

Letter from America: Getting Prices Right

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Recent controversy over the US consumer price index (CPI) has provided an unusually clear view of economics and economists at work shaping public policy, with government economists on one hand pitted against a group of distinguished academic economists and (largely conservative) elected officials on the other. The debate also yields a nice window through which to grade standard economic analysis for usefulness in dealing with the immediacy of an urgent policy debate, as well as for grading the policy debate in terms of its use of economic analysis. As always, the analysis and the politics are much more deeply interwoven than many of the participants choose to admit, at least in public, although in this case we have a fairly clear case where policy is driving the data—or at least trying to—and not the data driving the policy.

The story begins with the Federal Reserve, whose research suggested that the CPI, which is compiled by the Bureau of Labor Statistics (BLS), grows too quickly, partly because of the familiar substitution bias, but also because quality improvements were inadequately captured. Since much of Federal entitlement spending—including Social Security—is indexed to the CPI, Fed Chairman Alan Greenspan's endorsement of this research in January 1995 was quickly seized on by lawmakers. If the BLS could be persuaded to decrease the rate of growth of the CPI, large amounts of projected spending would never materialize, and no politician could be held responsible for cutting benefits for powerful constituents. Greenspan calculated that a one percent per year reduction in the rate of growth of the index applied to indexed programs would lower the Federal budget deficit by \$55 billion after 5 years. Speaker Gingrich quickly threatened that if the BLS didn't "fix" the CPI within the week, he would abolish the BLS. Instead, the Senate Finance Committee appointed a blue-ribbon committee of experts to consider the issue. The committee contained some of America's most distinguished and well-known economists; chaired by Michael Boskin of Stanford University (previously the Chairman of President Bush's Council of Economic Advisors), it comprised Ellen Durenberger of IBM, Robert Gordon of Northwestern University, and Zvi Griliches and Dale Jorgenson of Harvard. The committee's findings confirmed Greenspan's analysis, estimating that the CPI growth has had an upward bias of around 1.5 percent in recent years, and projected that there would be a bias of about 1.0 percent a year for future years if no corrections were made. Only a minor fraction of the bias was attributed to failure to allow for substitution, some was to slow updating for new goods (in spite of their dubious importance to the debate, a great deal of fun—and embarrassment—has been had with cellular phones) and the largest amount due to the failure to capture quality improvements.

In the last few weeks, the Republican Majority and President Clinton have agreed on a plan to balance the budget, without the aid of any revision of the CPI, revisions that, like any other modification to Social Security or Medicare, were opposed by the powerful lobbies for the elderly as well as by a majority of both Republicans and Democrats in the House of Representatives. Meanwhile, the economists in the BLS, ably led by Commissioner Katherine Abraham and the chief of price index research, Brent Moulton, have conducted a sterling counteroffensive. In the eyes of this referee, the BLS has won a clear victory on points. The agency already makes very substantial (and careful) corrections for quality—whenever there is any solid basis for doing so. It is instructive to compare the BLS analysis with that of the Commission, and in particular with its willingness to assume large quality effects—usually described (in an unusually well-chosen adjective) as "conservative"—for groups of commodities where, not only is there no solid estimate of quality effects, but where there is no literature or previous research of any kind.

Much of this debate would be familiar to any economist who has read any textbook treatment of price indexes. But unlike substitution bias—where there exist well-worked out and well understood methods for making corrections, there is much less solid work on the measurement of quality. There are literatures for specific commodities—computers, automobiles, and health care—and there is a distinguished but not very conclusive literature on hedonics. But as the debate has shown, economics has not succeeded in deriving a systematic and agreed-upon methodology for incorporating quality improvements, even for food, let alone for increases in life-expectancy or declines in crime rates—both of which are cited by Boskin as reasons why the elderly are overcompensated by the CPI.

There are also issues that are well-understood in economics that—although not entirely absent—have played a surprisingly small part in the public debate. Discussion of income effects are a notable absentee. It is largely taken for granted that the same price index works for everyone, probably not a bad assumption in recent years—although health care prices are an issue—but ignoring the issue surely stores up problems for another day. It must surely also be the case that the quality bias is different for different income groups; the range of foods in my Princeton supermarket is quite different from even a decade ago, but this is far from true throughout the country. There has also been too little discussion of whether it makes sense to insure the elderly (and other program recipients) against all price increases, whatever their cause. Such mechanisms do not achieve the obvious goal of social security, which is to tie the consumption of the elderly to that of the majority of the population. It is hard not to sympathize with the commonly expressed view that the Boskin Commission's conclusions were driven more by the opportunity to cut entitlement spending than by a serious consideration of the procedures that ought to be followed by a BLS doing the best possible job of producing a consumer price index. In any case, the manifest competence of its economists shows that the BLS needs no such advice.

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