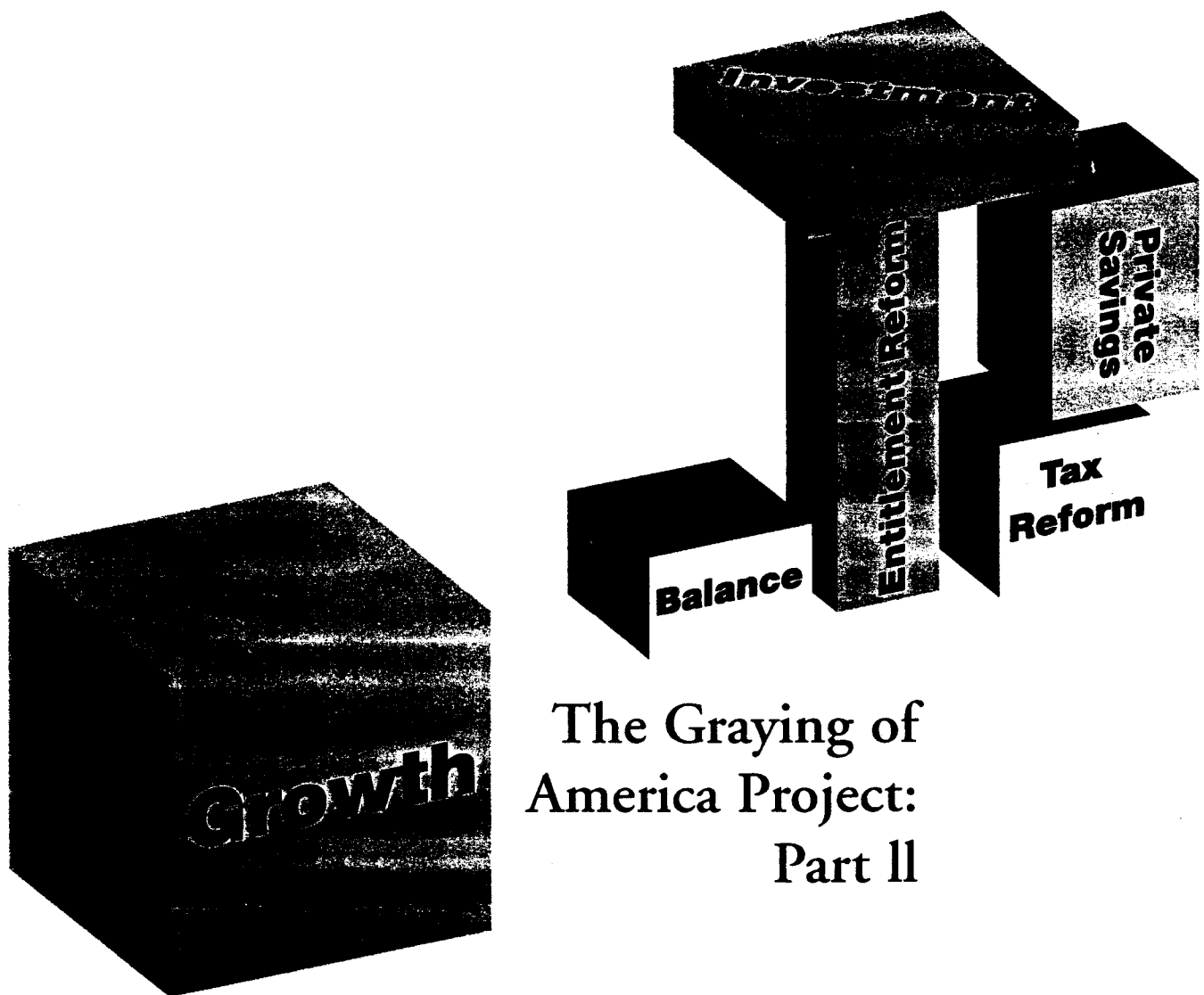


Building A Better Future



The Graying of
America Project:
Part II

The Committee for a Responsible Federal Budget
January 2000

The Committee wishes to express our gratitude to CIGNA Corporation. They provided a generous grant to underwrite the cost of printing this publication.

Support for this project was provided by the American Business Conference, the American Council of Life Insurance, CIGNA Corporation, The Food Marketing Institute, the Kerr Foundation, Kraft General Foods, The National Association of Manufacturers, The National Governors' Association, Oklahoma State University and the University of Oklahoma. The Committee is grateful for their generous contributions of resources and expertise.

Oklahoma State University co-hosted a symposium in Tulsa Oklahoma on October 26, 1999, to release this report and provide for further discussion of the issues it raises. The Committee is grateful to the University, for their interest in and contribution to resolving major public policy issues, and especially for the their fine work toward enhancing the value of this publication. See "Afterword" for a summary of that meeting.

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Building A Better Future

**The Graying of
America Project:**

Part II

The Committee for a Responsible Federal Budget

January 2000

About the Committee for a Responsible Federal Budget

The Committee is a bipartisan, non-profit educational organization committed to educating the public regarding the budget process and issues that have significant fiscal policy impact. The Committee sponsors analysis and research, conducts educational symposia, and prepares and distributes educational materials.

Goals

The broad long-range goal is to educate the public on the federal budget process and on the need for discipline and order in making spending and revenue decisions. The immediate, specific goal is to point out the prospect and consequences of continuing to delay action to address the longer-term fiscal and social policy challenges facing the nation.

The public must understand that such delay could lead to deficits much larger than the country faced in the last quarter century—deficits and debt so large as to threaten the very fabric of the country's economic and political life.

What We Do

The Committee sponsors symposia on budget and economic issues. We provide speakers for civic, academic, and business groups, and hold Congressional breakfasts for Members of the House and Senate interested in dialogue on the budget and related issues. Committee staff and Board Members write about the budget and related issues for major media outlets, provide background information and educational materials, and help explain the budget and the budget process to many audiences.

In the fall of 1982, the Committee launched an ambitious education and outreach program on the problem of the deficit. *The Exercise in Hard Choices* is to inform the American people of the nature and magnitude of the deficit and debt problems facing the country and the limited choices available to solve those problems. *The Exercise is updated regularly to reflect the actual choices Congress and the Administration are considering to reduce the Federal deficit and reorder national priorities. The Committee provides the Exercise workbook to educational organizations and other interested parties at cost.*

The Committee is a 501(c)(3) educational organization. All of its activities are funded through tax deductible contributions from individuals, foundations, corporations, and other interested groups. It accepts no government funding.

The most recent version of *The Exercise* is called *Building a Better Future: An Exercise in Hard Choices*. In a joint effort with American Express Financial Advisors, we adapted *The Exercise* to address issues raised in the *Fraying of America* project. Over a year-and-a-half, from materials development to completion, we held eight *Exercises* around the country. Thirty organizations participated and the project contributed greatly to this report. We thank everyone who played a part in this tremendous information-gathering, public education effort.

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Foreword

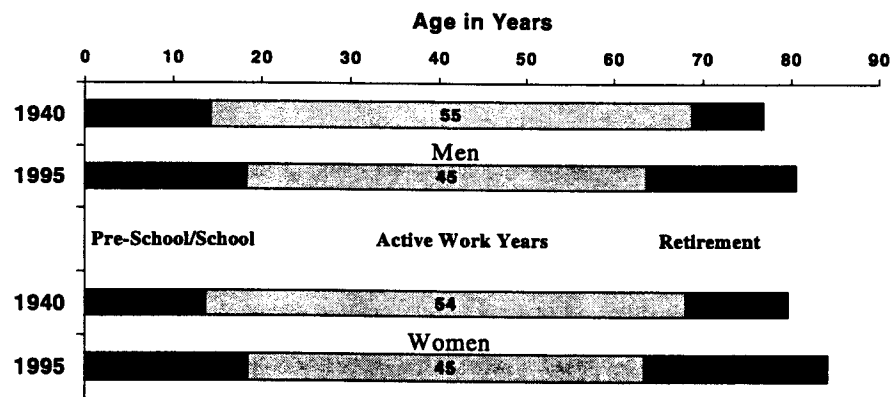
The Committee for a Responsible Federal Budget is a bipartisan private nonprofit organization created to educate the public about the Federal budget, the budget process and other important economic issues. For eighteen years we have worked to promote public understanding of Federal fiscal policies and promote candid discussion of real choices to solve problems.

For a quarter century persistent, very large deficits and growing debt

posed a serious threat to our economic future and standard of living. A series of deficit reduction bills culminated with the 1997 Balanced Budget Act and combined with robust economic growth to produce projected surpluses for the next decade or longer.

However, the population is aging, people are living longer. Labor force growth will slow to a snail's pace at the same time the baby boom population begins to retire in the early part of the 21st century.

Longer Life Expectancies, Shorter Working Lives



Source: Bureau of the Census, 1997.

Within a decade the oldest baby boomers will be 62—the age at which they can begin to collect Social Security. At 65 they will be eligible for Medicare. Eventually, there will be no other choices than to reduce benefits, increase payroll taxes or use tax receipts from other sources to help pay for that program.

Political leaders continue to discuss individual programs and policies as if each existed in a vacuum. Social Security, Medicare and the tax system generally are viewed as sources of our longer-term problems and all must contribute to the solution. Ignoring relationships between and among spending and revenue policies and their collective impact on the budget and the overall economy is folly.

The Committee initiated *the Graying of America* project in 1995. *Building a Better Future*, the report on part I of the project was published in July 1997. It documented the forces that will compel changes to current laws

and policies and private behaviors. It highlighted ways in which issues overlap and urged a strategic approach to public policy change. This report on the second phase of the project examines various approaches to reform entitlements and tax policies.

The Committee herein renews our appeal for prompt, concerted, coordinated action. And we reiterate the major conclusions contained in our initial report.

Increased productivity and growth are imperative to the nation's future economic and social health; and increased saving is imperative to increase productivity and growth;

Major demographic trends must drive public policies for the future;

Government must make decisions in an overall economic and budgetary context; and

The Federal government alone cannot solve all our problems. The private sector, State and local governments each must play a role.

Over the past two years, our Board reached five additional conclusions—

1. Fairness to future Social Security and Medicare beneficiaries and future taxpayers demands more candid disclosure of the cost and impacts of public policy change.

Trust fund balances, surpluses, or arbitrage cannot serve to finance public programs, activities and expenditures. Future taxpayers will bear the cost of future benefits.

Neither will borrowing cover the shortfalls projected in Social Security and Medicare. First, the amounts government would have to borrow are so large as to undermine economic vitality; and second, borrowing is a short-term solution. Eventually, tax receipts

must liquidate all government expenditures—including interest costs associated with government borrowing.

2. Fairness to our children and grandchildren suggests prompt attention to these longer-term challenges—

Current and projected surpluses could provide a cushion to make changes to popular programs and entrenched tax policies less wrenching than they will be if we squander this opportunity.

