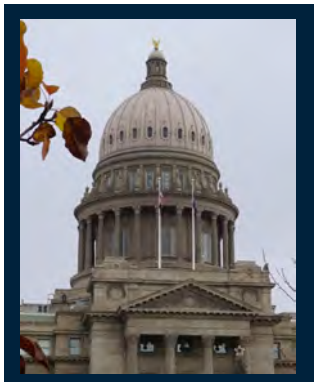
Evaluation report
February 2020

Chained Consumer Price Index

Office of Performance Evaluations
Idaho Legislature

Promoting confidence and accountability in state government



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Established in 1994, the legislative Office of Performance Evaluations (OPE) operates under the authority of Idaho Code §§ 67-457–464. Its mission is to promote confidence and accountability in state government through independent assessment of state programs and policies. The OPE work is guided by professional standards of evaluation and auditing.

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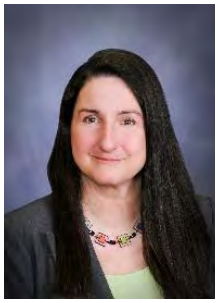

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Senator Mark Harris (R) and Representative Ilana Rubel (D) cochair the committee.

From the director

February 5, 2020

Members
Joint Legislative Oversight Committee
Idaho Legislators

Over time, inflation significantly impacts any statute or policy that references a specific dollar amount. However, Idaho rarely adjusts for inflation in state statutes. This evaluation compares the chained CPI to other relevant price indexes and discusses the widespread impact of inflation on state policymaking.

Adjusting policy to allow for inflation is more important than calculating the difference between the traditional CPI and the chained CPI. As Governor Brad Little writes in his response to our evaluation, "The impacts of inflation…need to be carefully considered for future policymaking decisions."

We appreciate the assistance we received from Chief Economist Derek Santos and other officials from the Department of Administration, the Department of Transportation, the retirement system (PERSI), and the Tax Commission.

Sincerely,

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Formal responses from the Governor, PERSI, and the Department of Administration are in the back of the report.

Chained CPI

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Key Questions

Legislative interest

During the 2019 legislative session, the Joint Legislative Oversight Committee assigned us to study the state's practices for indexing dollar amounts in statute, rule, and contracts. Indexing is the practice of regularly adjusting dollar amounts to keep up with inflation.

Legislative interest in the chained CPI comes after the federal government replaced the CPI-U with the chained CPI in the federal income tax code with the Tax Cuts and Jobs Act of 2017. The chained CPI is expected to increase more slowly than the CPI-U and lead to smaller inflation adjustments for tax bracket thresholds, credits, and deductions, a net increase in taxes over time.

Legislators also expressed interest in a review of the use of indexing in state contracts to ensure that these practices were fair to both the state and vendor.

Study approach

This study discusses three key questions:

1. Is Idaho using the most appropriate index when adjusting for inflation?
2. What would be the impact of adjusting certain policies for inflation, particularly using the chained CPI?
3. What practices do state agencies use to index contracts and what options exist to improve these practices?

These questions form the structure of the report.

Inflation is relevant to policymaking whenever a law specifies dollar amounts. For this report, we focus on general interest policies where the Legislature automatically adjusts for inflation. We further examine areas where other states or the federal government use automatic adjustment, but Idaho does not.

Acknowledgements

We received assistance from the National Conference of State Legislatures and from Idaho's Department of Administration, Division of Financial Management, PERSI, and Tax Commission.

Adjusting for Inflation

Measures of inflation

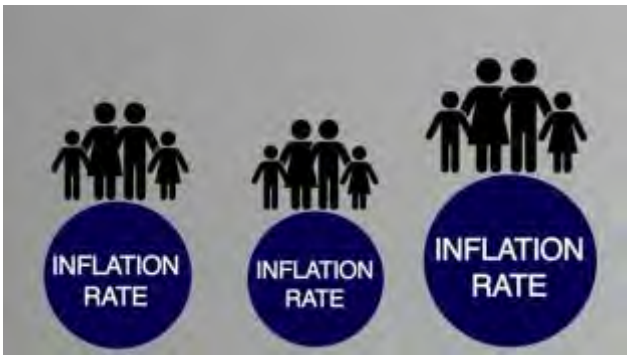
Inflation is an increase in the average price of goods and services over time. As prices increase, the same dollar buys less.

