23. Thoughts on indexing the elderly*

The Boskin Commission (BC) finds that the Consumer Price Index (CPI) reported by the Bureau of Labor Statistics (BLS) overstates inflation 0.8 to 1.6 per cent per year; the commission’s best estimate of the bias is 1.1 per cent. Economists have long suspected that the CPI and other price indexes overstate inflation. The bias moved from academia to the national stage when, urged by Alan Greenspan, Congressional leaders began to realize that its correction could contribute mightily to solution of intractable fiscal and political problems. Cutting indexation of benefits by one percentage point could cut nearly in half the actuarial shortfall of the social security system over the next 75 years. Reckoning also the revenue gains from slowing the indexing of personal income tax brackets, the correction would do wonders for the unified federal deficit, for example saving one-third of the deficit now projected for 2006.

The technicians of the BLS are well aware of the shortcomings of their index and work steadily to correct them. Congress should provide the agency the resources it needs. (Reckless and short-sighted budget economies threaten the whole body of federal statistics.)

Enthusiasts for cutting indexation – including Chairman Greenspan and Senators Lott and Moynihan – don’t want to wait for BLS’s improvements in its index. They propose another commission of wise disinterested experts who would determine each year how much to lop off the BLS’s CPI change for the purposes of official indexation. If the Boskin Commission had this responsibility right now, presumably the answer would be 1.1 percentage points. BC invites ‘Congress and the President [to] decide whether they wish to continue the widespread over-indexing . . . If the purpose . . . is fully and accurately to insulate the groups receiving transfer payments and paying taxes, no more and no less, they should pass legislation adjusting indexing provisions accordingly’ (Recommendation 16, p.86). BC elaborates, ‘This could be done in the context of subtracting an amount partly or wholly reflecting the over-indexing from the current CPI-based indexing.’ On the amount to subtract, presumably advice could be sought from the ‘permanent (rotating) independent commission of experts’ BC asks Congress to establish.

Prior to 1973, Congress frequently raised social security benefits, using as a principal reason the need to keep up with inflation. Legislation in 1972 introduced CPI indexation from 1975 on, to discipline and depoliticize this process. Now to supersede the technical objectivity of the BLS with annual judgment calls is a grave step.

AN INDEX SUITABLE FOR ADJUSTING PENSIONS?

The CPI is in the statistical and political spotlight mainly because of its use in indexing social security benefits. An important issue is whether it is suitable for that purpose, as it is presently designed and calculated and as it will be reformed by the BLS following the recommendations of the Boskin Commission. Surprisingly, this question is barely mentioned either in the BC report or in the ensuing public debate.

I argue for an index consciously designed for social security. I contend that this will become increasingly necessary if and as the CPI is changed in accordance with BC proposals.

When indexation of social security benefits was introduced, little thought was given to whether the CPI was appropriate for the purpose. The CPI is an all-purpose series, originally intended to give general statistical-historical information, not to govern settlements of public obligations. CPI-W, the index used for social security, seeks to track changes in the cost of the average market basket wage-earners buy. The other CPI, CPI-U, does the same thing for urban consumers. Neither is conceptually appropriate for indexing the benefits of the elderly.

The general assumption has been that it is close enough, and BC agrees: ‘Some have suggested that different groups in the population are likely to have faster or slower growth in their cost of living than recorded by changes in the CPI. We find no compelling evidence of this to date. . . ’ (p.72). After citing two studies in support of their complacency, the commission notes a piece of evidence to the contrary. This is BLS’s experimental CPI-E, measuring costs of the average market basket bought by persons aged 62 and older. From December 1990 to December 1995 CPI-E rose 0.35 percentage points a year faster than CPI-W. The difference is mainly due to health care, which, with a larger weight in CPI-E, recorded faster price increases than other CPI components. BC conjectures that, as health care inflation subsides and its upward bias is corrected, CPI-E will converge to CPI-W. This remains to be seen, and in any event there is no guarantee that other deviations between elderly and population-wide CPI movements will not arise in future.

The misfit between the standard CPI and its task of indexing social
security will actually be magnified by some of the reforms the Boskin Commission is proposing. Most of them are quite appropriate for a general-purpose index, but some are quite inappropriate for social security indexation. The principal problems arise in corrections to the increasing costs of medical care.

FROM CPI TO COST OF LIVING INDEX

To understand this paradox, it helps to begin with BC’s pervasive complaint, that the present CPI is not ‘a true cost of living index’ (p.1). Ultimately, BC seeks to convert the CPI into a cost of living Index (COLI). Recommendation 1 (p.78) reads: ‘The BLS should establish a cost of living index as its objective in measuring consumer prices. All our specific recommendations are aimed toward this goal.’

This complaint and this ambition permeate the report, from Executive Summary and Introduction to Recommendations and Conclusion. The CPI is simply ‘pricing a fixed (but representative) market basket . . . over time’ (p.i.), whereas ‘The change in the cost of living between two periods, for example 1975 and 1995, tells us how much income people would have needed in 1975, given the prices of goods and services available in that year, to be at least as well off as they are in 1995’ (p.1). Again, ‘A cost of living index is a comparison of the minimum expenditure required to achieve the same level of well-being (also known as welfare, utility, standard of living) across two different sets of prices’ (p.20). BC recommends two indexes, ‘one which is published monthly on a timely basis and is designed to maintain the spirit of the cost of living’, and one ‘which is published and updated annually and revised historically’ to introduce improvements in data and methods (pp.78–79). It is easy to imagine the second index as the vehicle for and rationale for judgmental corrections of the CPI in indexation, but BC does not suggest this.

