# LEADING ECONOMIC CONTROVERSIES

EDITED BY
Edwin Mansfield

# Leading Economic Controversies

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# Preface

Economics is an exciting subject—or it can be if it is taught properly. Obviously, one of the most important purposes of an elementary economics course is to get students interested in the subject, and this can best be done by showing them how the principles of economics can enable them to understand better the major economic issues of today. That in brief is the purpose of the Fourth Edition of this book, which focuses on eleven central policy areas: (1) Social Security (2) education, (3) the distribution of income, (4) competition and antitrust policy, (5) the environment, (6) farm policy, (7) GDP and economic growth, (8) fiscal policy, (9) taxation and personal investing, (10) monetary policy, and (11) international trade policy. One-third of the articles included are new to this edition.

These policy areas play a major role in practically any elementary economics course. To arouse students' interest in each of these areas, this book presents contrasting (or in some cases, complementary) views by leading policymakers (like Alan Greenspan, and John Kasich), prominent scholars (like Robert Barro, Alan Blinder, Barry Bosworth, Robert Eisner, Robert Hall and Alvin Rabushka, Paul Krugman, Burton Malkiel, Charles Schultze, and James Tobin), and major business executives (like Robert Lutz), as well as government advisory groups like the President's Council of Economic Advisers. Each of the articles is at a level that is appropriate for the typical undergraduate. The articles, many of which are based on speeches, tend to be lighter in tone—and hence more palatable to students—than many other discussions of these issues. Also, it is worth noting that these articles tend to be very up-to-date.

In each of the eleven parts of this book, after the articles presenting different views of a particular issue, there are questions for analysis. These questions, which can form the basis for classroom discussion or homework exercises, are meant to provide an overview of the articles and to encourage the student to relate key points in the articles to the principles of economics.

This book was originally conceived as a supplement to *Economics U$A*, Fifth Edition, but many instructors have used it to supplement other elementary economics textbooks; and some have used it alone.

E.M.

October 1997

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PART ONE

# SOCIAL SECURITY AND THE CONSUMER PRICE INDEX

Social Security payments are of great consequence to the aged and others in the United States. Thus it is not surprising that many citizens are worried about the government projections indicating that changes will have to be made in the Social Security system to maintain its solvency. The first article in this section, by President Clinton's Council of Economic Advisers, outlines the potential problems. The second article, by Barry Bosworth of the Brookings Institution discusses the findings of a panel of economists that the Consumer Price Index overstates inflation by about 1.1 percentage points annually. If this is true, Social Security payments could be lowered, thus making it less likely that major changes in the Social Security system would be required. However, Bosworth emphasizes that Congress should not "cede its responsibility to make critical public policy decisions to a group of putative experts."

# Problems Ahead for Social Security*

Janet Yellen,
Chair, Council of
Economic Advisers

## PRESIDENT CLINTON'S COUNCIL OF ECONOMIC ADVISERS

Without changing current law in any way, Social Security can pay full benefits well into the next century. Thereafter, without any changes in the structure of the program, funding will be sufficient to cover about 70 percent of benefits even 75 years from now. Nevertheless, the program faces a funding gap over the 75-year projection period and permanent imbalance after 75 years. The challenge is to restore balance to the program, raise national saving, and allow Social Security to continue to fulfill its many missions.

For almost 60 years, Social Security has provided elderly Americans with a basic level of retirement security. Currently, about 90 percent of "aged units"—married couples one of whom is aged 65 or older, and nonmarried persons aged 65 and over—get Social Security benefits. These benefits are the only form of retirement pension for about half of these households. Social Security is particularly important for the low-income elderly. For example, more than three-quarters of the money income (which includes earnings from work and interest, as well as retirement benefits) of households in the bottom two income quintiles comes from Social Security benefits. The comparable shares are about a quarter for the highest income quintile and about half for the second-highest.

*This is an excerpt from the *Economic Report of the President* (Washington, D.C.: Government Printing Office, 1997).

Social Security benefits keep some 15 million people above the poverty line and millions more from near poverty. As recently as 1959, when these data began to be collected, the poverty rate among the elderly was more than twice that for the rest of the adult population. Since then this rate has trended lower and is now slightly below that for other adults. Social Security has been a key factor behind this drop. Moreover, although the benefit schedule is progressive and some benefits are subject to partial taxation, Social Security benefits are not subject to an explicit means test. The lack of means testing allows many people to add other resources to their Social Security benefits and achieve a level of income not too far below that when they were working.

Social Security also provides protection against loss of family income due to disability or death. Roughly 5 million disabled adults and 3 million children receive monthly benefits; about half the children receiving benefits have lost one or both parents. In short, Social Security is an extremely valuable program that has raised the living standards of millions of Americans and markedly increased their sense of economic security by providing fully indexed annuities in the event of retirement, disability, or death of a breadwinner.

**THE SIZE OF THE PROBLEM**

In their annual report, the Trustees of the Social Security system publish projections of the system's revenues and outlays for the next 75 years. Three sets of projections are made, corresponding to three sets of assumptions about future levels of system costs. The intermediate cost projections in the 1996 report show that, from now through 2011, the Social Security system will bring in more money than it pays out. That is, payroll tax receipts plus receipts from income taxation of Social Security benefits will exceed outlays.