The US Bureau of Labor Statistics (BLS) publishes several measures of inflation. These measures track price changes of goods and services and can be used to compare prices over time. One common use of these measures is to adjust dollar amounts in law or in contracts for inflation to preserve the value of the dollar amounts.

The most used measures of inflation are the consumer price indexes. The BLS first published a Consumer Price Index in 1921. In the 1970s, the BLS began publishing both the Consumer Price Index for All Urban Consumers (CPI-U) and the Consumer Price Index for Urban Wage Earners (CPI-W), a subset of all urban consumers.

In 2002 the BLS introduced the Chained Consumer Price Index for All Urban Consumers (chained CPI). The BLS considers the chained CPI to be the most accurate measure of inflation experienced by consumers.

There is an important difference between the chained CPI and other indexes. The BLS uses up-to-date data on what people buy to calculate the chained CPI. In contrast, the BLS calculates the CPI-U and CPI-W using outdated expenditure data. For example, the CPI-U and CPI-W in 2016 and 2017 were calculated based on data collected in 2013 and 2014. As a result, CPI-U and CPI-W calculations fail to account for the tendency of consumers to buy specific goods and services less often when their prices increase more than average, a shortcoming known as substitution bias. The chained CPI has measured inflation at about 0.25 percentage points lower than the CPI-U and CPI-W.

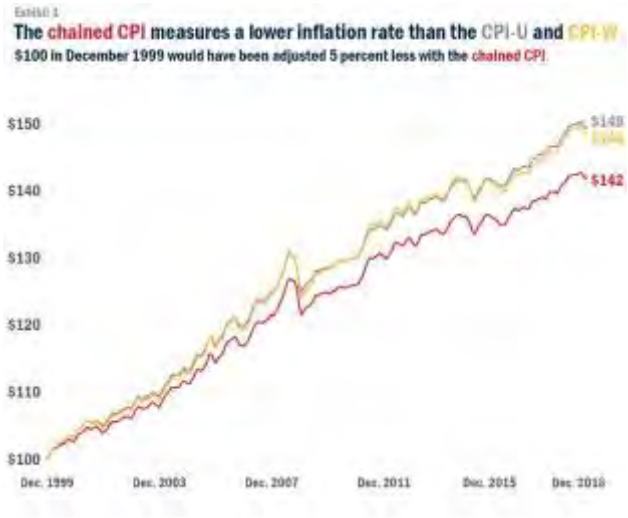


1 - The BLS explains differences between the chained CPI and other indexes in this video.

The chained CPI has measured inflation at about 0.25 percentage points lower than the CPI-U and CPI-W.

The up-to-date expenditure data used to calculate the chained CPI is available after the BLS releases the chained CPI. Therefore, when the BLS releases the chained CPI estimate for a given month, the estimate can continue to be revised for up to two years as more data become availabe. These revisions can complicate indexing when using the chained CPI because adjustments may be different when calculated at different times.

The known tendency of the CPI-U and CPI-W to overestimate inflation leads dollar amounts to be overadjusted. The difference each year is small, but the compounding effect becomes substantial over a long time, as shown in exhibit 1.



2 - Source: Bureau of Labor Statistics (see up-to date values).

In addition to consumer price indexes, the BLS publishes three other types of measures:

Producer price indexes measure changes in prices paid by producers of goods and services.

The International Price Program measures price changes for imports and exports.

The Employment Cost Index measures changes in hourly labor costs to employers, irrespective of employment shifts between occupations and industries.

These measures are also published by industry or region.

In addition, the Bureau of Economic Analysis publishes the Gross Domestic Product Deflator, which measures changes in the price of all goods and services produced in the country.

All indexes are used by governments or private entities to adjust dollar values for inflation in law or in contracts. In Idaho law, however, the CPI-U is the most common index referenced, as shown in exhibit 2.

The most commonly referenced measure in Idaho law is the CPI-U.