Almost all approaches to the challenges we face will mean that some or all future retirees receive somewhat less generous tax financed benefits than would be the case under current law. That being the case, we owe those future retirees as much advance notice as possible so that they can plan and save accordingly.

3. The actual solutions that the next (or future) President(s) and Congress(es) will adopt almost certainly are not part of the current political debate.

It seems incredible, but much political discourse today is focused on providing new/expanded benefits in Social Security and/or Medicare without providing any additional long-term financing.

Few political leaders have been willing publicly to acknowledge the fact that benefit cuts and/or tax increases are inevitable.

The rare politicians who do bite the bullet, i.e., propose benefit changes and/or tax increases, have not so far made proposals sufficient to close the gap between projected receipts and expenditures.

4. If individual or "private" accounts are to be part of the

solution to Social Security Reform, we need to rethink the role of tax-financed, government guaranteed retirement security benefits.

If government continues to guarantee benefit payments equal to or greater than current law, the program (or combined programs) will subsume as large or larger share of the economy and revenue base than the amount experts currently estimate.

This would make it imperative to sort out income redistribution goals from forced-savings goals in public policies, to provide for retirement income security and recognize that we cannot use the same resources twice.

To the extent that individuals benefit directly from earmarked personal contributions, those resources cannot be used to finance benefits for low-income earners.

Using surpluses or borrowing to finance initial contributions to personal or “private” accounts risks masking the impact on future taxpayers when beneficiaries begin to collect based on those accounts.

If the accounts do not increase net national savings, almost inevitably this would redistribute wealth—though redistribution might not be from higher- to lower-wage earners as is the case under current law.

5. Medicare reform and tax reform likely will prove to be even more difficult than Social Security reform and we probably are further from consensus on the shape of future tax and health care policy.

The United States is by far the wealthiest country in the world.

Except for four years of Civil War, the United States has forged political solutions to challenges we faced as our world changed. It is well within our grasp to address issues and solve the problems we confront due to changing demographics. The only question is, do we have the will to do so? An effective aging policy will include three basic elements:

1. *Increased national savings.* It is impossible to overstate the importance of savings, investment and growth to the success of any proposed policy change.
2. *Stronger Retirement Security.* Only ten percent of older Americans are poor, but without Social Security more than half would have incomes below the official poverty level. Without Medicare most retirees would not have health insurance.

The goal must be combined public and private resources sufficient to provide adequate support for retired individuals—especially those who cannot provide for their own needs—at an affordable costs to taxpayers.

3. *Allowance for other public needs*, including the needs of children and other non-elderly groups in the population.

Today's children are tomorrow's workers. We cannot afford to focus on the elderly at the expense of children's needs. One in four children in the U.S. is poor or near poor. Nearly half of all African-American and Hispanic children live at or below 125 percent of the official poverty rate. Poverty can contribute to lifelong handicaps, e.g., limited education and job skills, and poor health. It is wrong and shortsighted to limit the potential of our most precious resource.

Future workers will bear the burden of a larger retiree population. They also will have to care for themselves and their children—and save for their own retirement. Kidding ourselves about the cost of proposed reforms risks shifting costs to future workers—and the future workers just might refuse to pay.

Government cannot continue indefinitely to cut defense. People may differ about the cost of maintaining a "strong defense capability", but few will argue for "weak defense". The Federal government is not going to abandon all foreign policy objectives and concomitant costs. How much are we willing to cut other Federal programs to pay for rising retirement costs? We do not know.

One thing is certain: there are only four generic kinds of options to solve our public policy dilemma.

1. *Reduce the rate of growth* in benefits for most or all elderly;
2. *Reduce benefits for middle* and/or upper income retirees;
3. *Shift the burden for financing* virtually all public programs and policies except support for the elderly, defense and international affairs to States and local governments.
4. *Raise taxes.* Current law benefits imply Federal tax burdens equal to thirty percent or more of gross domestic product, compared to about twenty percent today. (Current GDP is about \$8 trillion. Thus 10 percent of GDP today is about \$800 billion.)

There is something wrong with any approach that claims to avoid all of the above (or some combination of the four). Anyone who claims that is not the case is either misinformed or misleading others. There simply are not any other options.

Some of this report will seem repetitive. We repeat a great deal of “common knowledge” because we believe that the facts bear repetition. We repeat some material from our report on the first part of this project, because we cannot assume that everyone will read both volumes. We hope sincerely that this report will spur a different kind of political debate. We hope it will help decision-makers think “outside the box”. We urge political leaders to launch a serious national debate and forge a contemporary consensus around the following questions—

- What do we believe today should be individual and family responsibilities?
- What is the consensus view regarding the role of government, i.e., what responsibilities are we willing to socialize and pay taxes to meet?

- What kind of government do we need to meet the needs of our entire population and continue to lead the world into the 21st century?
- How should public responsibilities be divided between and among Federal, State and local governments?

The American Business Conference, The American Council of Life Insurance, CIGNA Corporation, the Food Marketing Institute, the Kerr Foundation, Kraft-General Foods, The National Governors' Association, Oklahoma State University, National Association of Manufacturers, and the University of

Oklahoma provided support for this project.

Building a Better Future: An Exercise in Hard Choices, which was a joint project with American Express Financial Advisors, provided invaluable insights to inform this report. This publication is made possible by a generous grant from CIGNA Corporation.

The Committee extends our thanks to Susan Tanaka, who for five years served as Vice President of the organization and director of the Graying of America project. Susan currently is with the Congressional Budget Office, but she contributed a great deal to this report.

Bill Frenzel

Co-Chairman

Carol Cox Wait

President

Tim Penny

Co-Chairman

The Past is Prologue

For nearly 200 years of our history Federal spending, deficits and debt rose dramatically during war times. When wars were over, outlays, deficits and debt declined.

Peacetime recessions, even the Great Depression, had little effect on the size of the national debt. That pattern continued through World War I, World War II and Korea, largely because the scope of Federal programs, activities and functions was limited almost exclusively to national defense, foreign policy and assistance to veterans, their families and survivors.

The seeds of change were sown during the Great Depression with the advent of Social Security, unemployment compensation, agricultural price supports, rural electrification and telephone programs, etc.

Nonetheless, the pattern continued through the end of World War I, World War II and Korea. The end of World War I had dramatic budgetary impacts. Outlays declined from \$18.5 billion to \$6.4 billion (FY 1919-1920). Deficits turned to surpluses virtually overnight. Outlays did not reach \$6.4 billion again until 1936.

After World War II, deficits and debt again declined. Deficits all but disappeared until Korea. Between Korea and Viet Nam, outlays and debt declined relative to GDP. Deficits exceeded 1 percent of GDP only twice (2.6% in 1969 and 1.3% in 1962).

The Federal role and Federal policy changed dramatically during and after the Viet Nam War. The President and Congress did not cut everything else to pay for defense in wartime.

Federal Outlays, Deficits and Debt 1960's—1990's				
	1960's	1970's	1980's	1990's*
Outlays	17.9	23.9	22.3	21.0
Deficits	.9	2.4	4.0	2.0
Debt	47.9	39.3	43.3	65.0
Through 1998, most recent year for which actual numbers are available. Both CBO and OMB project that spending, deficits and debt will decline and revenues will increase as percents of GDP for the next decade or more.				

Budgets did not return to the status quo ante after the war was over. Average outlays increased by 4 percent of GDP and deficits averaged 2.4 percent of GDP. By the mid-1970's debt began to climb steadily relative to the overall economy, reversing a post World War II trend. (See table above.)

What caused such dramatic change?

Medicare Hospital Insurance, like Social Security, is financed through payroll tax contributions. Taxes dedicated to pay for Social Security and Medicare increased by nearly 4

percent of GDP between 1960 and 1990. But other Federal receipts declined as a share of GDP.

Total revenues did not keep pace with total spending. For the first time in history, the U.S. ran persistent very large deficits in peacetime and economic prosperity.

When we finally achieved budget balance¹, in 1998, spending and revenues each were about 2 percent of GDP higher than when Medicare and Medicaid were enacted.

¹Consolidated budget totals include "off-budget" surpluses or deficits. The Social Security Trust Fund is by far the largest off-budget account. Currently the Trust fund is in surplus. The consolidated budget balanced in FY 1999. The budget balanced for the first time, without Social Security surpluses in FY 2000.

The aggregates, however, don't disclose dramatic changes in the Federal role as evidenced by changes in the composition of Federal outlays.

- Total discretionary spending was 6 percent lower; but
- Domestic discretionary was up about one percent
- Defense was down 6 percent; and
- International spending was down about one-half of one percent of GDP.
- Entitlements and other mandatory spending increased by 5.5 percent; but
- Social Security and Medicare increased by 4.6 percent;
- Medicaid added another 1.3 percent; and
- all other entitlement spending actually went down.

Every time total Federal taxes rose very much above 19 percent of GDP for very

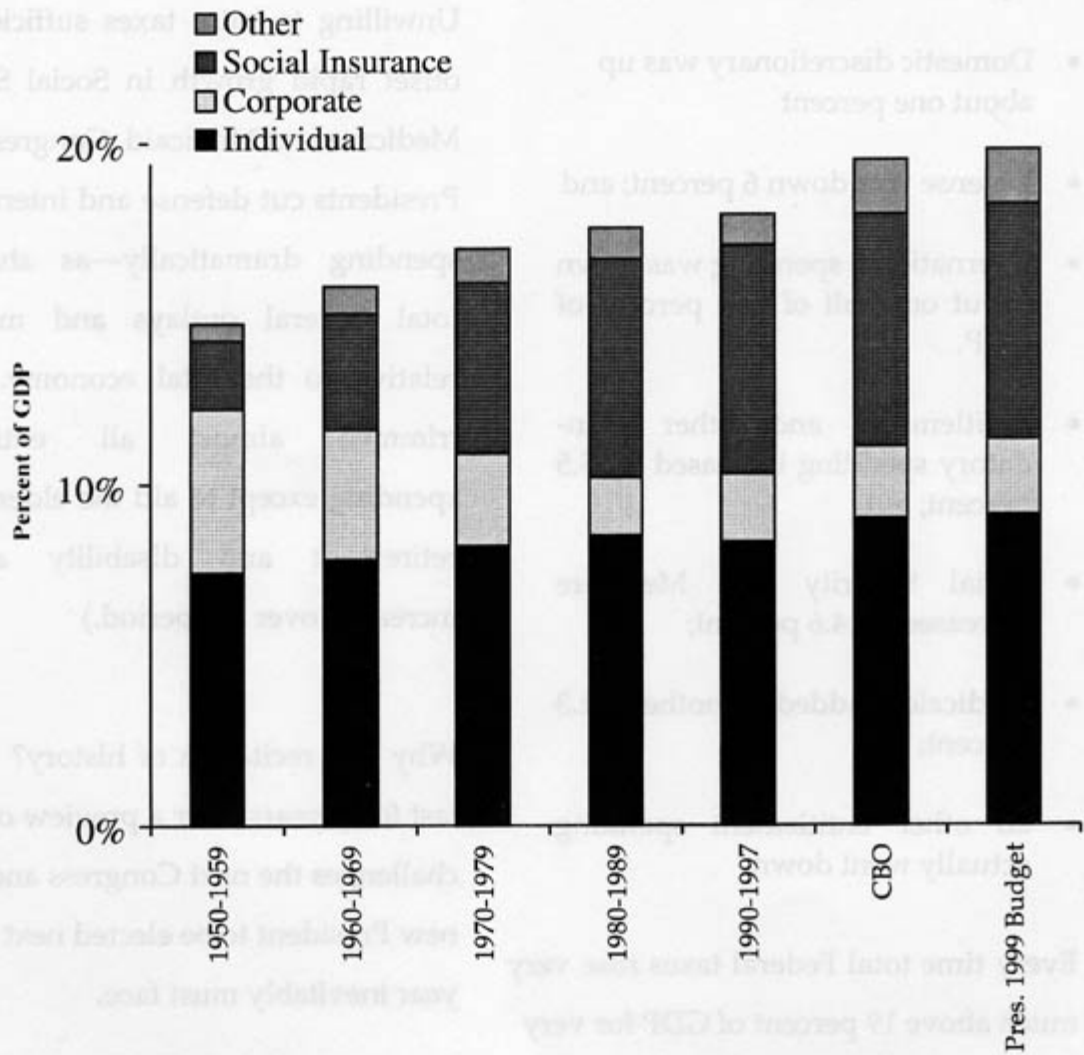
long, Congresses and Presidents (and both political parties) acted to cut taxes. Thus, increases in revenues dedicated to Social Security and Medicare Trust Funds forced reductions in receipts from other sources.

