home Page: Workplace Issues Online at: http://www.heritage.org/heritage/labor/

For 13 years, until February 1995, Mr. Wilson was a senior economist in the U.S. Department of Labor, Office of the Assistant Secretary for Policy, providing analysis to the Assistant Secretary, the Chief Economist, the Secretary of Labor, and the White House on a wide variety of labor market issues. His work included:

- Economic Impact Analysis Workgroup of the President Clinton's Health Care Task Force. Drafted the analysis of the impact of the proposed mandated health insurance on employment. For this work Mr. Wilson received the Secretary's Exceptional Achievement Award in 1994.

- Labor Force analysis of the impact of the 1989 minimum wage legislation for Secretary Dole, and President Bush's White House Domestic Policy Council.

- Economic analysis on the current condition of the U.S. economy, labor and macroeconomic trends and forecasts.

Education:

Mr. Wilson received a B.A. in economics from Kent State University in December 1979, and continued with masters degree studies at George Washington University from 1983 to 1987 in macroeconomics, microeconomics, econometrics, and labor market theory.

D. MARK WILSON
Labor Economist
The Heritage Foundation

Heritage Publications:

- California's Proposition 226: What It Means for Union Members and Their Family Budgets, Heritage Backgrounder, April 20, 1998.
- Increasing the Mandated Minimum Wage: Who Pays the Price?, Heritage Backgrounder, March 5, 1998.
- The Worker Paycheck Fairness Act: Ending the Involuntary Use of Union Dues, Heritage, Backgrounder, February 12, 1998.
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- Saving Lives By Cutting Red Tape: Redefine The Federal Role In Workplace Safety And Health, Heritage Backgrounder Update, Sept. 5, 1995.
- Welfare Reform and Job Training Programs: What Congress Doesn't Know Will Cost Taxpayers Billions, August 16, 1995.
- Four Reasons Why Congress Should Repeal Davis-Bacon, Heritage Backgrounder Update, June 7, 1995.

Other published articles include numerous editorials that have appeared in the New York Times, The Washington Times, and many newspapers.

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Mr. SHAYS. Thank you very much.

Dr. Popkin.

Mr. POPKIN. Thank you, Mr. Chairman. I have a written statement that I request be placed in the record. I will try to both comment on what I heard this morning and work that into my own testimony.

The first thing I'd like to note is that the discussion this morning seemed to be characterized as sort of an academic, Government statistical agency, policymaker colloquy. I want to point out that I'm a businessman, and I'm the president of an economic consulting company that I established 20 years ago, and that one of the things my clients ask me to do is to interpret, analyze, and forecast the statistics the Government puts out. And for me to do my job I need objective statistics that are as accurate as they can be. And as a result of that, I have kept an active interest in what goes on in the statistical system, and I follow the CPI issue very closely.

Like the other speakers on the panel, I don't, most of my comments are really forward looking not with respect, not so much with respect to what's already been done. We know the Council of Economic Advisors, the changes the BLS have made have reduced the annual inflation rate, or will reduce it by 1999 by seven-tenths of 1 percent. I heard Katharine Abraham this morning say eight-tenths of 1 percent. In any event, there's been a substantial reduction in the rate of inflation apparently as measured and reported by the BLS. There is—a good part of that comes from the substitution bias and no one would disagree with the correction of the CPI for substitution bias. I think that's the part of the Boskin Commission report that was widely accepted. The reason economists say, and the Wall Street Journal reports, that almost three quarters of the economists they pooled thought the Boskin estimate was too high, the reason they thought that really had to do with the quality estimate which I'll get into at a later issue.

But of all the issues that must be addressed if the CPI is to be a better proxy for the cost of living, correction for substitution bias is, perhaps unfortunately, the easiest. That's why it could be accomplished most quickly. But it's unfortunate because what it really means is that the BLS has corrected for the overstatement first, so the potential understatement bias is posed by moving the CPI to a cost-of-living index remain and there are fewer upward-bias elements to offset them.