By that time the baby-boomers will have begun to retire, and growth in the labor force will slow, reflecting the decline in the fertility rate that occurred after 1960. The resulting increase in the ratio of retirees to workers will cause the outlays of the system to rise above taxes. In the relatively short period from 2012 through 2018, the annual interest income on assets in the Social Security trust funds will, together with tax receipts, produce enough revenues to cover benefit payments. After that, if no action is taken, total income will fall short of benefit payments, but the shortfall can be covered by drawing down trust fund assets until the funds are exhausted in 2029. Of course, the exhaustion of the trust funds does not mean the end of Social Security benefits. Even if no changes are made on the tax or the benefit side of the equation, payroll and benefit taxation at current rates will provide enough money to cover 75 percent of promised benefits in 2040 and nearly 70 percent in 2070.

# The Politics of Immaculate Conception*

BARRY BOSWORTH

Last December the Advisory Commission to Study the Consumer Price Index issued a report arguing that the CPI has been overstating inflation for the past few decades—by 1.1 percent in recent years. The commission recommended that the overstatement be corrected forthwith.

Years of neglect and underfunding have seriously eroded the quality of the U.S. statistical system, and the commission's attention to the adequacy of the CPI as a measure of inflation is welcome. But the accuracy of national statistics was not the only issue Congress had in mind when it appointed the commission. Adjusting the CPI in accord with the commission's recommendation would have major effects on taxes, federal benefits, and the goal of future budget balance.

The commission's conclusion that the CPI overstates inflation was not surprising. It is consistent with earlier research on the price indexes, and few analysts would disagree. But there is less empirical basis for the commission's estimate of the magnitude of the bias. While the estimate is consistent with a number of recent survey articles, it is important to understand that all the reports are extrapolating from a common small set of empirical studies, none of which was intended to provide an unbiased as-

*This article appeared in the *Brookings Review* in Spring 1997. Barry Bosworth is a senior fellow at the Brookings Institution.

sessment. The empirical studies, most arising from research conducted at the Bureau of Labor Statistics, focused on specific problems with the CPI—and, naturally, on those areas of the CPI where the effect would be largest. At this time, we do not know the extent to which the results of studies of those narrow areas can be generalized to other parts of the index.

The issue of bias in the CPI involves both technical aspects of constructing an index and measures of quality change. The technical issues are straightforward, and the commission estimates their impact on the rate of change in the CPI at 0.5 percent per year. The commission has highlighted some basic problems and provided specific suggestions that would help resolve them. Congress should provide the funding to update the index, and the BLS should move in the direction proposed by the commission. The result would be a better index.

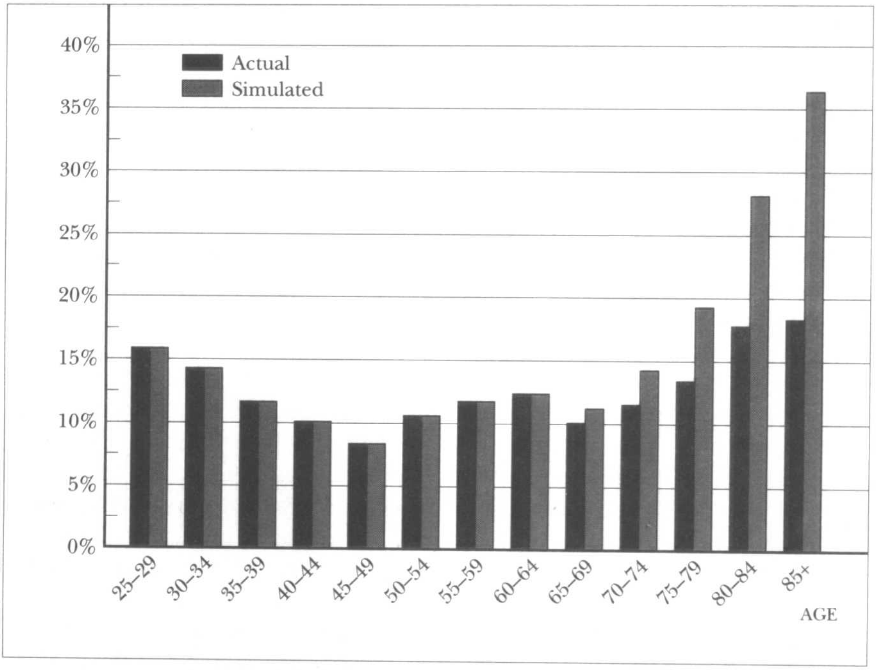
The problems with the commission's recommendations arise in connection with the issue of quality change, the remaining 0.6 percentage point of overstatement. In the first place, the commission's report fails to reflect fully the extent to which the current CPI already adjusts for quality change. Of course the quality of some goods and services has improved. But that is not the point. The real question is whether the quality improvements have been more than are embodied in the current procedures. For, though few people outside the BLS seem to know it, the index already reflects a large amount of quality gain. In 1995 the total price increase in a subsample of the CPI, covering about 70 percent of the total, amounted to 4.7 percent. But the BLS determined that 2.6 percentage points, or slightly over half the increase, represented improvements in quality. That is, quality improvements offset about half of the gross price increase, yielding an estimated 2.2 percent inflation rate.