Unwilling to raise taxes sufficiently to offset rapid growth in Social Security, Medicare and Medicaid, Congresses and Presidents cut defense and international spending dramatically—as shares of total Federal outlays and measured relative to the total economy. They trimmed almost all entitlement spending except to aid the elderly. (All retirement and disability accounts increased over the period.)

Why this recitation of history? The last forty years offer a preview of the challenges the next Congress and the new President to be elected next year inevitably must face.

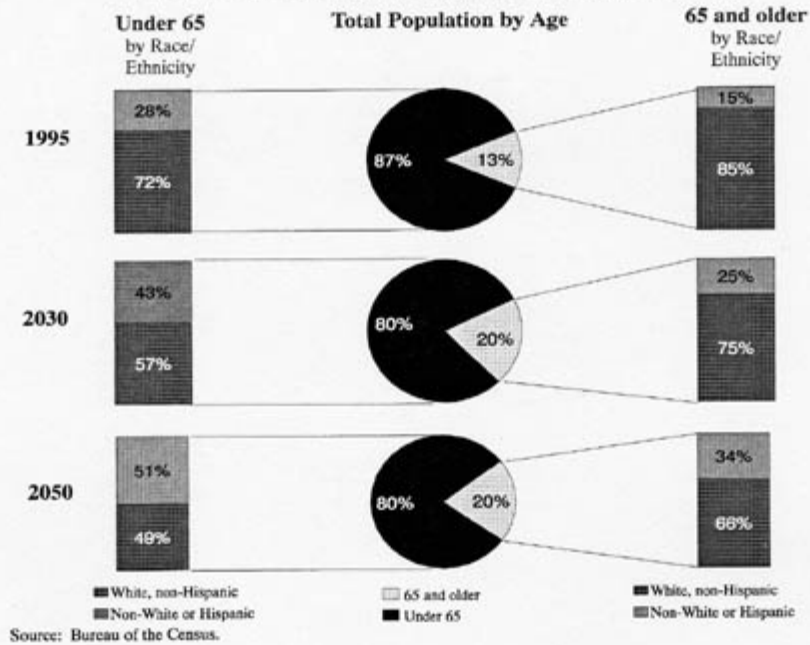
Federal Revenues as a Percent of GDP

(Post-World War II Average 18% GDP)

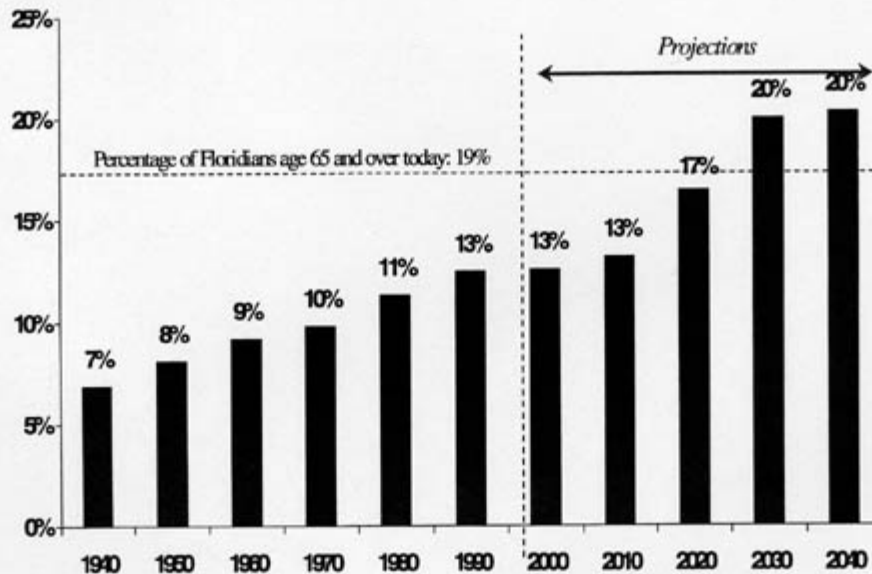


Projected Population Trends

U.S. Population: Race, Ethnicity, and Age



Population Age 65 and Older



Demography as Destiny

Defiance may be admirable but denial is dumb when it comes to aging. If demography is destiny, the United States is on the precipice of dramatic change. Within a generation our population will be—

- Larger—There will be 75 million more people, a 27 percent increase.
- Older—The number of people 65 and older will double, as will the numbers who live to be 85 and above.
- More diverse—40 percent of Americans and 50 percent of children under 18 will be Hispanic, Asian American, African American, or Native American.

More than 75 million baby boomers rapidly are approaching retirement age. They are the largest cohort ever to move through the U.S.

population. Their needs have dominated public policy debates throughout their lives. That won't change when they retire. People over 65 will comprise 20 percent of the total population in 2030, compared to 13 percent today. Most of the growth in the retirement-age population will occur after 2010, as the baby boomers retire. The shift to an older population, however, will persist long beyond the baby boom because life expectancy is increasing and probably will continue to do so.

As a consequence, the country almost certainly will spend a larger share of economic resources to support older Americans than we do today. How much larger a share; from where will the resources be diverted; and what can we do today to improve future prospects?

However we answer those questions, continuing prosperity will depend on growth. Growth depends on productivity. As the number of retirees rises faster than the working population, each worker must be more productive. Productivity increases will depend on a skilled, educated work force and a large, modern capital stock. To increase future productivity, therefore, we must save and invest more today.

We must invest in human capital—our future labor force—and in physical capital—technology, plant and equipment.

The United States is a low saving country. Focusing public policy to meet future needs requires, therefore, that we focus like a laser beam on strategies to increase saving. What public policies likely will produce increases in national saving? We cannot afford to dissemble or kid ourselves in this

regard. Clear thinking and total honesty must be the hallmarks of the savings debate.

Governments can increase national savings by running surpluses and buying back debt held by the public. Institutions and individuals that hold government debt are not likely to go on a consumption binge because Treasury retires debt. They almost always reinvest. Thus reducing government debt adds almost dollar for dollar to net national savings.

Individuals and families save in many ways. Personal savings may be invested in homes, in other real property and financial assets. Families take primary responsibility for raising children. They invest regularly in human capital, though government plays important roles in education, health care financing and other ways.

Saving is consumption delayed.

Increased growth may make it possible to devote smaller shares of GDP to meet elderly needs in future years. But growth is a goal. It is the end product of successful economic policies. Growth is not a means to the end. To increase growth we must increase saving. Toward that objective, some of us will have to consume less in the short term.

Privatization may play a role in Social Security reform. But nobody in Washington is talking of privatizing the Social Security system. And if they were, privatization in and of itself would not solve the problem.

Indeed, permitting some workers to put some or all of the payroll taxes they pay under current law into proprietary accounts could make it more difficult to meet the needs of

low-income seniors in future years. And individual accounts can reduce government expenditures only if we reduce the amount government guarantees some or all beneficiaries will receive when they retire.

The impact of individual or private accounts on net national saving depend on a number of factors including but not limited to—

- Expectations. Will everyone receive as much or more than under current law? Or will those who can be required to save more for themselves? To what extent could government guarantees encourage irresponsible investment behaviors?
- Substitution. Will increased saving for retirement be offset by reduced saving for other purposes?
- Fiscal policy. Will government borrow to finance individual accounts; or will government surpluses reduce debt and add to national savings?

Arbitrage cannot solve our problems. If government can borrow cheaply to invest in the stock market, and make money to fund retirement benefits, why not use this approach to finance defense, education, law enforcement and transportation? Why stop with Social Security? Common sense tells us this won't work!

Increased rates of return can only transfer resources from one group to another unless accompanied by increases in productivity and growth. In the long run, the real rate of return on saving for the entire economy cannot exceed productivity growth. That is just another way to say that the sum of the parts cannot exceed the whole.

Investing Social Security Trust Fund Assets in private securities may or may not increase resources explicitly dedicated to fund benefits. Increased risk is the price we pay for

potentially higher returns. If the higher returns do not materialize, workers (whose payroll taxes funded the riskier investments in the first instance) would have to pay more taxes or benefits for retirees would have to go down.

Even if the Social Security Trust Fund were to realize higher rates of return, the increased rates of return must be accompanied by increased economic growth, or they must be offset by losses to someone else somewhere else in the economy. Share prices could decline, interest rates could rise or dilution could reduce returns to private investors. To reiterate the obvious, given the same size economy increased returns to the Social Security Trust Fund must mean losses to some other individual(s) or institution(s).

Mandates in these debates almost always turn out to be thinly disguised taxes.

It is extremely unwise to try to flummox taxpayers this way. Eventually they will figure it out, and if they are unwilling to pay something will have to give. Honesty is not just the best policy, it is the only policy that possibly can succeed when it comes to collecting taxes from constituents who elect their leaders.

Surpluses are not an alternative to taxation to pay for Federal programs. Surpluses are annual tax receipts in excess of annual outlays. On-budget surpluses are mostly income tax receipts. Congress and the President can decide to dedicate some portion of the income tax base to pay for Social Security and Medicare (in addition to payroll taxes). But if they do, that should be a deliberate choice consciously taken. There should be no confusion.