I think, Mr. Chairman, you addressed that this morning when you asked the question, "What are downward biases in the index?" And I think there are some and because the way this has worked out with the downward—the upward biases have been corrected first, I think that makes all the more urgent the need to move forward to correct some of the downward biases.

Now, one of the downward biases that is, really can be corrected right now and no one addressed it today. In 1971 when I was in charge of the CPI, I recommended that the environment be treated, environmentally opposed costs like a catalytic converter on a car be treated as a price increase, not a quality change. My boss bought it. Someone far above questioned it, and it got reversed. And the BLS has treated that kind of thing as a quality change, not a price increase as I think it should be treated ever since.

Mr. SHAYS. Given that we just have two of us here, let me interrupt you. I don't understand the significance of it. What is the impact of it being a quality change versus an increase in the cost?

Mr. POPKIN. If you look to the catalytic converter as something that no one would buy for their car——

Mr. SHAYS. Right.

Mr. POPKIN [continuing]. Unless everybody else had to buy them.

Mr. SHAYS. I realize it added to the cost.

Mr. POPKIN. It adds to the cost. The BLS asked the auto companies for the cost of making that catalytic converter and they'll subtract it from the sticker price of the car when they start to price it. That lowers the rate of inflation.

Mr. SHAYS. Right, because they consider it a quality change?

Mr. POPKIN. Because they consider—which, in fact, the Boskin Commission and the CBO have indicated and provided estimates that, in fact, it should be treated as a price increase.

Mr. SHAYS. And that was your recommendation many years ago?

Mr. POPKIN. And that was my recommendation in 1971.

Mr. SHAYS. How will you deal with a seat belt?

Mr. POPKIN. Seat belts I would treat as a quality change because I benefit directly when I sit in my car and I strap on that belt. I don't benefit directly if I put a catalytic converter on my car and nobody else does.

Mr. SHAYS. The argument would have been that in the long, long, long run it was a quality change because health care costs go down, and so on. That would be the argument? There was an argument on the other side with the catalytic converter?

Mr. POPKIN. Well, for the catalytic converter——

Mr. SHAYS. You don't have——

Mr. POPKIN. As I recall the argument on the other side came from the people who put out the GDP because if you treat it that way in measuring GDP, output should go up——

Mr. SHAYS. Right.

Mr. POPKIN [continuing]. Because somebody had to work to make that catalytic converter.

Mr. SHAYS. Right.

Mr. POPKIN. And you'd miss that, and that's really what swung the argument in 1971.

Mr. SHAYS. Jump in.

Mr. TOWNS. Yes, let me just say what about the new spark plugs where you don't have to have a tune up as often?

Mr. POPKIN. Well, I mean, that would be a negative quality deterioration. There are other things in cars that are quality improvements. In fact, the BLS has calculated that as compared with 1969, today's auto is 70 percent better. I think that underscores how difficult, is it 70 percent better? Is it 50 percent better? Is it 90 percent better? Does it fly instead of ride? Those are the kinds of questions, these are tough questions that you come into when you start to evaluate quality change. So, I think on this issue there's agreement with the original BLS position that I took in 1971. The CBO and the Boskin Commission have also agreed that environmentally imposed costs should be treated as a price increase and not a quality change, and I see no reason why the BLS doesn't do that because they know what the number is that they have to plug in.

Now, let me come to what I think is a more important issue but it was touched on this morning. It's the issue of the index family. Whose cost of living should be measured in measuring the cost of living? The Boskin Commission really never addressed this issue. However, increasingly economists are coming to address it. And I would point to a recent symposia published in one of the leading journals of the American Economic Review in which there was a report, there was an article by Boskin, but two of the other articles had to do with this issue of what is the index family and how do you do a price index for that index family? And I think that that issue was raised by several members of the committee this morning. And what they were talking about, let me characterize it this way, I think the panel understands that when you just add up dollars of spending for the whole economy and do a percentage distribution, that the Cadillacs weigh more heavily than the used cars in terms of pushing up the weight of automobiles in the index, for example.