What is adjusted?	What is the legal authority?	How is the amount adjusted?
Income tax brackets	§ 63-3024	Annually adjusted using the CPI-U.
Income tax brackets (partial-year residents)	§ 63-3026A	Annually adjusted using the CPI-U.
Cost of living adjustments for state employee pensions	§ 59-1355	Annually adjusted. Minimum is 1% or the CPI-U, whichever higher. Maximum is 6% or the CPI-U, whichever lower.
Sales tax distribution to counties to defray election costs	§ 63-3638(8)	Annually adjusted using the CPI-U; cannot drop below initial $4.2 million amount.
Minimum size of a qualified charitable gift annuity to be excluded from insurance requirements	§ 41-126(1)(c)	Annually adjusted using the CPI-U "or some equivalent measure."
Net worth standards to be exempt from certain insurance requirements	§ 41-1212(5)(b)	Adjusted for 5-year period using the CPI-U.
Reimbursement thresholds for claims to the small employer carrier reinsurance program	§ 41-4711	Annually adjusted by at least the medical component of the CPI-U, unless board and director of the program support less.
Threshold for a nonprofit hospital conversion transaction for antitrust purposes	§ 48-1502	Annually adjusted based on hospital services component of the CPI-U.
Medicaid reimbursement for building costs of skilled care facilities.	§ 56-309	Annually adjusted using an index from the Marshall Swift Valuation Service or the renter's costs component of CPI-U.
Endowment fund benchmark market values for determining gains and losses	§ 57-724	Annually adjusted using the CPI-U.
Revocation reporting thresholds for rebojoints	§ 67-6519	Biennium adjusted using the CPI-U.
Amount of financial assurance required for waste tire storage sites	§ 39-6902	Annually adjusted using the CPI-U.
Forest management cost allowances	§ 63-1705	Adjusted using 10-year rolling average changes in the Producer Price Index.
Resource allowance limits for aid to the aged, blind, and disabled program	IDAPA 16.03.05.745	Annually adjusted using the CPI-U.
Property reimbursement rate for nursing facilities	IDAPA 16.03.10.275	Annually adjusted using an index from the Marshall Swift Valuation Service or the renter's costs component of CPI-U.
Annual deductibles for Medicare supplement plans	IDAPA 18.04.10.023.05	Annually adjusted using the CPI-U.
Medicaid cap on overall hospice reimbursement	IDAPA 16.03.10.450	Annually adjusted using the CPI-U.
Fee schedule for public safety communication maintenance fees	IDAPA 15.06.03.100	Annually adjusted based on "the Consumer Price Index" or as contracts are negotiated.
Real price appreciation of stumpage	IDAPA 35.01.03.960.09	Unspecified. Not adjusted using the Producer Price Index for softwood logs and bolts

Why inflation matters to policymaking

Dollar amounts specified in statute embody legislative intent. Inflation decreases the value of static dollar amounts. If dollar amounts are not adjusted, the resulting effect is the same as if the Legislature were lowering the specified dollar amounts each year. Alternatively, if dollar amounts are adjusted too much, the effect is as though the Legislature raised the specified amounts each year.

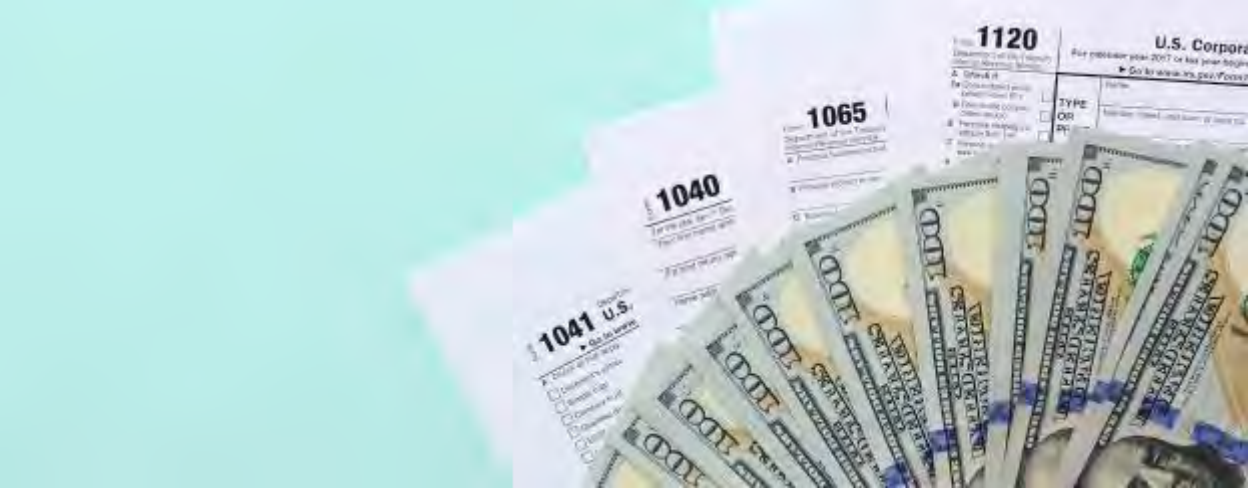
Some dollar amounts in statute have not been adjusted since before the 1970s and 1980s, which featured years of double-digit inflation.