As projected surpluses will evaporate in future years, using on-budget surpluses for such purposes implies income tax increases in future years.

We will have to make some hard choices. The choices facing the United States are not difficult by international standards. We are a very wealthy nation. The changes we must make to meet the needs of baby boomers when they retire—and continue to raise standards of living for workers and children—are marginal and manageable. But they are politically difficult precisely because they demand that we save in the short term, to grow the economy over the long term. It is hard for this generation of politicians to say no to this generation of voters in order to secure the future for our children and grandchildren. But that is the essence of this debate.

In the final instance, government guaranteed (tax financed) cash support and health care financing for retirees will be somewhat less generous than under current laws and policies or taxes will go up a lot. The burden of future benefit reductions may be spread across all future retirees, or we can reduce benefits more for middle and upper income retirees

Tax policy like spending policy involves difficult tradeoffs. In the abstract, almost everyone supports tax simplification. But much of the complexity in current tax law supports saving for retirement, purchase of health insurance, home ownership and other socially desirable goals. In some instances, tax policies may harmonize with spending policy. For example, workers and their employers deduct the cost of health insurance and retirement savings from their

incomes before tax. One might argue that Social Security and Medicare payments to and on behalf of retirees also help to fulfill social objectives. Certainly, any changes that shift greater responsibility to individuals and families to meet the needs of retirees in the future should harmonize with whatever changes we contemplate making in tax policy.

There is a lot of support in Washington (and the country) for a "flat tax" or "flatter" rate system. The flat/flatter tax debate often seems fraught with confusion between rate and base issues. All of the flat tax proposals currently under discussion would shift the focus of taxation from incomes to consumption. House Minority Leader Richard Gephardt's flatter tax proposal, by contrast, would continue to tax incomes.

Serious debates about tax reform should begin with the base, i.e., what should we tax—and what if anything ought to be exempted from the base? Once we make those determinations, there will be ample time to debate rate structures. Clearly, the broader the base the lower the rate required to raise a given level of tax revenue.

In this respect, the health care reform and tax debates may be similar. Just as tax reform discussions have tended to center around how to pay for a specific benefit, coverage or procedure (sometimes for specific groups).

The health care segment of the economy has few problems with growth. Health spending, after a few years of relative stability, is again growing faster than the rest of the economy. Today health spending is 14 percent of gross domestic product (GDP). The Health Care Financing Administration (HCFA) projects that

national health spending will approach 17 percent of GDP in 2007. Growing health care spending is neither “right” nor “wrong” but it comes at the expense of other needs. Health care financing becomes more difficult as health care becomes more expensive and that may lead to increases in the numbers of people without health insurance.

In health care financing we need to begin with basics. It seems clear that as a society we will not let people die on the steps of hospitals—whether or not they can pay for care.

But that does not translate into an explicit, universal, tax-financed entitlement. Nor is everyone insured. We pay some of the costs through programs such as Medicaid and Medicare. We shift some of the costs (charging those with insurance more than their fair share). State and local taxes cover part of the costs through clinics, county hospitals, etc.

Medicare is very sensitive to trends in overall health care spending. Medicare beneficiaries are older and more likely to use health care than the younger population. Health care cost growth and growing numbers of eligible beneficiaries cause projected spending for Medicare to double over the next decade—even before the baby boom begins to retire.

Until recently, concern about cost growth dominated Medicare policy debates. Medicare contributed more than half of total spending reductions contained in the 1997 Balanced Budget Act. But Medicare spending is growing slower than anticipated prompting providers to argue that the BBA changes went too far. In addition, budget surpluses have tended to undermine fiscal discipline.

In this environment, many are arguing to expand Medicare

coverage to include early retirees, more prescription drugs for more beneficiaries, and/or long term care.

The health care needs of Older Americans are compelling. Yet few politicians are willing to advocate tax increases to pay for the current Medicare program—much less for expanded benefits or coverage. Policy makers must balance access and cost control goals. To achieve that balance they must be candid about costs and about who is going to pay the bills.

It is not at all clear just what health care services (short of crisis intervention) we believe should be universally available—even if we must pay the costs through taxes. Medicaid meets most of the health care needs for poor people. Medicare provides health insurance for the elderly.

But those programs are based on the status of the beneficiary—not on any determination about some minimal level of health care coverage society is committed to fund.

Perhaps our approach to automobile insurance could inform the health insurance debate. First we must decide what kind of coverage we are determined that everybody must have, we can discuss how best to ensure that everyone is covered.

But the debate tends to drift back and forth, between and among, three

distinctly different topics—which groups should be covered and what should be the “basic” benefit; how to provide coverage for selected groups; and how to finance specific coverages and benefits. Down that road lies confusion.

Full, open and honest debate almost certainly will result in limits on choice or access to medical care we pay for through taxes, i.e., the care we finance for somebody else. Decisions such as this ought to be made in the most transparent manner possible.

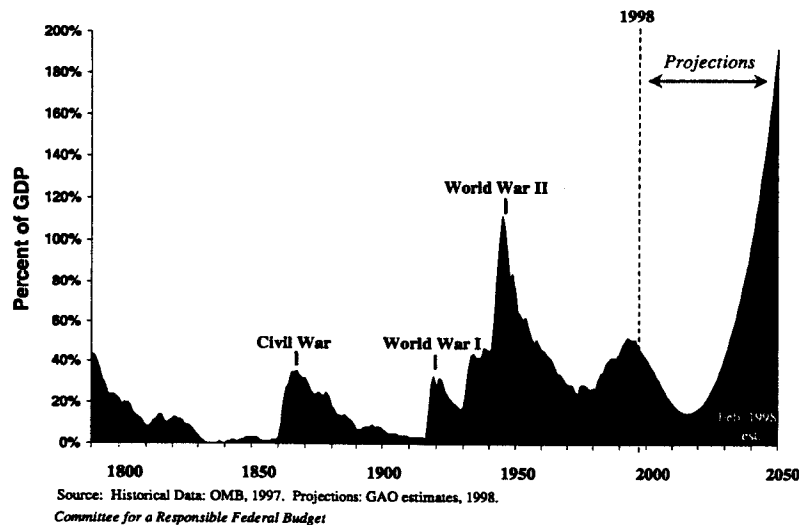
Budget—Perspectives and Context

The Magnitude of the Problem

In the United States today, there are 76 dependents for every 100 people working age². By 2030, the ratio will rise to 1:1. The increase in dependency ratio is attributable entirely to increases in the elderly, who will look to tax-financed government programs for a major share of their retirement income and health care financing.

Projected growth has serious implications for federal budgets. The Congressional Budget Office projects that Social Security and Medicare costs would double (as a share of GDP) under current laws and policies between now and 2030. Social Security and Medicare would consume half the budget in 2030, compared to 28 percent of today's spending.

Budget Balance Improves, but Does Not Fix, Projected Deterioration in Long-Term National Debt Situation



² Dependents are children below age 20 and adults age 65 and older

Unless taxes go up commensurately, the projected growth in these two programs would come at the expense of other public programs and priorities. Left unchanged Social Security and Medicare eventually would result in escalating deficits and debt so large that standards of living would decline.

Window of Opportunity

Over the last four years, the nation's fiscal picture has brightened considerably. In 1998, the federal budget ran a surplus for the first time in 29 years. Virtually all State budgets also ran surpluses.

Federal budget surpluses will last well into the new millennium assuming favorable economic conditions continue and assuming Congress and the President don't spend the money. The economy is in its eighth year of continuous growth. Growth, low interest and inflation have combined to propel the Dow

Jones Industrial Average well past the 10,000 mark. Across the population, unemployment rates are at historic lows. Baby boomers are entering their prime working years. Americans, according to most indicators, are doing well. In sum this the ideal time to lay the groundwork for the economic and social changes to come.

Policy makers could begin by agreeing, sooner rather than later, on a sustainable fiscal policy framework. At a minimum, they need to agree on Social Security and Medicare reform.

Tax reform also could help. The public is fed up with complexity in the tax code. Economists and the business community express concern about the system's harmful impact on the economy. Many complain that the system is unfair. These concerns fuel interest in fundamental reform.

Tax reform and entitlement reform can complement each other.

Tax reforms that encourage increased saving, investment and economic growth will help to address the challenges posed by an aging society.

Presidents and Congresses struggled for nearly two decades to balance the budget, passing one deficit reduction bill after another. Raising taxes never is popular. Thus political rhetoric focused on shrinking the size of government, relative to the overall economy, if not in absolute dollar terms.

Fiscal restraint paid off. Federal spending grew in nominal dollars to \$1.7 billion, but the economy grew faster than the budget. Outlays are at the lowest level in 25 years, at 19.5 percent of GDP. In 1998, the federal government actually ran a unified budget surplus for the first time in almost thirty years.

Changes in big spending programs and tax systems almost always incur substantial transition costs.

Surpluses could ease the impact of transition costs in two ways—

Surpluses used to retire debt reduce interest costs and free up money to meet program needs; and

Surpluses could be used as offsets and thus alleviate the need to raise taxes or make deeper benefit cuts to cover transition costs.

Small changes in spending or tax policies today can make major differences ten, twenty, or thirty years into the future. Simple fairness requires long lead times for large changes in programs such as Social Security and Medicare, so people can adjust while they are working to meet the different reality after they retire.

Downside to Budget Accountability

"Big Government" out of style. Politicians are reluctant to discuss honestly the likely costs of reform. Policy makers and their constituents would like to "have their cake and eat it too". That often means providing benefits at no apparent cost.

This has produced a number of needlessly complex reform proposals. Ultimately, it could lead to public policy paralysis, if leaders are unable to move forward except along seemingly painless paths.

Social Security reform, Medicare reform and tax reform all offer examples of this phenomenon.

Social Security reform is essential because future benefit costs will outstrip dedicated tax receipts. Reform must put the current program on sound financial footing

or replace it with a financially secure system. In either case, real reform must help increase net national savings. Only by doing so can we ensure an increase in resources available to meet future retirees' needs. Future retiree benefits, whether they come from public or private sources, will be less burdensome if the economy is bigger.

Politicians focus on politics rather than economics. Most proposed Social Security reforms are structured first and foremost to address political concerns. They promise the same or increased benefits. They would not raise taxes. Some even promise lower costs. They focus on labels, e.g., "individual accounts" and distract attention from costs and sources of financing. They depend much too heavily on increased rates or return and too little on increased growth.

As a result, most would divide up the future economy somewhat differently than we do today—allocating a larger share of the whole to meet retirees' needs — but few would diminish significantly the economic burden of a larger retiree population.

Medicare faces more serious financial problems than Social Security. Costs are accelerating faster than enrollment and the dedicated tax base. Modernizing Medicare to keep pace with rapid change in medicine, e.g., adding prescription drug coverage would increase costs. Many argue in favor of expanding Medicare coverage to early retirees. Others favor better long term care benefits.