My proposal is that you take the percentage distribution in each household from this consumer expenditure survey that was discussed this morning, take the percentage distribution in each household. Household A spending 2 percent on this, 4 percent on that, and you average the percentage distributions in each household, and that way there will not be the over weighting of the spending of the upper income part of the income distribution.

The question was asked this morning, "Who does the CPI represent?" That question was answered in the same symposia that I referred to by Professor Deaton from Princeton. He said that the CPI can best be characterized as capturing the prices paid by someone who is at the 75th percentile of the income distribution. That is 75 percent up from the bottom, and 25 percent from the top.

Mr. SHAYS. Which would be about approximately what income?

Mr. POPKIN. I would guess it would be above $75,000.

Mr. SHAYS. Yes, that's what I was——

Mr. POPKIN. I think. So that's something that I think that if the committee——

Mr. SHAYS. Only because I interrupted him. I've cut your clock only because I've interrupted and I——

Mr. POPKIN. Did you restart it, it's OK?

Mr. SHAYS. No, we're just going to let you——

Mr. TOWNS. He just shut it down. [Laughter.]

Mr. SHAYS. I just shut it down.

Mr. POPKIN. Oh, OK, OK.

Mr. SHAYS. But I don't want you to——

Mr. POPKIN. Well, I am trying to move along, I realize it's late in the day and we're all——

Mr. SHAYS. But I have interrupted you.

Mr. POPKIN. And one of the reasons I think it's important that the BLS move first to decide these index family issues and how it's going to weight the index is because that affects the quality adjustment problem. One of the witnesses this morning kept stressing the need for more quality adjustment. I don't think you know how to make a quality adjustment until you know what your index family is. And I'll give you this example. Everybody has got a VCR, and the BLS didn't put VCR's in early enough. Well, if you're doing an index that focuses on people around the median income distribution, they didn't have the VCR when those prices were coming down the curve at first. They only stepped in and started to buy when those prices really got affordable for them.

Mr. SHAYS. Yes.

Mr. POPKIN. So you didn't lose, you were not contributing to upward bias in the index if you were talking about the cost of living for somebody at that percentile. So I think I would like to see the BLS present a plan and Commissioner Abraham suggested that they have done work on different families. I think it can be done and I would put that as a high priority item.

I certainly commend the committee's position vis-a-vis the BLS. I think it's important, it's vital that the country feels that their statistics are not being politicized by any outside group. This is just as Congress, you have their outsiders, too, who are coming in, and you have to protect the BLS and do everything to keep the BLS as an honest broker in looking at ideas, but having the final judgment.

Mr. SHAYS. But you even pointed out something, maybe unwittingly, in your comments that there's a debate within the Government as to the impact, for instance, on the gross domestic product and so on. So, there are lots of factors here and I guess it would be naive for me not to realize that.

Mr. POPKIN. Yes. So, I think those are my basic——

[The prepared statement of Mr. Popkin follows:]

Prepared Statement
of
DR. JOEL POPKIN
Joel Popkin and Company, Washington, DC

Before the

Subcommittee on Human Resources
Committee on Government Reform and Oversight
United States House of Representatives

April 29, 1998

This Committee has requested testimony on three issues regarding improvements in the Consumer Price Index (CPI):

1. What the Bureau of Labor Statistics (BLS) has already done;
2. What the BLS has decided to implement in January 1999; and,
3. What the BLS' long range plans are to maintain the objectivity and accuracy of price and cost-of-living indexes on a timely basis.

I will briefly comment on (1) and (2) and provide my views about the direction of long-run plans. But because written testimony before a congressional committee must necessarily be presented in advance to Committee staff, it is quite possible that some issues I will raise have simultaneously been addressed by the BLS at this hearing. And I am hopeful that today's BLS testimony will already reflect some of the recommendations I will develop in this testimony. However, I should note that I cannot find them in the BLS contribution to the Symposia on the CPI that appeared in the latest issue of the American Economic Association's *Journal of Economic Perspectives* (JEP).

In its most recent report, the President's Council of Economic Advisers has estimated that improvements made through 1997 and those slated for 1998 and 1999 will reduce the annual rate of increase in the CPI by seven-tenths of one percent (0.28 + 0.41 percentage points). All but one of the improvements, in place and to be put in place, have lowered the measured inflation rate.