The Legislature may prefer to adjust dollar amounts only upon legislative deliberation rather than automatic adjustment. However, without adjustment, inflation undermines the legislative intent of fixed dollar amounts in statute.

Selecting the appropriate index to adjust for inflation is important. Suitable indexing allows the Legislature to preserve the intent behind a fixed dollar amount even as the value of a dollar changes. The CPI-U, since 2000, has overestimated inflation by about 7 percentage points.

Not adjusting for inflation, however, has a larger impact than the overestimation of the CPI-U. A static dollar amount, one that is adjusted each year at zero percent, has been underadjusted by 42 percentage points. This underadjustment is six times as large as the overadjustment from using the CPI-U.

Inflation in State Policy



Idaho statute outlines the way the state will collect and distribute tax revenue. Only rarely does statute include automatic adjustment for inflation. When automatic adjustment is used, it usually refers to the CPI-U.

Inflation slowly changes tax policy.

Tax policy represents the Legislature's decisions about who, what, and how much to tax. Unless taxes are appropriately adjusted, inflation changes these initial policy decisions. Appropriately adjusting tax policy for inflation will ensure that a person's tax burdens do not arbitrarily change.

Fixed dollar amounts lose value over time while percentages do not. As long as Idaho's tax policy includes both fixed dollar amounts and percentages, inflation, in part, determines who pays how much tax on what.

For example, in 1970 Idaho's personal income tax revenue was 1.53 percent of statewide personal income. By 1982, after a decade of high inflation, personal income tax revenue had increased over 50 percent to 2.33 percent of personal income. The increased tax burden came in spite of lower tax rates: in 1973 the Legislature cut the rate paid at the top tax bracket from 9 percent to 7.5 percent and each other bracket by the same amount.

The high inflation of the 1970s and early 1980s helps highlight how inflation can change tax policy. While personal income tax brackets are now adjusted, most of Idaho tax code is not. A spreadsheet online compares revenue from different taxes to personal income from fiscal years 1970 to 2018.

Idaho's individual income tax is inconsistently adjusted.

The tax rate on individual income increases with taxable income (from 1.125 percent in the lowest bracket to 6.925 percent in the highest bracket). Until 2000, Idaho did not index tax brackets for inflation, which led to bracket creep. That is, a person's tax burden increased even when their ability to buy goods and services did not.

The US Joint Committee on Taxation estimated that using the chained CPI rather than the CPI-U to adjust federal income tax brackets will increase federal income tax collections by $2.5 billion in 2019 and $35.6 billion in 2027.

With legislative action in 2000, the Tax Commission automatically adjusts Idaho's tax brackets using the CPI-U. These adjustments are calculated using the annual average price level compared with the average in 1998. The CPI-U's slight overestimate of inflation leads brackets to increase more than inflation each year. In 2000 the BLS had yet to introduce the chained CPI, so it was not an option when the Legislature made this change.

Exhibit 3 compares tax brackets as slightly overadjusted by the CPI-U to tax brackets had they been indexed using the chained CPI. We estimated, using income numbers from tax year 2017, that using these slightly lower brackets would have led to $7.4 million in additional taxes.

Exhibit 3

The CPI-U increased individual income tax brackets more than the chained CPI would have.