Everyone supports increased efficiency, but most options to achieve that goal increase beneficiary

costs or reduce patients' choice of providers, neither of which is popular.

Medicare reform debates center on two basic approaches. Both eventually would require additional tax support. One would limit payment for covered services and procedures³. The other would limit the amount taxpayers contribute toward each retiree's health care costs. Proponents of each say the other is too costly, either to beneficiaries or to taxpayers.

The debate is going nowhere. Americans expect someone else to pay for health care. No politician wants to explain to constituents what it would cost taxpayers to provide the benefits everybody seems to want for the elderly.

³ This is the approach that Congresses and presidents have adopted to limit Medicare expenditures since the inception of the program.

Tax reform could complicate the policy agenda. Most fundamental reform proposals would reduce or eliminate most tax incentives and penalties in return for lower rates and less government influence over economic decisions.

The three largest tax expenditures in current law promote home ownership, private retirement savings, and employer-sponsored health insurance coverage.

It is hard to predict changes in saving behavior and health insurance coverage that might flow from reducing or eliminating those tax preferences. It is clear that such changes could have dramatic consequences for Social Security and Medicare reform. But the tax reform debate tends to focus on rate reduction. Politicians are no more anxious to talk about cost in this context than in debates around entitlement reforms.

The Budget as a Reality Check

Piece meal approaches to reform cannot succeed because they risk committing the same resources over and over again. Social Security cannot be reformed at the expense of Medicare, or vice versa. Neither can be reformed at the expense of everything else in the budget. Tax reform designed to promote saving cannot succeed if it produces huge budget deficits and rising debt.

If, on the other hand, policymakers can agree on overall objectives, separate reforms can complement and reinforce one another, multiplying the effectiveness of each and producing synergistic effects.

That is why budget context matters. The budget functions as a reality check. It forces recognition of competing priorities and tradeoffs. It distinguishes cost shifting from real savings.

The budget reminds us that the right size government is the one voters will fund through tax dollars.

Opinion polls offer contradictory perspectives on voter preferences. Yes, polls tell us that there is strong support for elderly entitlements among all age groups in the population. Yes, polls tell us that people think taxes are too high. But polling also tells us that voters expect elected representatives to keep the budget under control. Political leaders cannot stay in office, remain popular, and keep constituents' respect by providing benefits at the cost of mountains of debt.

Those who would prefer to escape accountability for the cost of policy change dismiss budget concerns as misplaced preoccupation with "accounting". That is a mistake. Budget analysis discloses important

information about shifts in public and private responsibilities, as well as the impact of proposed policy change on other government responsibilities.

The Social Security debate particularly has raised the issues of public versus private roles.

Many Social Security reform proposals appear to alter the division of responsibility between the federal government, on the one hand, and individuals and families on the other.

In most instances, however, the shift is largely cosmetic. Government would play such a dominant role that to call such systems private is a misnomer. Individuals would have limited investment choices. Individual accounts would remain out of reach until beneficiaries reach retirement age.

Even at retirement, under most plans, nominal owners of such accounts would not have full control over the capital. Retirees would be forced to choose between phased withdrawal and annuitization. Benefits would be based on Federal laws and regulations—just as is the case under the current Social Security system. Initially, some plans would guarantee minimum benefit payments from the accounts.

It could be decades (if ever) before most retirees could expect to be better off than they would have been under traditional Social Security.

Increased gains due to investments in private stocks and bonds rather than government securities are largely illusory. Those higher rates of return are associated with higher risks. Government borrowing to fund “individual” investment accounts would push up interest costs. That in turn would benefit retirees at the expense of taxpayer

workers. Moving money around does not increase saving or overall returns. In the long run, the real return on saving cannot exceed the real rate of growth in productivity. That is true whether retirement savings are divided into individual accounts and managed privately or pooled together and managed publicly.

The Budget Context

The more things change the more they remain the same. Most of the credit for budget surpluses should go to the economy rather than to public policy change. In fact, surpluses would be larger if Congress and the President had put government on automatic pilot.

Nevertheless the long term looks daunting, and most of the difficulty is due to current law Social Security and Medicare benefits

Three of the largest government programs — Social Security, Medicare and Medicaid — provide substantial benefits to older Americans. Under current laws and policies those programs would consume 7 of every 10 tax dollars by 2030.⁴ That kind of growth will crowd out other spending, lead to huge deficits, or create inexorable pressure to raise taxes.

Reform in an Era of Surpluses

Surpluses could make reform easier or they could increase the difficulty of an already complex calculus.

The President and most members of Congress emphasize the link

between budget surpluses, debt reduction, and Social Security and Medicare reforms. But the Administration and Congress both have plans for substantial portions of projected budget surpluses that have nothing to do with either debt reduction or long-term reform.

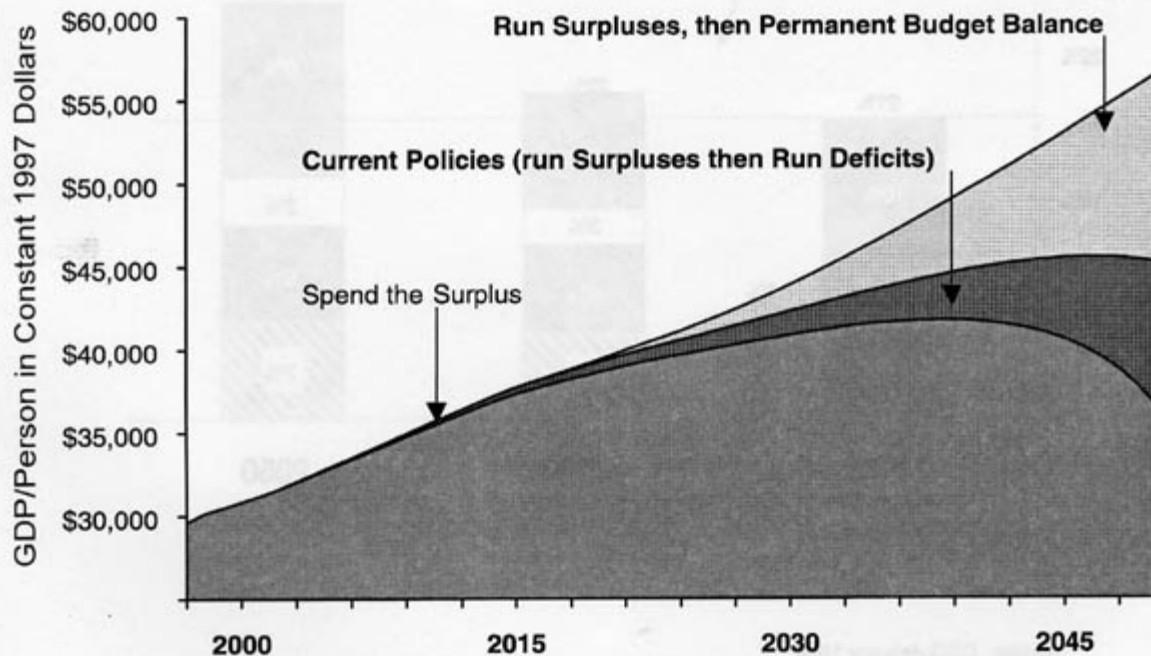
Surpluses seem to act like a magnet for new spending and tax cut ideas. The advent of budget surpluses started a feeding frenzy that threatens to undermine budget discipline. Indeed projected surpluses could disappear in a flurry of tax cuts and spending increases that serve short-term political objectives. It is hard to get policymakers to focus on the long-term.

⁴ Sources: Congressional Budget Office and General Accounting Office Long Range projections

Elections happen in the here and now. Today's voters decide the future of their elected leaders. For politicians and for voters, Social Security and Medicare problems seem a long way off.

The future is uncertain. Times are good. Budget surpluses make good times look even better. Any course of action, including inaction, entails risk and uncertainty. It requires far more energy act than to do nothing at all. Thus, inertia rests with doing nothing.

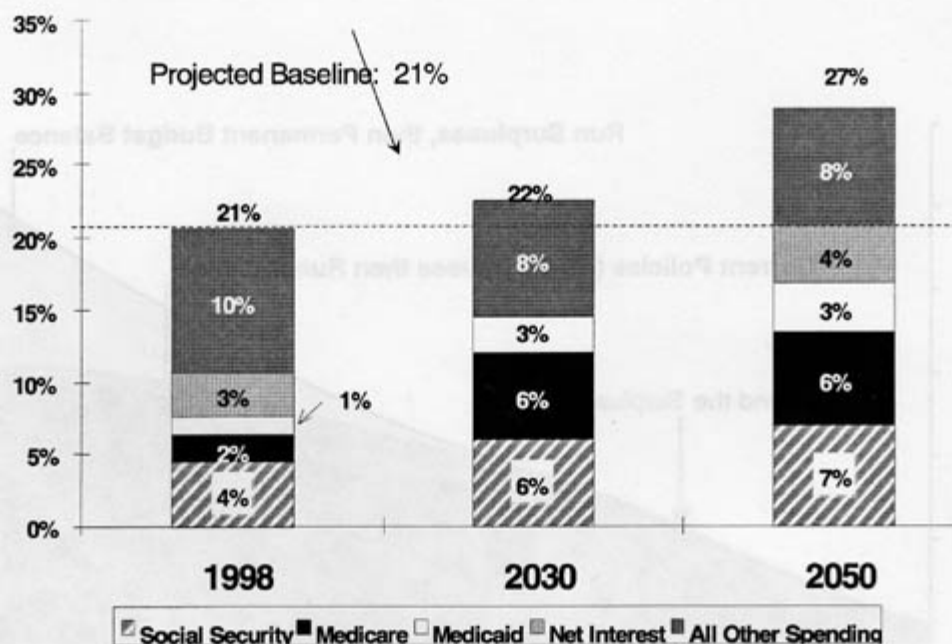
Continued Fiscal Discipline Would Produce Significant Long-Term Economic Benefits



That would not be all bad if Congress and the President really be so bad if Congress and the President did nothing. Surpluses would go to retire debt. That would reduce interest costs, free up resources for other uses, and eventually facilitate reform.

Unfortunately, that likely will not occur. Rather, Congress and the Administration may succumb to the temptation to use up projected surpluses long before they actually can materialize.