Three phases in metamorphosis of CPI to COLI can be distinguished, though they blend into each other. The first is for BLS to do better its present task of measuring changes over time in the prices of representative market baskets bought in cash transactions. Reforms include changing statistical formulas to eliminate bias; allowing more promptly for consumer substitutions among commodities and outlets; improved sampling and more accurate data collection. These reforms are not controversial. BC estimates that they would cut 0.51 percentage points from present CPI inflation.

The second category involves more adequate treatment of changes in quality of existing products and of gains in well-being attributable to introduction of new products, all still within the domain of cash market
transactions. Examining the CPI, commodity by commodity, BC find 0.60 percentage points of upward bias.

The third category recognizes the contributions of a host of non-market changes in the physical and social environment to consumers’ utility, welfare, well-being, or quality of life, and thus their relevance to estimates of cost of living. These changes are like improvements in product quality and introductions of new products but are not directly traceable to specific market transactions. BC regard these changes as strongly positive on balance. They look forward to research that will eventually put dollar estimates even on diffuse and in-kind quality-of-life events. No such estimates are in their 1.1 total bias now. However, it seems likely that having the third category in reserve makes BC more willing to resolve upwards uncertainties in the other categories.

MEDICAL CARE IS THE MOST IMPORTANT PROBLEM

To return to the particular problems of indexing the elderly, most items in the 0.6 points of bias of the second type concern quality improvements and product innovations. Many of the examples may not be fully appreciated or exploited by older consumers, for example computers, internet, automobiles, cellular phones, fax, compact disks. But the most important problem is treatment of the quality of medical care.

Allowing for quality changes that arise either from modifications of existing products or from introduction of new products is the most difficult task facing makers of index numbers. It is particularly problematic in the realm of medical care. Certainly reductions in the inputs, chiefly of professionals and hospitals, required for a given procedure, should be reflected in the index, offsetting rises in the hourly costs of those inputs. By analogy, as new procedures replace old, it is natural to look for the economies in inputs required to achieve the same outcomes. But quite frequently the outcomes of new procedures were just not attainable before. The new product does better for the patient and costs more, but since the inferior old procedures are no longer available, the patient does not have the choice of pocketing in dollars any imputed value of the change, whether she or an insurer or Medicare is paying the bill. Very frequently the quality gain, of a single advance in medical technology or of the synergy of many advances, is to extend healthy life. The BC report argues that quality-of-life negatives (pollution, crime, suicide, divorce) are more than offset by identifiable though incompletely measured positives, ‘but most importantly by the major increase in longevity, which perhaps swamps everything else’ (p.77).
SHOULD LONGER LIFE MEAN LOWER PENSIONS?

This may well be true in reckoning the cost of living for younger people and for the nation as a whole. The extensions of life, indeed of healthy life, afforded by the miracles of modern medicine are remarkable gains in human welfare. But it does not make sense to diminish indexation of old people's pensions on this account, because these most significant advances in social well-being actually accentuate the risks the social security system is designed to insure. This paradox is good reason to accompany reform of the standard CPI with creation of another index tailored to indexation of pensions.

Our health care system is determined to give every patient the most up-to-date care, however expensive. The elderly consumer of medical services has no feasible way to diminish his or her consumption of the bulk of those services in order to obtain extra cash for consumption of non-medical goods and services. That may be a tradeoff the society as a whole can make, but it is not available to one individual alone. When she leaves the hospital after the operation that prolongs her life, the octogenarian still has to buy groceries.

Social security was originally conceived as social insurance, universal and compulsory. The risk insured is that of out-living one's financial resources, of not dying before the money runs out. The monthly checks are meant to avert that fate, providing not just minimal subsistence but reasonable replacement of pre-retirement wages. In the 1930s when social security was enacted, the risk of outliving one's resources was still fairly new. Workers who voluntarily or involuntarily retired usually became charges on their own children. Social security was both adapting to and creating new demographic and social realities.

In practice, social security's income replacement objective is implemented by computing the participant's average history of social security-taxable earnings scaled up by a national wage index to the year he or she is age 62. This average is converted into annuity entitlements by a formula that is progressive in the sense that it treats participants disproportionately more generously the lower their wage histories. These dollar amounts are in turn indexed by the CPI relative to its level in the year the participant was 62. Broadly speaking, then, the price indexation is intended to stabilize the consumption value of annual benefits, once the wage-replacement value of the benefits has been set at the same ratios as for previous cohorts (an average of about 37 per cent.)
SHOULD NON-MARKET FACTORS BE INCLUDED?

In general, I believe, it is not appropriate to try to adjust cash benefits for non-market additions to or subtractions from ‘quality of life’, whether from medical care in kind or from natural and social changes in environment. The Boskin Commission is over-ambitious for itself and BLS if it expects to estimate a ‘cost of living’ index that will keep utility or well-being constant. Better to concentrate, especially in constructing indexes with dollars-and-cents implications, on measuring as accurately as possible changes in the costs retired people face in buying the consumption goods and services they acquire in markets for cash. BLS already tries to allow for changes in quality of specific products or their replacements, and they can do better. But it would be arrogant for bureaucrats or commissions of wise men and women to judge by how much improvements in general conditions of life offset increases in recorded market prices.

Let us not forget that indexation need not, should not, bear the whole burden of keeping benefits in line with needs. Congress can change the basic amounts of the benefits, and has often done so. Until now Congress has chosen not to diminish cash social security benefits because of Medicare and the increased effectiveness of medical treatments. Congress can change that policy, but it should not rely on the pretense that there is objective technical justification for eroding old folks’ pensions annually by precise amounts.