The income tax rate (%)	2017 statutory brackets ($ taxable income)	2017 CPI-U brackets ($ taxable income)	2017 chained CPI brackets ($ taxable income)
1.6%	On the first 1,000	On the first 1,472	On the first 1,408
3.6%	Up to 2,000	Up to 2,945	Up to 2,816
4.1%	Up to 3,000	Up to 4,417	Up to 4,224
5.1%	Up to 4,000	Up to 5,890	Up to 5,632
6.1%	Up to 5,000	Up to 7,362	Up to 7,040
7.1%	Up to 7,500	Up to 11,043	Up to 10,560
7.4%	Over 7,500	Over 11,043	Over 10,560
	Total revenue collected using 2017 income numbers:	$1,766,488,676	$1,773,915,544
			+ $7,426,868

3 - Calculations based on data from the Tax Commission (additional detail in underlying model). Rates for single households based on tax year 2017.

Idaho adjusts its standard deduction using the chained CPI, and its tax brackets using the CPI-U.

While Idaho code specifies how tax brackets are adjusted, it refers to federal income tax code to determine Idaho's standard deductions. The federal government adjusts these deductions using the chained CPI.

The federal government is not alone in using the chained CPI to index its income tax code; Maine and South Carolina have both indexed tax brackets and certain deductions to the chained CPI.

Inflation reduces the value of Idaho-specific income tax credits, deductions, and exemptions.

In October 2019 the Tax Foundation released an overview of state policies to adjust income taxes for inflation.

Idaho-specific credits, deductions, and exemptions are not automatically adjusted for inflation. Some have lost more than half their value since they were last adjusted.

Idaho has 40 income tax credits, deductions, and exemptions. Seventeen specify dollar amounts that are not indexed. Tax credits reduce income tax owed while deductions and exemptions reduce taxable income. Inflation increases people's tax burden by decreasing the value of their credits and increasing their taxable income.

Idaho has 40 income tax credits, deductions, and exemptions. 17 lose value to inflation.

Some of the most affected credits and deductions are listed in exhibit 4. These credits and deductions are often intended to encourage or reward specific behavior. Inflation dilutes that intent.

Exhibit 4

Some tax credits and deductions have lost more than half their value to inflation.

Value lost to inflation (%)	Tax break	Year last updated
72.3	Deduction for costs of replacing wood stoves	1976
63.9	Credit for dependent who is elderly or has a disability	1981
59.9	Credit for donations to youth rehabilitation institutions	1982
41.2	Credit for cost of equipment manufacturing products using postconsumer waste	1994
30.6	Credit for investing in qualified broadband equipment	2001
29.7	Credit for donations to educational institutions	2006
7.0	Credit for grocery tax	2015

4 - Source: Analysis of statute and historical information in the General Fund Revenue Book. *Adjustments made using the CPI-U research series published by the US Bureau of Labor Statistics. See a full listing of tax credits, deductions, and exemptions.*

Inflation causes Idaho's tax policy to rely more on taxes not affected by inflation.

Three of Idaho's four largest sources of revenue, as shown in exhibit 5, are either unaffected by or partially adjusted for inflation. Motor fuels tax is the only exception. The Legislature has periodically adjusted the motor fuels tax, which offsets much of inflation's impact.

Exhibit 5

Inflation changes the calculation of some taxes, causing the state to rely more on percentage taxes.

Tax	Calculation method	Effect of inflation on tax burden	2019 revenue ($)
Individual income	Variable percentage	Increases taxable income and decreases value of tax breaks	2.0 billion
Sales	Fixed percentage	No change	1.9 billion
Motor fuels	Fixed dollar amount	Decrease	369.0 million
Corporate income	Fixed percentage	No change	309.0 million
Cigarette	Fixed dollar amount	Decrease	34.6 million
Beer and wine	Fixed dollar amount	Decrease	10.2 million

5 - Source: Analysis of statute and review of multiple fiscal years of the General Fund Revenue Book*, Division of Financial Management.*

Six states index their gas taxes using the CPI-U.

Inflation has decreased the importance of revenue from product taxes. In fiscal year 1973, Idaho collected 5.5 times as much sales tax revenue as it did beer, cigarette, and wine tax revenue. In fiscal year 2018, Idaho collected almost 39 times as much sales tax revenue as revenue from these product taxes.

In contrast, revenue from the tobacco products tax, which is levied as percentage rather than a fixed dollar amount, has slightly increased relative to the sales tax. A spreadsheet showing the relative importance of these taxes is available online.