Federal Budget as a Percentage of GDP



Source: CBO January 1999

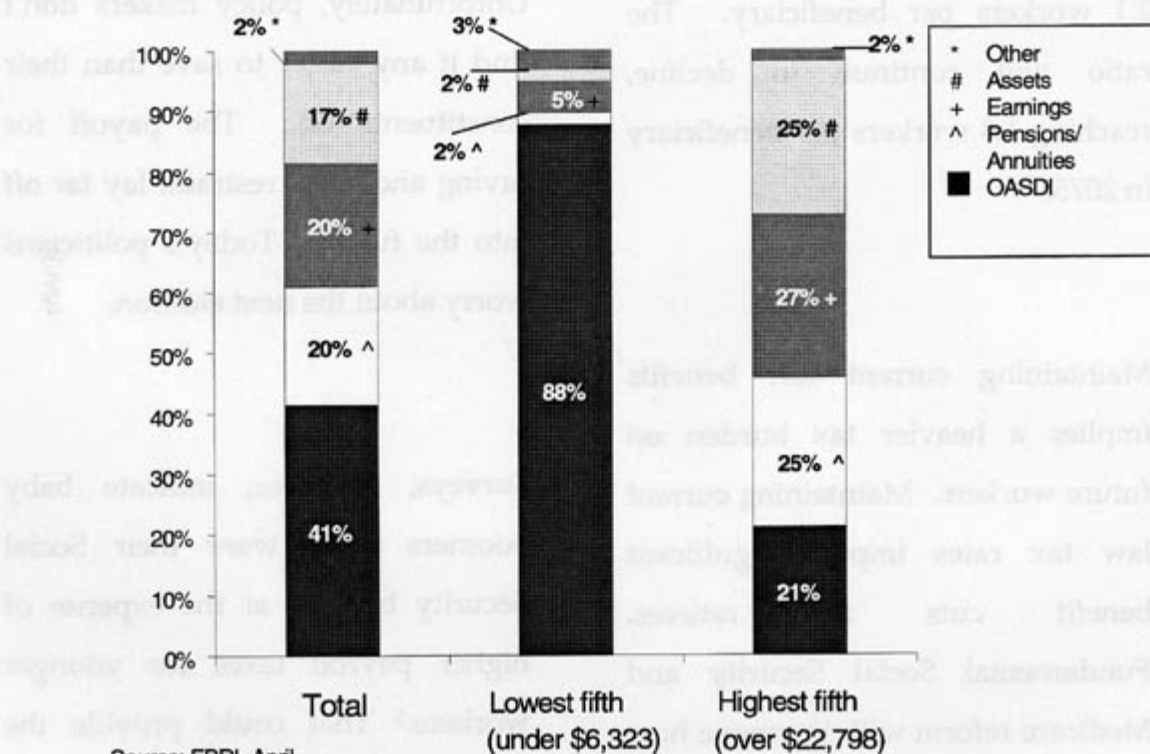
Income Security & Health Care Support for the Future

Retirees, by definition, rely on income from sources other than employment. Increasingly, however, older adults continue to work. That may be out of necessity or it may be due to choice. The trend, however, is clear. Today's older population

receives income from four major sources—

- Social Security;
- Pensions and annuities;
- Earnings from assets; and
- Earnings from employment.

Sources of Income of the Older Population: 1997



Source: EBRI, April 1999.

Social Security and Medicare, like all pay-as-you-go programs, are affected by changing demographics. The programs promise future benefits to today's workers in exchange for their payroll taxes. But the revenues to pay for those promised benefits will come from future workers. Today, there are 3.4 taxpaying workers for every beneficiary. By 2030, after the baby boomers have retired, there will be 2.1 workers per beneficiary. The ratio will continue to decline, reaching 1.8 workers per beneficiary in 2075.

Maintaining current law benefits implies a heavier tax burden on future workers. Maintaining current law tax rates implies significant benefit cuts for retirees. Fundamental Social Security and Medicare reform will determine how the costs are allocated across the population and across generations.

In addition to paying down publicly held debt, policy makers should refrain from enacting policies that will make the long term fiscal situation worse. That is, they should be wary of encouraging more current consumption through new benefits or tax cuts unless they pay the full cost of those policies over the long term.

Unfortunately, policy makers don't find it any easier to save than their constituents do. The payoff for saving and fiscal restraint lay far off into the future. Today's politicians worry about the next election.

Surveys, however, indicate baby boomers don't want their Social Security benefits at the expense of higher payroll taxes for younger workers.⁵ That could provide the opportunity for politicians to assert greater stewardship over the future.

⁵ For example, see Louis Harris & Associates, Inc., *CIGNA/Harris Coming of Age Poll*, April 1997

Income Security and Health Care Support are not exclusively Elderly Issues

Social Security is by far the largest income security program in the budget. Indeed it is by far the largest program in the budget. The minimum social Security benefit is below poverty level. Nonetheless, Social Security is essentially a guaranteed minimum income for the elderly.

The Federal government funds cash support payments to other groups—

- Veterans and their survivors;
- Poor families with children;
- Farmers;
- The disabled;
- The unemployed; and
- Federal civilian and military retirees. Federal retirement benefits are obligations government incurs as an employer and properly should be viewed as part of employee compensation.
- The Federal government may be the last remaining U.S. based employer of any size to consider compensation piecemeal, i.e.,

salaries separate from health and other insurance, separate from pension benefits, leave and other non-cash compensation. But that is an issue for another day and another report. The point here is that Federal employee pensions are a special case. Federal pension costs are not income maintenance costs. They should be debated in a broader context—but the broader context is not national income maintenance policy or retirement policy, it is employee compensation policy.

The elderly are the only group to or for whom the Federal government finances income security payments that are neither means-tested nor based on any condition other than age, e.g., income prior military service, poverty, unemployment or disability.

- Temporary Assistance for Needy Families, Family Support, Aid to Families with Dependent Children and Job Opportunities and Basic Skills programs make payments to States and local governments for time-limited income support to poor families with children.

- The Earned Income Tax Credit is meant to offset the impact of payroll taxes for low-income workers. It is a "refundable tax credit", i.e., families with too little tax liability to take full advantage of the credit receive cash payments.
- Supplemental Security Income (SSI) benefits go to the disabled and the elderly poor.
- There is no universal Federal program to provide income maintenance payments to poor adults without children. Some States and localities provide such support and there is limited Federal assistance to those that do so.

Income maintenance policy issues tend to focus on means testing versus other "status" definitions to determine eligibility. With respect to retirement security, this debate tends to divide people in odd ways. Many "liberals" argue that Federal retirement income security must not be means tested for fear of turning it into a welfare program and undermining public support. Many "conservatives" respond that it makes no sense to tax working

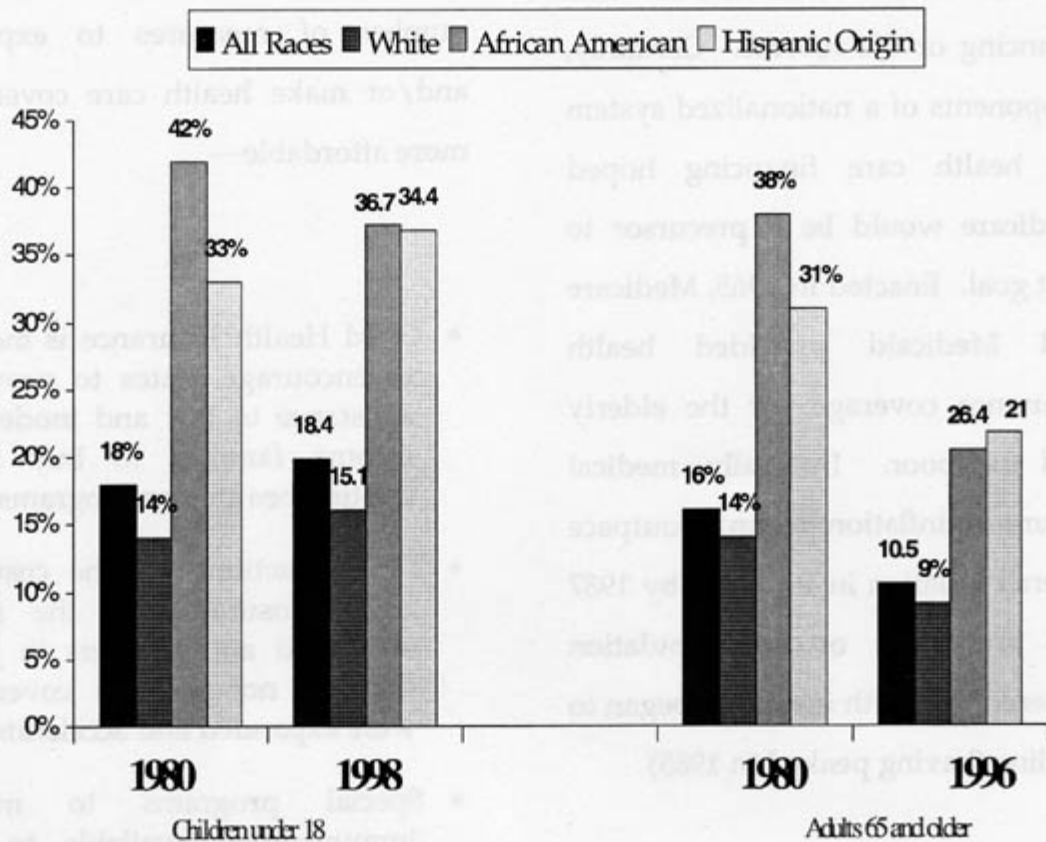
families to fund benefits for retirees who have higher incomes and greater wealth than the worker-taxpayers do.

Recent changes in public assistance policy place time limits on payments to poor families. Those changes—and a booming economy—have been very successful to move welfare recipients into jobs.

Some advocates for the poor express concern that a mild recession could end that trend and leave many vulnerable families that have exhausted eligibility for public assistance in the lurch.

If that occurs, rising costs of programs for retirees could make it more difficult to meet the needs of non-elderly poor families. That could exacerbate debates around means- testing elderly entitlements.

Poverty Rates by Selected Characteristics 1980 & 1998



Source: Bureau of the Census, 1998.

Committee for a Responsible Federal Budget

By 2030 Medicare Costs are projected to equal Social Security and total 12 percent of GDP (twice the combined 6 percent of GDP today)⁶. Sometimes it is hard to tell whether the Medicare debate drives the broader debate about health care financing or the reverse. Certainly, proponents of a nationalized system for health care financing hoped Medicare would be a precursor to that goal. Enacted in 1965, Medicare and Medicaid provided health insurance coverage for the elderly and the poor. Ironically, medical insurance inflation began to outpace overall inflation in 1982 and by 1987 the proportion of the population covered by health insurance began to decline (having peaked in 1985)

High levels of uninsured individuals and families raise two policy questions—

1. What health care costs are we prepared to socialize and fund through tax receipts; and
2. How to avoid cost shifting and “free riders”.

Recent Congresses have enacted a number of measures to expand and/or make health care coverage more affordable—

- Child Health Insurance is meant to encourage States to provide assistance to low and moderate income families to buy into existing health care programs;
- Tax deductions for the cost of health insurance to the self-employed and workers in jobs that do not provide coverage were expanded and accelerated;
- Special programs to make immunization available to all children;
- Medical Insurance Accounts and a variety of other measures.