Of the seven-tenths total reduction, the two largest contributors, accounting for almost half, have to do in some way with correcting for so-called substitution bias. All economists would, at least in theory, support the view that such a correction is appropriate if the CPI is to represent changes in the cost of living. The Boskin Report put substitution bias at 0.5 percentage points, but that estimate has been shown to double count some substitution effects.[1] So the new formulas the BLS has adopted to address substitution have just about remedied the problem, at least as quantified by the Boskin report.

The other 0.6 percent of the 1.1 percentage point bias reported in the Boskin panel report is the contentious part. A *Wall Street Journal* survey, published February 25, 1997, after the release of the Boskin report, found that over 70 percent of the 320 economists surveyed had smaller estimates of CPI bias. That view most likely reflects the skepticism about the quality and new goods estimates put forth by the Boskin panel, which account for the other 0.6 percent, rather than skepticism about substitution.

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[1]See statement of BLS at hearings of the House Budget Committee, April 28, 1995.

As far back as 1961, the Stigler Commission recommended the CPI conform to a cost-of-living index (COLI). Recognizing that some parts of this change would be easier to accomplish than others, I recommended, when in charge of the CPI and PPI at BLS, that the CPI be characterized as a cost-of-living oriented index (COLO).[2] In that way, the public would know the BLS objective, but also that it would be reached as measurement of each various cost-of-living facet became possible.

Of all the issues that must be addressed if the CPI is to be a better proxy for the COLI, correction for substitution bias is, perhaps unfortunately, the easiest. That is why it could be accomplished most quickly. It is unfortunate because it means that the BLS has corrected the overstatement biases first, so the potential understatement biases posed by moving the CPI to a COLI remain, and have fewer upward bias elements to offset them. Therefore, it is imperative that the BLS move quickly to estimate other facets that comprise a cost-of-living index. Until it does, there is a greater likelihood that beginning in 1999 the CPI may be understating inflation than overstating it.

The first change needed, and the most obvious, is to correct the error in handling environmental-related costs. In 1971, I recommended that the cost of a catalytic converter for auto emissions be treated as a price increase, not a quality change. That recommendation was

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[2]See J. Popkin, "Problems and Progress in Improving Measures of Wholesale and Consumer Prices," *Business Economics*, May 1973, pp. 32-37.

implemented, then reversed and to this day the treatment of environmental costs is not handled properly in the CPI when viewed from a cost-of-living perspective.

The Boskin report and other economists now advocate the treatment I had recommended over 25 years ago. Yet, no plans to correct this problem have come to my attention in BLS' statements. The BLS passed up an opportunity to adopt this recommended approach when several years ago it chose to treat the higher pump-price of the special environmental winter blend of gasoline as a quality change, even though it was not related to its ability to improve the operational performance of autos. The BLS should reverse this procedure as soon as possible. That can be done quickly. Data and estimates exist. They were used in BLS' aborted attempt to do it in 1971 and have been used by the CBO and the Boskin panel. The effect can be quantified. And the BLS should expand its investigation of other goods and services that cost more because of requirements that they be produced in a more environmentally friendly way. Surely other items, besides auto-related ones, now cost more without a corresponding increase in their quality in providing their basic service.

But that step as well as the aforementioned adjustments for substitution among market basket items in response to relative price change are only the first ones necessary if the CPI is to move to a COLI.

There is another key conceptual issue critical to the empirical implementation of a COLI. It involves how the index family is defined and how weights are developed and a sample of items is drawn for such family or families. The Boskin panel did not address this issue, but should have. The BLS, itself, has reported some experimental results, evaluating different approaches to the issue, but it too has not reported plans to consider it.

The present CPI covers all-urban consumers. Its weights are calculated by adding spending of urban consumers in each expenditure category and calculating expenditure proportions at the economy level — 15 percent on food, 5 percent on apparel, etc. The item sample is then drawn to represent consumer spending in those expenditure categories.

