

How Would Shifting to a Chained CPI Affect the Federal Budget?

By Virginia P. Reno, Thomas N. Bethell, and Elisa A. Walker

Introduction

Two recent deficit reduction commissions called for using a new consumer price index to make cost-of-living adjustments (COLAs) in Social Security and other federal benefits and to adjust brackets in the federal income tax code. Proponents of the new index – the chained CPI-U – describe it as a technical correction that would make the benefit adjustments more accurately reflect the cost of living experienced by average consumers. Others maintain that the chained CPI-U falls short of reflecting the living costs experienced by the elderly and disabled because it does not take account of their higher out-of-pocket spending for health care. NASI's Fact Sheet No. 2, *Should Social Security's Cost-of-Living Adjustment Be Changed?*, explores how adequately the chained CPI-U would track living costs of Social Security beneficiaries compared to a special price index for the elderly. Because Social Security provides an ever-greater share of elders' incomes as they grow older – as pensions are eroded by inflation, employment options end, and savings are depleted – even a minor erosion of the real value of benefits is a public policy concern.

This fact sheet examines the impact of the chained CPI-U on the federal budget over the next decade (2012-2021), drawing on estimates by the Congressional Budget Office (CBO). Because the chained CPI-U grows more slowly than indexes now used, it would reduce benefit outlays and increase revenues. Nearly two thirds of the impact would come from benefit reductions in programs such as Social Security, federal pensions, veterans' pensions and compensation, and Supplemental Security Income, while one third would come from increased revenues. Beyond the first ten years, revenue gains are likely to shrink, while benefit cuts borne by elderly and disabled recipients are likely to remain indefinitely.

Benefit Reductions for Elderly and Disabled Americans

CBO assumes that the chained CPI-U will increase 0.25 percentage points more slowly than the CPI-W, which is now used to adjust Social Security benefits and most other federal pensions. Switching to the chained CPI-U would reduce Social Security benefits over the next ten years (2012-2021) by an estimated \$112 billion. If the chained CPI-U were also used to adjust federal civilian and military retirement pensions and veterans benefits – both compensation payments for those injured on active duty and means-tested pensions for low-income aged and disabled veterans with wartime service – federal outlays would be reduced by another \$24 billion over ten years. Using the slower-growing chained CPI-U to adjust other COLAs – including that of the means-tested Supplemental Security Income program for low-income aged and disabled citizens – would reduce outlays by another \$9 billion.

Impact on Federal Benefits and Revenues of Shifting to a Chained CPI-U, 2012-2021

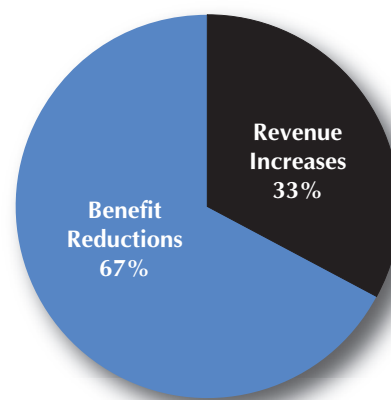
Source of Change	Billions of dollars	Percent of total
Benefit reductions	\$145	67%
Social Security	\$112	52%
Civilian and military pensions and veterans' benefits	\$24	11%
Supplemental Security Income and other programs with COLAs	\$9	4%
Revenue increases	\$72	33%
Total	\$217	100%

Source: Congressional Budget Office. *Reducing the Deficit: Spending and Revenue Options*, March 2011 (updated with new revenue estimates June 10, 2011).

Revenue Increases from the Tax Code

Tax brackets and other parameters of the federal personal income tax code are currently adjusted by the regular CPI-U. If the chained version of that index were used instead, CBO assumes that brackets would increase 0.25 percentage points more slowly per year, on average. The Joint Committee on Taxation, which provides tax analyses for CBO, estimates that over ten years this change would bring in \$72 billion of additional revenues. This is the combined effect of higher tax payments as taxpayers' real incomes rise more rapidly than the slower-growing price index and lower outlays for refundable tax credits, such as the earned income tax credit.

Effect of Chained CPI on Deficit Reduction, 2012-2021
\$217 Billion



How Permanent Would the Changes Be?

Proponents of shifting to the chained CPI-U generally assume that the benefit reductions and revenue increases will persist for the long term. Yet, tax laws frequently change from one year to the next. In fact, budget analysts often peg tax projections beyond ten years to broader measures of the size of the economy. As noted by the Office of Management and Budget in *Analytic Perspectives, Fiscal Year 2012*:

“There is some built-in momentum in the tax code that would tend to push up average tax rates over time. For example, the tax code is indexed for inflation, but not for increases in real income, so there is a tendency for individual income taxes to increase relative to incomes when real taxable incomes are rising, everything else being equal. Beyond the 10-year budget window, the projections [of revenues]... assume that this feature of the current tax code will not be allowed to raise individual income taxes.”

Similarly, CBO's *Long-Term Budget Outlook* (June 2011) uses two scenarios: an extended-baseline scenario that largely tracks current law; and an alternative scenario that is generally considered more likely. In the latter, revenues other than payroll taxes are assumed to revert to a constant share of gross domestic product (GDP) after the first ten years. These conventions among tax analysts reveal an expectation that revenue gains to be had from shifting to a slower-growing price index will be short-lived. It is anticipated that lawmakers will adjust policies to maintain taxes at a stable (and lower) share of GDP over the long term. In contrast, there is no precedent for assuming that future lawmakers will revisit and/or undo the cuts in monthly benefits for older and disabled Americans. Use of the slower-growing price index to adjust benefits is likely to be permanent.

Conclusion

This analysis of CBO estimates of the impact of switching to a chained CPI-U for adjusting benefits and taxes finds that, over the first ten years, two thirds of the deficit reduction would come from cuts in benefits borne by elderly and disabled Americans, while one third would come from new revenues. Beyond the first ten years, revenue gains are likely to shrink, while cuts in benefits for the elderly and disabled are likely to remain indefinitely.

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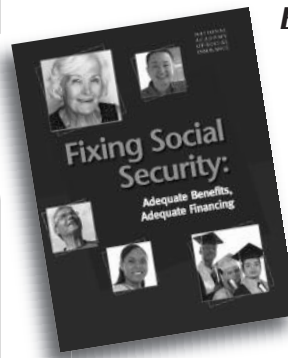
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NATIONAL
ACADEMY
OF SOCIAL
INSURANCE

1776 Massachusetts Avenue, NW, Suite 400, Washington, DC 20036-1904
(202) 452-8097 • (202) 452-8111 Fax
nasi@nasi.org • www.nasi.org