⁶CBO Economic and Budget Outlook, January 1999, p. 43

Nonetheless, the percentage of the non-elderly population covered by health insurance continues to decline. That is almost certainly a function of rising health care costs; and rising health care costs may be driven at least in part by the ever expanding pools of money devoted to pay health care costs.

Moreover, managed care and other measures designed to control health care cost increases are under attack from patients who dislike any limits on their choices of providers and/or access to services—and from providers who dislike any limits on their incomes.

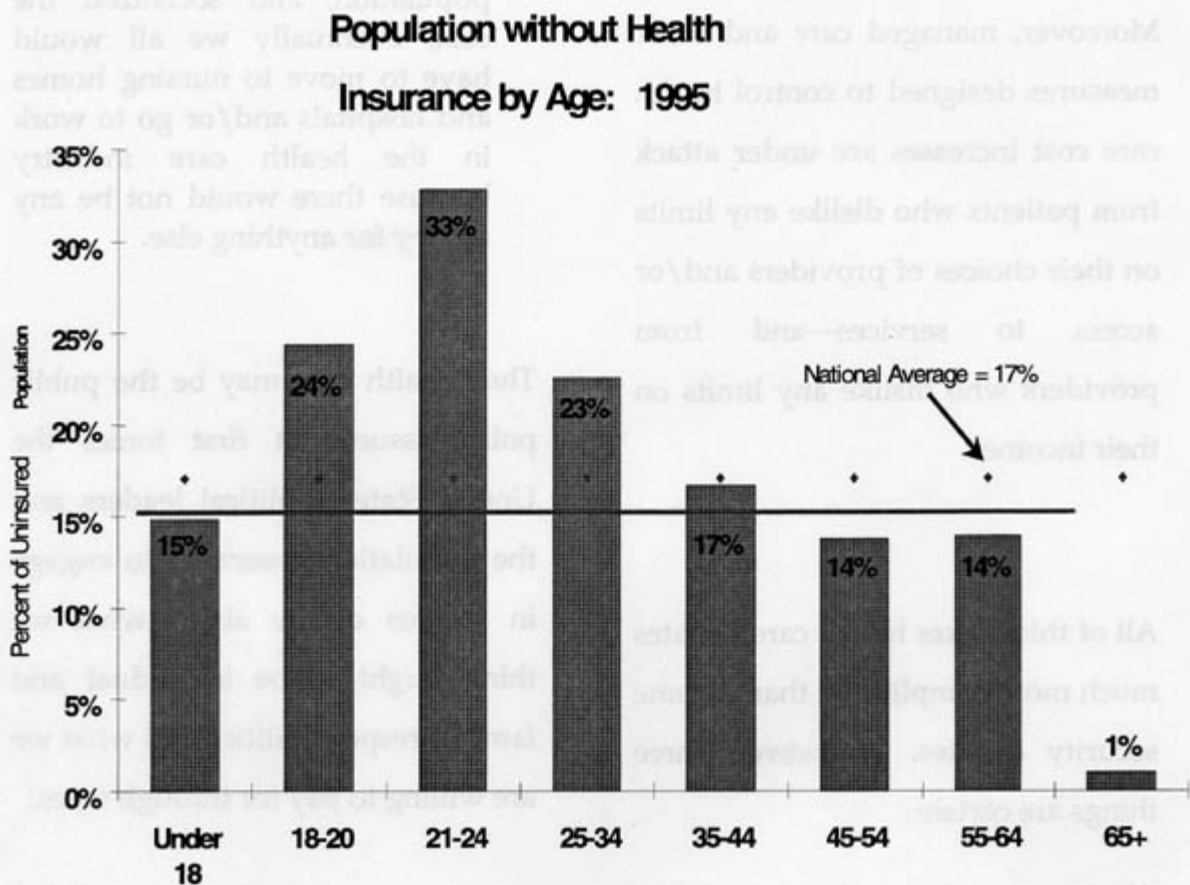
All of this makes health care debates much more complicated than income security debates. However, three things are certain.

- Health care cost pressures eventually must force us to recognize that everybody cannot have access to all the health care services they would like at somebody else's expense.
- The rising cost of retiree health care must be met in ways that are consistent with providing for the health care needs of other groups in the population.
- If we provide unlimited access to unlimited health care benefits and services for the entire population, and socialized the cost, eventually we all would have to move to nursing homes and hospitals and/or go to work in the health care industry because there would not be any money for anything else.

Thus health care may be the public policy issue that first forces the United States (political leaders and the population generally) to engage in serious debate about what we think ought to be individual and familial responsibilities and what we are willing to pay for through taxes.

It is sad if "little Billy suffers a terrible illness and his family uses up their entire savings to pay the bills". But are little Billy's neighbors (and people who do not know him or his family) prepared to pay higher taxes so the family can protect some of their savings?

If some of the savings dissipated by Billy's illness were intended to support the parents in retirement—and if Billy recovers to become rich and successful—should the child support the parents in later years or should that burden transfer automatically to taxpayers?



Source: Employee Benefit Research Institute Analysis of the March 1995 Current

These are not easy issues. They illustrate some of the connections between and among retirement policies and policies directed to help the non-elderly in our society, some of whom may be more vulnerable than some retirees.

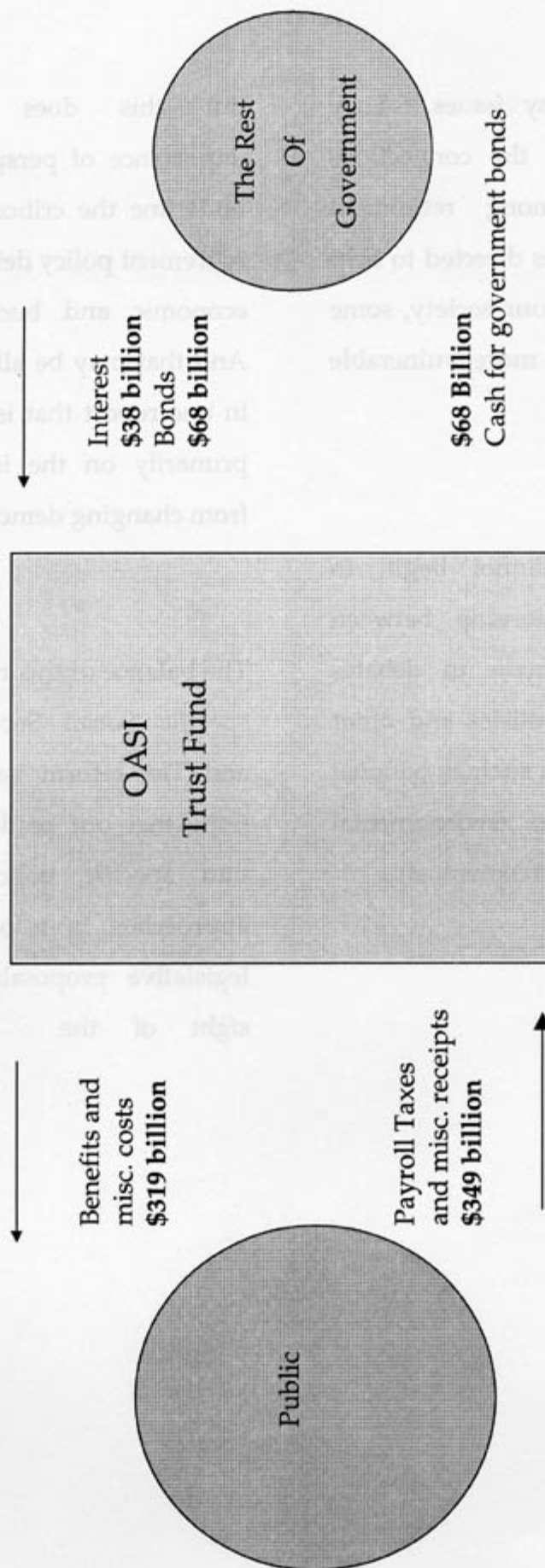
This exposition cannot begin to describe the relationship between choices we will make in debates about retirement policies and other public policy issues such as national defense, education, environmental protection, law enforcement, etc.

But this does illustrate the importance of perspective. It does underline the critical need to place retirement policy debate in a broader economic and budgetary context. And that may be all that we can do in one report that is meant to focus primarily on the issues that arise from changing demographics.

The balance of this report deals with specific Social Security, Medicare and Tax reform issues. We only hope that our readers, as you dip into specific policies, alternative approaches to reform, and actual legislative proposals will not lose sight of the "big picture".

Figure 1: Operations of the OASI Trust Fund

(Fiscal Year 1997)



Social Security Reform

Social Security contributes over 40 percent of the income of the population age 65 or over. Over 90 percent of elderly individuals receive Social Security benefits. Social Security is much more important to low-income retirees than to those who are better off. That is by design. Benefits are based on earnings — but low-income workers receive higher benefits relative to pre-retirement earnings (replacement rates) than their higher wage counterparts.

Social Security is social insurance. It covers workers in 95 percent of jobs. It provides inflation-adjusted benefits to retired workers and spouses. It provides protection against loss of income from work due to disability. It also provides income to dependents when workers die before reaching retirement age. In 1940, annual maximum taxable earnings were \$3,000 (equivalent to \$29,000 in 1999 terms) and the total

For the most part, Social Security is a pay-as-you-go-system. Most (85 percent) of the payroll taxes collected today are used to pay benefits for current retirees and other beneficiaries. The remaining tax collections are credited to the Social Security Trust Fund, invested in interest-bearing special U.S. Treasury debt obligations, and reserved for future needs. (See Figure 1 for illustration of Trust Fund Operations.)

For nearly fifty years, Social Security reform meant expanding benefits and increasing dedicated taxes to pay the bills. Strong economic growth and an expanding labor force made it possible to expand benefits even though the people 65 and older grew from 6 percent to 13 percent as a share of the total population. contribution rate was 1 percent. In 1999 employers and employees combined pay 12.4 percent on up to

\$72,600 in taxable earnings for Social Security, plus another 2.9 percent on all wages and salary for Medicare. (See table 1.)

Figure 1 illustrates payments into and out of the OASI Trust Fund.

The "public" represents non-governmental entities.

Workers pay payroll taxes. That revenue and miscellaneous receipts (from fines, etc.,) is deposited into the Trust Fund. The Trust Fund pays benefits to retirees and dependent survivors of covered workers who die before reaching retirement age.

The Trust Fund is a separate account in the United States Treasury.

Any balance remaining in the Trust Fund, after benefit and miscellaneous obligations have been met, is transferred to the "rest of government".

OASI is Old Age Survivors Insurance.

OASDI is Old Age Survivors and Disability Insurance.

HI is Hospital Insurance.

OASI is paid for from one trust fund.

There is a separate Disability Trust Fund.

HI is sometimes referred to as "Part A" of Medicare. HI benefits are paid from the Medicare Trust Fund.