The beer tax, last updated in 1961, is $4.65 per barrel of beer that contains less than 5.1 percent alcohol by volume. If adjusted with the CPI-U (which includes data back to 1913), that amount would have been $38.94 in December 2018. The tax on wine and beer that contains more than 5.1 percent alcohol by volume was set at $0.45 per gallon in 1971. It would have been $2.77 in December 2018 dollars. The cigarette tax, set at $0.57 per pack in 2003, would have been $0.78.

Not all revenues are deposited directly to the general fund. Various taxes have revenue earmarked for specific purposes. These earmarks are specified either as a percentage of a certain revenue source or as a fixed dollar amount. When inflation affects tax policy, it also changes how the Legislature has decided to use the money.

Few spending commitments in Idaho code are indexed.

Just as tax policy slowly changes with inflation, so does inflation impact the Legislature's decisions about how to distribute tax money.

For example, the Legislature distributes sales tax revenue among several sources:

An amount, adjusted for inflation, to counties for elections 11.5 percent to local governments 1 percent to a transportation expansion fund A fixed $27 million to reimburse local governments for two property tax exemptions A fixed $5 million and $4.8 million for the permanent building fund and

the water pollution control fund Sales tax collected from remote sellers for the tax relief fund Most of the remainder to the general fund

Inflation has eroded the value of reimbursement for personal property tax exemptions and reduced resources to the permanent building and water pollution funds. The inflation-adjusted value of the distribution to the permanent building fund has decreased 26 percent since it was last adjusted in 2000, and the value of the water pollution fund distribution has decreased 57 percent since last adjusted in 1984.

The distribution to counties for elections is adjusted using the CPI-U. In fiscal year 2011, the Legislature distributed $4.1 million to counties. Had the Legislature used the chained CPI rather than the CPI-U, counties would have received $4.65 million in fiscal year 2019 rather than $4.74 million.

Public employee retirement

Idaho's pension for state and local government employees, PERSI, offers a cost-of-living adjustment each year to retirees. This adjustment is meant to maintain the purchasing power of retirees' pensions when there are increases in the cost of living.

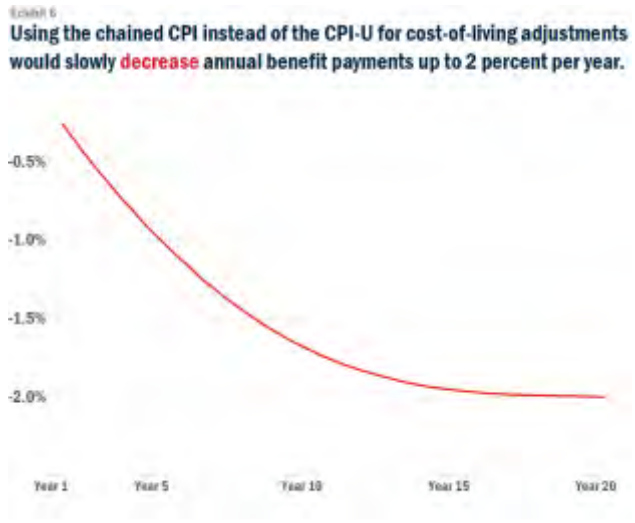
A mandatory adjustment each year is made equal to a 1 percent increase or inflation as measured by the CPI-U, whichever is less. With legislative approval, PERSI's board may authorize an adjustment over 1 percent, up to inflation as measured by the CPI-U or 6 percent, whichever is less. The board may only authorize such an adjustment if the fund has enough assets to pay its liabilities.

Changes to the method used to calculate cost-of-living adjustments, such as switching to the chained CPI, may invite legal challenge if applied to current members as a violation of the implicit contract with those members. Both PERSI management and its independent actuary shared these concerns. However, the Legislature could change cost-of-living calculations for new hires and avoid these concerns.

A cost-of-living adjustment is meant to maintain the purchasing power of a retiree's pension when general prices increase.

We used 20 years of PERSI's annual financial statements and publicly available mortality data to simulate the effect of switching to the chained CPI for cost-of-living adjustments. We compared adjustments using the CPI-U and chained CPI assuming retirees received the full cost-of-living adjustment each year. If the Legislature or board authorized lower adjustments, the difference between using the two indexes would be less.

As exhibit 6 shows, using the chained CPI could decrease total spending on benefit payments by 2 percent per year after about 15 years from implementation.



