

## **A Chained CPI Just Makes Sense**

Every year, the Federal budget is adjusted for inflation. This happens a number of ways, but the two most important are inflation-related increases in Social Security benefits, and inflation-related changes in income tax brackets.

One of the issues that's come up in the budget debates is whether we should change how we measure inflation. Inflation measures how much the general price level has changed; if all prices rose by the same amount, say 2%, then clearly the inflation rate would be 2%. But what if some prices rise by 4%, and other prices don't change at all? Then what's the inflation rate?

Traditionally, the Consumer Price Index (CPI) has handled this problem by using a "typical market basket" of goods. Suppose for simplicity that everyone buys just two things, meat and vegetables. Suppose also that meat prices rise 4% and vegetable prices don't change. Then if we generally spent half our income on meat and the other half on vegetables, the inflation rate would be half 4% plus half 0%, or 2%. If on the other hand we spend only one fourth of our budget on meat, the inflation rate would be one fourth 4% plus three fourths 0%, or 1%.

The CPI works pretty well, but it's not quite perfect. The problem is that the "typical basket" of things we buy gradually changes over time. Suppose that last year we divided our \$200 budgets equally between meat and vegetables, spending \$100 on each. Then meat prices rose 4%. If we continued to eat half meat and half vegetables, that basket would cost \$104 plus \$100, or \$204, a 2% inflationary increase.

But suppose in the meantime we all switched to eating a lot less meat and a lot more veggies. Maybe we did that because the price of meat went up. Or maybe it was part of a long term trend towards eating healthier. Either way, now that we're eating only one fourth meat, our new "typical basket" only costs \$52 for the meat plus \$150 for the vegetables, or \$202, only a 1% inflationary increase.

Then using the traditional CPI would overstate the amount of inflation, increasing Social Security benefits and adjusting our tax code a bit too much. Both ways would increase the Federal deficit by just a little bit more.

A chained CPI solves that problem, by continually adjusting the "typical market basket" used to calculate inflation. It requires the government to continually adjust its measure of total US consumer spending, something that was impossible to do 30 years ago, but is relatively easy to do today. It gives us a slightly more precise measure of inflation. So shouldn't we just adopt it as our new standard?

The difference is not a big one. Under the traditional CPI, inflation has averaged about 2.7% since 2002. Under a chained CPI, it would have averaged 2.4%. A senior citizen getting \$1000 a month ten years ago, instead of about a \$27 inflationary monthly bump each year, would have seen their monthly benefits rise about \$23.50 each year. And the income level at which the top tax bracket starts would have risen by only about \$7500 a year, instead of over \$8800 annually.

Politically, Democrats don't like the impact on Social Security, calling it a cut in benefits. Politically, Republicans don't like the impact on the tax code, calling it a tax increase. But in reality, it's neither. We want to automatically adjust both taxes and Social Security for inflation. Shouldn't we be doing that as accurately as we can? If so, a chained CPI just makes sense.