There is an alternative method discussed in the economics literature that can be applied to the CPI-U, or a more narrowly-defined index family. It is to use an average of the percentage distribution of individual household expenditures among market basket categories. The present BLS weighting system gives more weight to spending patterns of upper income families because per household they spend more dollars. In view of the increase in the inequality of the distribution of income, the CPI weights have become even less representative of the typical American household. Angus Deaton, in a contribution to the aforementioned Symposia in the JEL, has calculated that in 1990 the U.S. household for which CPI weights are correct lies at the 75th percentile of the expenditure distribution. It would be even higher than that if more recent data were used and income were used instead of expenditures. The BLS method serves to place a higher weight on the more expensive varieties of goods like personal car phones, home computers, and airline travel.

These are some of the areas where the Commission is most worried that quality change is understated or new goods are not promptly introduced. It is conceivable, even likely, that many quality improvements are in items and varieties that are beyond the reach of median-income households. Thus, while the CPI may overstate inflation in the market basket for high-income consumers, it may understate inflation for low-income households. The BLS needs to examine the whole issue of whether the impact of quality change and new items is different on households in different percentiles of the income distribution. The issue of whether the CPI is to be weighted correctly, in my view, by averaging households' spending proportions or by preserving the current system, must be addressed before further work can go forward on quality change and new products. How to treat those two issues can only be intelligently informed when the index family and weighting are decided.

Most observers agree that a cost-of-living index, if it were developed in practice, would be the appropriate measure to index entitlements and certain aspects of the tax code. I have tried to emphasize that substitution, quality change, and new products are not the only issues separating the CPI from a COLI. Two mentioned so far in this testimony are the index family and representing it properly and the taking account of the impact of environmental costs on consumers. Crime, congestion, infrastructure, income and other taxes, and government services are others. Some of these, such as the environment and crime, are principally quality-of-life issues, but they often prompt consumers to spend income to prevent an erosion in their level of well-being. Taxes paid directly and indirectly by consumers and the quantity and quality of the government services they receive in return also affect their cost of living.

Finally, this Committee solicits input about what Congress can do. While there may be differences of opinion about research and implementation priorities, there should be no disagreement with the view that the BLS must remain independent of the political process. Congress needs to know what the BLS plans to do before it can appropriate funds, but those plans must be developed independently by the BLS, free from interference from any quarter. Some have recommended that a permanent, independent, public, professional entity be established and funded by the BLS to provide research input. But, the BLS already has a formal mechanism to do this. It has business and labor research advisory committees. Perhaps, it could establish an academic research advisory committee. Any more formal mechanism would facilitate politicization.

The BLS would be better advised to consider establishing arrangements with national laboratories, such as the National Institute of Science and Technology (NIST) to get the kind of technical advice needed to identify new products and evaluate quality change. Other agencies the BLS could draw on are the National Institute of Health research arms, the Consumer Product Safety Commission and the Environmental Protection Agency. Economists should not be put in the position of playing the roles of engineers, doctors, and environmental scientists.

The BLS has taken the first steps toward a COLI. But the public needs to know promptly the rest of its plan. Perhaps, these hearings will act as a catalyst to that end.

Mr. SHAYS. Proposals from what you've done. Yes, we have covered some of this territory maybe not as concisely as I would like in the earlier panel. But this is, I think an issue that both the ranking member and I are kind of wrestling with. We basically determine the CPI for a particular family, and that income level is more than $75,000 in this sense. Give me the percent because I'm going to nail that down, and maybe we can adjust that for the record. You said it was at?

Mr. POPKIN. Seventy-five.

Mr. SHAYS. Yes, OK. The thing that fascinates me is if I'm a fairly poor person, I'm going to pay my rent, I'm going to buy my food, and I'm going to try to get clothes for myself and for my kids. And, you know, I'd love extra activities like being able to go to a movie and so on. But I also want that car, and the car is not going to be new. So I'm going to get a second-hand car, not a new car. I'm not going to realize the benefits of some of the newness. But I'm going to still have to get that darn auto insurance. So when you figure out the auto insurance in terms of the market basket, you are making a determination that it's only a certain percent of my income, 75th percentile. And, in fact, it's a much bigger part of my income, and so, I just see a gigantic distortion because if that goes up significantly I'm impacted very negatively.