6 - Source: Calculations using PERSI annual reports and publicly available mortality numbers (additional detail in the [underlying model]).

As an additional consideration, retirees may experience higher inflation than the general population. Retirees typically spend more of their income on housing and medical care than the general population.

The Government Accountability Office assessed the tradeoffs for using various indexes to adjust Social Security in a January 2019 [report].

Other spending commitments

The Legislature has used the CPI-U to adjust the annual appropriation for discretionary spending for public school operations. The increases tied to the CPI-U were 1.7 percent ($4.03 million) for fiscal year 2019 and 2.9 percent ($7.45 million) for fiscal year 2020. By comparison, the chained CPI in those same years would have been 1.2 percent and 2.5 percent respectively.

In rule, some fixed dollar amounts are indexed, though the effects on spending are indirect. For example, the maximum resources available for a person to qualify for Medicaid's aged, blind, and disabled program are adjusted using the CPI-U. Adjusting these amounts using the chained CPI could increase participant reimbursement amounts for Medicaid costs. Similarly, adjusting Medicaid's cap on overall hospice reimbursement using the chained CPI would lead to less growth of the spending cap.

Kansas is the only state that uses the chained CPI to adjust resource allowances for a Medicaid waiver program.

Idaho also uses the federal poverty guidelines to determine eligibility for various programs, such as Medicaid and property tax reduction. The federal poverty guidelines are thresholds of household income based on the number of people in the household. These thresholds are indexed by the federal government using the CPI-U. By using the CPI-U elsewhere in Medicaid rule the state maintains consistency of amounts adjusted this way with the federal poverty guidelines.

The importance of inflation adjustment goes beyond taxes and spending.

Inflation is important to consider across all areas of state law, wherever dollar amounts are written in statute, from criminal law to bankruptcy law. Inflation changes the legislative intent of these laws.

For example, inflation causes more thefts to be classified as felonies. A threshold of $1,000 in stolen property set in 1998 distinguishes misdemeanor theft from felony theft. That $1,000 threshold today is equivalent to one set at $680 in 1998. Inflation has changed state policy toward theft without any legislative action.

At the same time, inflation reduces the deterrence value of criminal and civil fines. The $1,000 maximum fine for misdemeanor theft today, set in 1981, is equivalent to a $377 fine in 1981.

In 2016 Alaska became the first state to index the dollar value of property distinguishing misdemeanor and felony theft.

7 - Federal law includes automatic adjustments for bankruptcy thresholds and civil monetary penalties.

Recommendation

If the Legislature wishes to preserve the intent embodied by dollar amounts in statute, it must automatically adjust amounts for inflation. The chained CPI represents the best estimate of general inflation. We have developed a checklist to assist policymakers to write successful automatic adjustment clauses.

Contracts

When the State of Idaho contracts with a vendor, the vendor's future costs are uncertain. If the contract includes a fixed price, the vendor bears the full risk and reward of unexpected changes in cost. If costs are higher than expected, the vendor loses; if lower than expected, the vendor gains.

The state can share risk for cost changes with the vendor by contracting for a variable price, which can include inflation adjustment. We reviewed contracts not just based on the choice of index, but whether the automatic adjustment clauses were appropriate and unambiguous.

To assess the state's adjustment practices, we looked at three primary sources of contracts between the state and vendors:

1. The Idaho Transportation Department (ITD) establishes and manages contracts for road construction.
2. The Division of Public Works within the Department of Administration establishes and manages contracts for leases and construction projects.
3. The Division of Purchasing within the Department of Administration administers most executive agency contracts over $10,000.

Contracts administered by ITD and Public Works are automatically adjusted in ways appropriate for their industry.

ITD's standard contracts for roadway construction include automatic adjustment clauses for the cost of asphalt and the cost of fuel. The adjustments are made using indexes reported by ITD each month. If the cost of asphalt has changed 10 percent or the cost of fuel has changed 20 percent from their respective costs at the beginning of the contract, payment to the vendor is increased or decreased accordingly.

This clause puts the vendor at risk for small variations in cost and the state at risk for large variations.

ITD's standard contract also allows it to terminate a project if the cost of asphalt increases 50 percent or more, potentially making a project no longer viable.