The CPI commission is arguing that the quality adjustment should have been 0.6 percentage points larger, 3.2 percent rather than 2.6 percent. They could be correct, but on the basis of existing evidence, we don't know that. I don't see how anyone can be that precise. Indeed, one disappointing feature of the commission's report is that it offers no new procedures to improve the estimate of quality change; it simply asserts that it is larger than estimated by the BLS.

Much of the dispute arises out of different views of how producers go about introducing price and quality changes. If most quality changes are small and incremental in nature, current BLS techniques may overlook them and end up misstating the price change. But if price and quality changes are tied closely together in the introduction of new models, the BLS methodology may overestimate quality improvements and understate inflation, a possibility ignored by the commission. In most cases, major changes in a product's characteristics will result in its being dropped from

**CHART 1** Low-income Population by Age, Actual and Simulated, 1995

Percentage below current poverty income level




Source: Calculated from March 1996 CPS using poverty level as measure of low income.

the index, implicitly attributing most of any price change to quality. Thus, price increases that are imbedded in new models are ignored and assumed equal to those of other products in that month. On average, a product's characteristics will undergo major change every two years.

In addition, the commission argues that the CPI should be an index of the cost of living and not just the average cost of a fixed market basket of goods and services. That seems right in concept. A cost of living index would reflect the fact that consumers can avoid some price increases by switching to substitute products. But pushing that idea to the extreme can open a can of worms that exceeds the capacity of the current methodology. Where do we draw the line between economic and noneconomic aspects of the cost of living, and are they separable? How should we value the time required to shop for the lowest price and increases in the range of consumer choices?

Congress is drawn to the issue not out of a fascination with the arcane issues of index number construction, but because the CPI is used to adjust large elements of the federal budget—Social Security benefits and income tax brackets—for annual increases in the cost of living. A revised CPI offers an "immaculate conception" version of deficit reduction in which spending is cut without Congress taking the blame. While the first-year savings from a lower CPI would be small, they build up over time. A 1.1 percentage point reduction in the annual increment to the CPI would save $150 billion in the tenth year, or about 1 percent of the GDP. It is becoming evident, however, that procedural changes by the BLS will generate only a fraction of the commission's suggested overestimate of 1.1 percent. Thus, it is suggested that a group of "experts" who are knowledgeable of the actual increase in the nation's average cost of living could provide Congress with a more accurate measure, again providing Congress with some cover for benefit reductions.

Were it not for the politics of immaculate conception, I don't think that Congress would be considering this particular form of benefit reduction. Consider, for example, its impact on the nation's oldest citizens. The typical retiree can expect to receive Social Security benefits for about 20 years. The importance of these benefits rises with age: private pensions have no inflation adjustment and retirees tend to use up their own assets. The proposed adjustment to the CPI would have no effect on the benefit of a new retiree, but benefits in each succeeding year would rise by a smaller percentage. After 10 years, benefits would be reduced by about 12 percent; after 20 years, by 25 percent. Currently, the average income of those over age 80 is only two-thirds that of people aged 65–69, and the poverty rate rises from 10 percent for families with a head aged 65–69 to 18 percent for those over age 80. The recommendation of the commission would exacerbate that trend. If the recommendation had been in effect for the past two decades, the proportion of those aged 65–69 with income below the current poverty standard would rise only marginally to 11 percent, but for those over age 80 it would soar above 30 percent.

Congress will have to scale back Social Security benefits in future years, but it should consider carefully the implications of how it makes the cuts. It makes far more sense to concentrate the cuts at the beginning of the retirement period when individuals can mitigate their effect by postponing retirement or working part-time, not when retirees are in their 80s and have no employment options. Nor should Congress cede its responsibility to make critical public policy decisions to a group of putative experts. Unless they are expert shoppers, it is not at all clear what they are supposed to know about annual changes in the cost of living that cannot be incorporated in the procedures of the BLS.

## QUESTIONS FOR ANALYSIS

**1.** Have Social Security benefits played a role in lowering the poverty rate among the elderly?

**2.** Is there likely to be an increase in the ratio of retirees to workers? What effect is this likely to have?

**3.** What was the conclusion of the Advisory Commission to Study the Consumer Price Index?

**4.** Does Barry Bosworth agree with the Advisory Commission to Study the Consumer Price Index that, because of changes in the quality of goods, the Consumer Price Index overstates the inflation rate by about 0.6 percentage points per year?

**5.** According to Bosworth, the recommendations of the commission would increase the percentage of people over 80 with incomes below the poverty line. Why?

**6.** Bosworth argues that Congress should not cede its responsibility to make critical public policy decisions to "experts." Do you agree? Why or why not?