Mr. POPKIN. That's right. That's sort of a fixed cost. It goes with the territory.

Mr. SHAYS. Yes, it is a fixed cost.

Mr. POPKIN. Right.

Mr. SHAYS. I don't have much substitution. Really what I'd probably do is what, excuse me, I wouldn't think of doing this, but what some people probably do, is they probably at some point drop their auto insurance. They literally drive without auto insurance.

Mr. POPKIN. You know this is very topical in another sphere which is the recreational vehicles. If you make the assumption that recreational vehicles are very expensive, and only bought by people in the upper 25 percent of the income distribution, and the insurance companies keep a level, but they create more damage.

Mr. SHAYS. Right.

Mr. POPKIN. But the insurance companies keep their premiums level, they're essentially imposing more of the insurance burden on the lower income families who are driving the small cars.

Mr. WILSON. Mr. Chairman, I'd like—two points I'd like to make. One is the consumer expenditure survey currently collects family income data. They ask that in terms of keeping the diary in what you spend your income on. And they ask, "how much is your family income?" And that, so——

Mr. SHAYS. Let me ask you this——

Mr. WILSON. It's made fairly easy with the expansion——

Mr. SHAYS. Let me interrupt you a second. You're saying that when they do interview these families, they've asked them to keep a record?

Mr. WILSON. They keep a diary. There's an interview and there's also a diary.

Mr. SHAYS. But do they pay them to keep that diary?

Mr. TRIPLETT. No, it's voluntary.

Mr. WILSON. One of the other points I'd like to make is when we're talking about lower income families, there is a potential, I believe, that the substitution bias could indeed actually be larger for those families. When the price of Red Delicious apples go up, they may choose a different apple. When the price of——

Mr. SHAYS. Just talk in your "mic," a second, I'm sorry.

Mr. WILSON. I'm sorry. When the price of Red Delicious apples go up, they may choose different apples. When the price of hamburger goes up, they may choose to have pasta.

Mr. SHAYS. Right.

Mr. WILSON. So you may end up with a degree of substitution among those families and therefore, perhaps, a higher substitution bias in the old CPI, a portion of which will be addressed by the moving to the geometric mean at the lower-level substitution bias but it still doesn't address the upper-level substitution bias. That bias occurs when families choose between or substitute between hamburger and pasta for dinner. That's something that the index, I think Dr. Triplett was discussing.

Mr. SHAYS. We're not saying it in terms of income? You know, I'm just qualifying that.

Mr. WILSON. Well, there is a possibility that those choices, perhaps, don't, aren't made as often by higher income families.

Mr. SHAYS. I would think that they wouldn't be. I would think that income levels would determine your substitution rate.

Mr. WILSON. Yes.

Mr. SHAYS. Did you want to, Doctor?

Mr. TRIPLETT. Well, I just wanted to comment that this is a difficult area. There has been a lot of research on price indexes for different kinds of groups, for income levels, for the elderly, as mentioned this morning. The difficulty—and none of the research, by the way, seems to show that there are major differences in inflation rates across demographic groups. They do tend to show that within demographic groups, if you just apply the weights of the consumer expenditure survey, for example, for people who are in low-income groups, you find a lot of differences in indexes for people in the low-income group and a lot of differences among the people in the high-income group, but the average difference between the two groups isn't great.

Now the trouble with all that is, you're using the price indexes that the BLS collects. So Joe's example is on the mark. If you're going to do a low-income price index, you wouldn't go and price high-income goods. You'd price low-income goods. And if you were doing, there was some question about pharmaceuticals this morning, if you're doing an older person's pharmaceutical index, older people don't buy the same pharmaceuticals as younger people. And so you'd price the exact kind of pharmaceuticals that older people buy rather than just taking a package across the spectrum. So the difficulty with all this research is it only changes the weights and applies the weights to the same price indexes that have been collected across the board and it just turns out those exercises don't give you big differences in inflation. But they don't really answer the question because the question is you want to know, not only the weights, but also what people buy, and how are those prices moving.