Public Works manages leases for land and buildings for the state. It integrates automatic adjustment into leases in two ways:

1. With agreement from the lessor, Public Works adjusts the annual lease rate by the change in the CPI-U each year. Many leases also establish a maximum increase or decrease of 3 percent. Public Works reported that lessors generally prefer fixed escalation, such as 2 percent a year, to variable escalation rates. As such, only about ten percent of leases are indexed.
2. Upon renewal of a lease, Public Works proposes a new lease rate based on actual inflation from the original lease date, measured by the CPI-U, even if the lease had not been adjusted using the CPI-U.

Public Works could use the chained CPI rather than the CPI-U to adjust leases more appropriately, transitioning to the new measure as leases are renewed. However, the automatic adjustment clauses were unambiguous.

The Division of Purchasing usually chooses negotiated price adjustments to automatic price adjustments.

ITD and Public Works do not manage the same variety of contracts as the Division of Purchasing. Purchasing manages contracts for most state agencies and with a large variety of industries. As such, Purchasing's standard contract is not as specific as ITD's and Public Works' and does not include an automatic adjustment clause.

The lack of automatic adjustment reflects a preference by Purchasing for negotiated price changes. Purchasing reported that many agencies prefer to know prices ahead of time for budgeting purposes. Additionally, Purchasing tends to prefer short-term contracts where fixed prices lead to minimal risk from inflation.

Purchasing has also found that negotiated, rather than automatic, adjustments were desirable in situations where variables other than price are flexible, such as the frequency of product delivery. Negotiation allows the agency and vendor to come to mutually beneficial and cost-saving agreements.

We requested a list of all contracts under the supervision of the Division of Purchasing. From almost 1,100 contracts, we selected a cross section of 24, each with a total value of more than $1 million, from a variety of agencies with a focus on high-dollar and long-term contracts.

Many contracts reviewed would not have been candidates for indexing.

For example, the Idaho Behavioral Health Plan, which is the state's largest contract, is required by federal regulations to set prices based on an actuarial study of costs. Other contracts, such as statewide contracts for computer equipment, use pricing based on a negotiated discount from list prices. These methods of price adjustment intrinsically account for inflation even without indexing.

Only 3 of the 24 contracts we reviewed had inflation-adjustment clauses. Each references a different inflation measure.

1. A contract for uniforms for correctional officers references the price change in men's and women's apparel, components of the CPI-U.
2. A long-term contract for the operation of a substance abuse programming facility references the CPI-U for urban areas with fewer than 500,000 people in the west region (CPI-U all items in the west region, size class B/C).
3. A contract for freight services is adjusted using the CPI-U, all items in the west region. Unlike the index used to adjust the price for the substance abuse programming facility, this index includes urban areas such as San Francisco and Seattle where prices have increased faster than the national average in the past decade.

For more information about the differences between these indexes, see an up-to-date comparison of the chained CPI, the CPI-U, and indexes for the western region.

The contract for freight services is doubly problematic, as it also allows the vendor to be reimbursed for increases in fuel prices. Unlike ITD's contracts, no provision is made for decreases in fuel prices. About two years after the contract began, the price of fuel had declined by nearly half, according to the referenced price index.

Recommendation

When the Division of Purchasing includes inflation adjustment clauses in its contracts, the clauses should adhere to best practices as detailed in our checklist. We did not evaluate whether Purchasing should index more contracts than it does. Rather, when indexing is appropriate for a specific contract, Purchasing should ensure that the adjustment clause is appropriate and unambiguous.

The standard contract language currently used by Division of Purchasing for price changes is as follows:

1. *All prices shall be firm against any increase for one (1) year from the effective date of the contract. A price adjustment will be considered after the first year of the contract, and for each contract renewal period thereafter. If a price increase is requested, it will be the responsibility of*

the Contractor to notify the State thirty (30) calendar days in advance of the desired effective date and provide supporting documentation of industry wide increases justifying the request. The State will notify Contractor whether the request is approved within ten (10) days of receipt of the request.

2. *If there is an industry wide price decrease, Contractor must notify the State immediately of the decrease; and make the price decrease effective for the State on the same day it becomes effective for the Contractor. If the State is not properly notified of price decreases, the pricing at the time of order will be used for invoice payment and the Contractor will provide refunds or credits as necessary.*

Office of Performance Evaluations

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Idaho Legislature