Mr. SHAYS. Yes, sir?

Mr. POPKIN. I would just tack on to that, that information can be collected. The kind that we need. It's more expensive but, to do it, but it can be collected.

Mr. SHAYS. Let me just go to the gentleman 1 second. I just say that one of the observations that I made the last time we had BLS before us is what an extraordinarily important responsibility to have, and what an ignored agency on the part of Government in terms of the appointments of them, of the people, the commissioner, and so on, the significance of that appointment, and also the need to make sure they have the best staff and the resources necessary.

And it strikes me that there's a lot more that BLS could be doing that would be helpful. A new Congress and a new President, I don't mean Republican or Democrat, I just mean new, may say "There's a lot more we want you to do because we want to break up the income levels and we want to have a cost of living for one income level and a cost of living for another, a CPI for one and a CPI for another, and one for the elderly, and determine how Social Security is impacted particularly for the elderly with one on them." Is that something that conceivably we would want to move toward?

Mr. TRIPLETT. My suggestion would be that, what would seem to make sense, one would do a pilot, some sort of pilot study, and see how much difference it makes, you don't have to do the whole thing full blown. Katharine Abraham, this morning, said that would really be expensive. I think she's probably right. But you probably wouldn't want to do the whole thing full blown, you'd want to have some pilot and then you could compare the results of the pilot. Maybe in Florida or some area where you've got, don't have any problem collecting prices for things that elderly buy or Social Security recipients buy. And just see how that moves. Do it right for some small area in a pilot. See how it moves and then make your decision after you've got that pilot as to whether or not this is something that we want to put public funds into.

Mr. SHAYS. Thank you very much. Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman. I thank you very much for your comment because that was the question I was going to ask. I really appreciate you in terms of your views on that. The Congressional Budget Office has estimated that one half percentage point change in the CPI could result in a deficit reduction of approximately $25 billion. And, of course, 5 years after the alteration, 40 percent of that savings will be in program reductions, and 60 percent will be in increased taxes. Can you tell us what is the likely effect these changes will have on the overall economy?

Mr. WILSON. Certainly reduced interest rates, interest rate premium and the market will go down. That will certainly improve, in my opinion, improve the real rates of productivity and economic growth in the long run.

Mr. POPKIN. Could I comment on that? I'm not so sure, and this relates to a comment Mr. Wilson made earlier in his testimony. The inflation rate is running about 2.5 percent per year on the old basis before the BLS puts in these 1999 improvements. The short-term interest rate, the interest rate on a 3-month Treasury bill is about 5.5 percent, or 5.25. That means that the spread is almost

300 basis points for riskless investments. In other words, if the short-term interest rate is 5.5 and the inflation rate is 2.5, the difference is 3.

Now, I don't think that the financial markets are necessarily accepting of the view that there's a bias in the CPI from looking at those numbers because if you believe the original Greenspan and the Boskin estimate, they would take that 2.5 percent inflation rate down to maybe 1.25, and, yet, the markets are willing to trade Treasury bills at 5.5. Well, that's 4 or 5 percent, 400 basis points of real spread. That would make those short-term instruments very, very lucrative investments because there's no risk associated with them. So I'm not so sure that the market is really, really quite views the CPI bias issue the same way a lot of academic economists do.

Mr. SHAYS. How did you get into that by——

Mr. TOWNS. No, but I thought it was very interesting information that he gave us though, and it also points out that this is a very complicated——

Mr. SHAYS. What triggered the question, I missed that question? What was the, I heard the answer, what——

Mr. POPKIN. Impact on the economy.

Mr. TOWNS. Economy.

Mr. SHAYS. OK.

Mr. POPKIN. So, I'm really saying that I don't think it's going to have much impact on the economy because I'm not so sure that the markets accept the Boskin conclusion.

Mr. TRIPLETT. Yes, I think that people do tend to build some sort of notions of accurate statistics into their decisions. It seems to me that I heard an anecdote about a congressional committee, I've forgotten which one it was, it asked the Federal Reserve Board for policymaking mistakes because the CPI was inaccurate and as I remember, this was not an official statement but there were some unofficial statements by the staff, "well, look we already took it into account, we haven't made any mistakes."

Mr. SHAYS. They discounted it.

Mr. TRIPLETT. And so I think, you did that, I see——

Mr. SHAYS. No, we didn't. You're saying they discounted it already?

Mr. TRIPLETT. Well, they took it into account and so I think that's probably true of other decisionmakers in the markets as well. The markets form some estimate of whether they think there's a CPI bias and take it into account and probably what we tell them about it is something that's information for them but it isn't necessarily going to move their decisions by the full amount of the change in the CPI. So I'm supporting what Joel said about that.

Mr. POPKIN. There's one other, one other thing about the CPI and the Fed I'd like to add, and that is, that whether or not the CPI, as a measure of the rate of inflation is biased, what the Federal Reserve pays a lot of attention to is whether that rate is accelerating or decelerating, whether it's speeding up or slowing down. And no one has alleged that there's any bias in the BLS measurement of changes in the inflation rate, it's the actual rate itself that they question. Should it be two or should it be three? But whether it should be two or three, when it starts going up to four and five, we'll know there's been an acceleration of inflation.

Mr. TOWNS. Right. Thank you very much. Let me just sort of close on this, you asked, you answered in terms of the pilot project, part of this early on but should I be concerned about the effects that reduction in the CPI would have on Social Security and Medicare? The elderly are least likely to be able to absorb a reduction in income. If this is a problem, what should be done about it? Well, first of all, is it a problem, would you see it as a problem?

Mr. POPKIN. Well, in many respects that's, that's a policy issue. The part of the policy that I would react to is the following: that as I understand the tax law, there, if you, if you're on Social Security but your income exceeds $26,000 then part of your Social Security is taxed. So let's say that you cut the CPI and that cuts a $100 a year off everybody's Social Security payment. For the person in the higher income bracket, it means he doesn't have to pay quite as much as taxes. So that really says that a $100 reduction in Social Security payments for someone whose Social Security is not taxed is a full $100. If you're taxed on your Social Security, it's less than $100. So there's that sort of regressive aspect to it.

Mr. TOWNS. Any other comments? I think you——

Mr. TRIPLETT. Yes, I think I would agree with something that Bob Gordon said this morning. There are a lot of considerations in escalated Social Security payments that ought to be taken into account that probably aren't CPI issues. And what we're really interested in, I think, in the broad sense is fairness and equity and how we're going to distribute the total resources we've got among the retired and the un-retired people. And I'm not sure that we've thought enough about how we should do that distribution and how we should do the escalation, in focusing exclusively, we focus on the CPI because that's——

Mr. TOWNS. Right.

Mr. TRIPLETT [continuing]. The way it's done now but that's not the only way to do it. And maybe looking at this issue in a broader context is more fruitful than focusing too much on the CPI issues in relation to Social Security.

Mr. TOWNS. Good, excellent point.

Mr. TRIPLETT. Yes.

Mr. WILSON. I agree Dr. Triplett and Joel that accuracy here is really the primary issue when you're discussing CPI. In terms of the equity issues and the impact on how it's felt is a different policy discussion. There's been a lot of discussion about indexing, changing the index to a wage based, a wage inflator rather than a price inflator, price index, so, that's a different discussion. I think what's really most important in what's in front of us today is getting the best and most accurate cost of living measure that we can get.

Mr. TOWNS. Thank you very, very much. You've been extremely helpful. Mr. Chairman, I yield back.

Mr. SHAYS. I thank you Mr. Towns, also this panel, I thank you for your patience in waiting for us to get through the first panel but you were well worth waiting for. It was very interesting and we thank you very much. It helped clarify some points and I'm happy you participated. Thank you.

We'll close this hearing.

[Whereupon, at 2:07 p.m., the subcommittee adjourned subject to the call of the Chair.]

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