OASDI and HI are funded from payroll taxes.

Medicare Part B or SMI (Supplemental Medical Insurance) is a voluntary program the cost of which is paid about ¾ from federal general revenues. About ¼ of the cost is deducted from enrollees' Social Security checks.

Special Treasury Bonds are deposited in the Trust Fund, representing those transfers and interest payments on Trust Fund balances.

Cash transferred to the "rest of government is used to pay for non-Social Security programs and reduce debt held by the public.

Table 1. OASDI/HI Payroll Taxes, Selected Years

Year	Annual Maximum		Contribution Rate (in percentage)					
	Taxable Earnings		Employees & Employers (Each)			Self - employed		
	OASDI	HI	OASDI	HI	Total	OASDI	HI	Total
1937 to 1949	\$3,000		1.00		1.00			
1951 to 1953	3,600		1.50		1.50			2.25
1957 to 1958 *	4,200		2.25		2.25			3.38
1966 **	6,600	\$6,600	3.85	0.35	4.20	5.80	0.35	6.15
1973	10,800	10,800	4.85	1.00	5.85	7.00	1.00	8.00
1979	22,900	22,900	5.08	1.05	6.13	7.05	1.05	8.10
1983	35,700	35,700	5.40	1.30	6.70	8.05	1.30	9.35
1984	37,800	37,800	5.70	1.30	7.00	11.40	2.60	14.00
1990	51,300	51,300	6.20	1.45	7.65	12.40	2.90	15.30
1991	53,400	125,000	6.20	1.45	7.65	12.40	2.90	15.30
1994	60,600	***	6.20	1.45	7.65	12.40	2.90	15.30
1999	72,600	***	6.20	1.45	7.65	12.40	2.90	15.30
Future Schedule:								
2000	and +	***	6.20	1.45	7.65	12.50	2.90	15.30
thereafter								

SOURCE: Social Security Administration (1996 and 1999).

* Disability added

** Medicare added

*** Ceiling on earnings subject to HI taxes was repealed by OBRA in 1993.

+ Based on automatic adjustment in proportion to increases in average wage level.

By the 1980's Social Security was in trouble. In 1982 the program had to borrow from the Medicare Trust Fund to pay benefits. Treasury was borrowing from the public and redeeming debt held by the Social

Security Trust Fund. (Treasury is required by law to redeem Securities held by the Trust Fund as needed to pay benefits.)

By July 1983, Trust Fund assets would have been exhausted and receipts would not have funded all benefits due. These conditions created an atmosphere of crisis that enabled Congress and the President to enact a package of reforms that scaled back benefits and raised taxes. But they waited until it was absolutely necessary to act.

Some of the 1983 Social Security Amendments Act changes began to chip away at the baby boomer problem. The eligibility age for full retirement benefits was raised from 65 to 67, but those changes were not effective until 2003, and the change only affects workers born after 1937.⁷ In addition, the 1983 Act raised taxes more than necessary to pay benefits until the baby boomers began to retire. The plan would take greater advantage of productive work years of a large workforce partially to

advance fund baby boomer retirement benefits.

The surpluses thus generated could be used to buy down debt held by the public. That would reduce government's liabilities and interest costs and make it easier to pay benefits to that very large cohort in retirement.

Unfortunately, things did not work out that way. Throughout the 1980s and early 1990s, the federal government ran historically high peacetime deficits. Social Security surpluses helped offset the cost of other programs and reduced the amount government had to borrow from the public. Nevertheless, debt held by the public went from \$1 trillion to over \$3 trillion (rising 10 percent of GDP) and interest costs grew from 11 to 15 percent of the budget between 1983 and 1998, when the budget finally balanced.

⁷Beginning in 2003, the retirement age will rise 2 months a year, until it reaches age 66, for those born in 1938-1943. It remains at 66 for those born in 1943-1954. The retirement age will rise an additional 2 months per year, until it reaches age 67, for those born in 1955-1960. For workers born in 1960 and later, the normal retirement age is 67.

Why Worry Now?

Each year, the Social Security Trustees report on Social Security's status. These reports include 75-year estimates of the program's financial operations. Major milestones in the latest report include:⁸

- 2014: Social Security cash surpluses (payroll tax revenues in excess of Social Security payments) disappear;
- 2021: Payroll tax revenues plus interest earnings on trust fund balances no longer sufficient to cover benefits;
- 2034: Trust fund balances exhausted. At that time, payroll tax revenues will be sufficient to pay 71 percent of promised benefits.

These dates seem distant and hardly convey a sense of urgency to reform, especially given the nature of the American political system.

But trust fund solvency is only one measure (and not a very good one) of the soundness of Social Security policy. It is the cost of benefits — the amount of future promises—that will determine the program's viability, not the size of the trust fund.

Beginning in 2014, general revenues or proceeds from public borrowing will be needed to make interest payments to the trust funds and redeem Treasury debt held by the trust fund. Focusing on the status of the trust fund isolates the program from the rest of the budget and provides no insight into the program's affordability relative to other public priorities. Social Security cannot be financially secure if the rest of government is broke. Retiree's income security cannot come at the cost of insecurity for the rest of the population.

⁸ From the 1999 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Trust Funds, intermediate assumptions

The Social Security debate is, in fact, a debate over how to divide up future national income. Current law implies a 30 percent cut (2 percent of GDP) in Social Security benefits after 2034. If current law does not change, retirees' share of national income would be that much smaller. Social Security reform plans attempt to keep retirees' income claims from falling that much.

- The most straightforward way to avoid benefit cuts would be to increase payroll tax rates. But that would place the full burden of the shortfall on future workers, claim a larger share of their earnings, and hit lower income workers harder than those with higher incomes.
- Another way would be to use general revenues to supplement payroll taxes. That also would increase claims against workers, but the burden would be spread over non-wage income in addition to wages and salaries and distributed according to the progressive income tax rate structure. Total tax burdens could be kept level, but that would entail cuts to other programs. Using non-Social Security surpluses to extend the life of trust funds or fund Social Security

benefits is one approach to general revenue financing.

- A third possible approach would be to offset the implied reduction in Social Security benefits with a greater accumulation of individual savings. Workers would have to forego some consumption in order to save more, but they are more likely to be able to afford it when they are working than when they are retired. Note that if workers don't actually increase their total retirement savings, or they go out and borrow to maintain their old consumption patterns, they won't be able to offset a Social Security benefit cut.

Successful Social Security reform will not merely extend the life of the trust fund. Instead, it will provide an affordable program that future taxpayers will be willing and able to support given the totality of public and private needs. That is why policy makers must consider Social Security needs in the context of growing Medicare costs, education needs, national defense requirements, and children's need for income support, to name just a few other public responsibilities.

Why Reform?

Social Security reform can make significant contributions towards the economic policy goals identified earlier in this report:

Increase national savings.

Current workers could advance fund a greater share of their own future retirement costs by saving more today. Saving expands capital investment, promotes productivity improvements and economic growth. That could ease the burden on future workers to support a burgeoning retired population.

Everyone would benefit from an expanded economic pie and retirees would realize increased investment incomes. Workers would be better able to help retirees and retirees should need less help. Talk about a win, win proposition—increased saving is the closest thing there is to a “silver bullet” to help solve the challenges facing the United States in the twenty-first century.

Strengthen future prospects for individual retirement security.

The budget and the economy will not sustain indefinitely Social Security’s current benefit and tax levels. People who can expect higher incomes from savings-based assets will feel less dependent on tax-financed benefits. Thus encouraging those who can save to do so, could make benefit restraints easier to enact and decrease the need for tax increases in future years.

Many people will have no option but to rely on Social Security for a major component of their retirement income. Reform will help assure that system will be there at least for those who most need it while encouraging those who can assume greater responsibility for saving for their retirement to do so.

Allow for other public priorities.

Reform can lighten the tax burden of younger generations or allow resources to be directed to other parts of the budget. Social Security costs will increase by 2 percent of GDP between now and 2020. That is equivalent to one-third of all current spending on discretionary programs.

Analytic efforts are underway to learn more about ways in which various proposals might affect individuals and families. Much work needs to be done before we can understand better how changes would affect the economy and the budget. But common sense tells us that current workers (tomorrow's retirees) must assume greater responsibility for their own retirement income needs. Even so, future workers likely will pay more in taxes and future public benefits will be less generous than current law provides.

Will a specific Social Security proposal increase national savings, and if so how much? That is far from certain. Public policies and individual decisions outside the scope of reform ultimately will answer that question. Some proposals plan explicitly to increase government borrowing in order to fund "individual retirement accounts". Such an approach might have no net impact on net national

savings—or total savings might actually decrease. It is imperative, therefore, to subject all reform proposals to several kinds of economic and budgetary analysis. The goal must be to increase retirement savings and, simultaneously, increase net national savings as well.

Getting from Here to There

There are only two strategies to increase national savings: increase private savings or reduce government debt.

- Private saving consists of personal saving and undistributed corporate profits. Personal saving includes contributions to employment-based retirement savings plans as well as bank deposits, purchases of mutual fund shares, and other financial investments.
- Government saves by running budget surpluses and reducing debt held by the public. Social Security surpluses constitute government saving, if the surpluses are not offset by spending for other purposes.

Recent improvements in national saving are entirely attributable to public budget surpluses. The federal budget balanced for the first time in 29 years in 1998. All 50 States reported balanced budgets or budget surpluses last year. Given recent events in Washington DC, it is not likely that government will save all of the projected surpluses. Tax cuts or spending increases well could reverse the positive trend.

Personal saving, as mentioned earlier, is now negative. Some economists argue that the personal saving rate does not provide an accurate picture of how well people are doing because it does not include capital gains and growing home equity. However, despite eight years of continuous economic growth and recent huge gains in the stock market, only a quarter of working Americans are "very confident" that they will have enough money for a comfortable retirement.

Another 44 percent are "somewhat confident", 19 percent are "not too confident," and 12 percent are "not at all confident."⁹

Shifting Saving Does Not Equal More Saving.

Shifting saving does not increase the total. Indeed, such circular activity may have pernicious effects, as it may create an illusion of gain and thus undermine the will to make the hard choices necessary actually to achieve the goal.

- Shifting savings from the public to the private sector does not increase the whole, which after all is a sum of the parts. But it could have important implications for the distribution of future retirement income.
- A truly private system would place asset control in private hands.

⁹ Paul Yakoboski and Pamela Ostuw, Employee Benefit Research Institute, and Jennifer Hicks, Matthew Greenwald & Associates, *What's is Your Savings Personality? The 1998 Retirement confidence Survey*, August, 1998

Those who saved more, and or made smarter investments, would retire comfortably. Those who saved less, or invested less wisely, would have lower incomes in retirement. People who earn more probably would save more and enjoy higher retirement incomes. In a public social insurance system, such as Social Security, political choices determine who is eligible, and how much each will receive. Public systems redistribute income within and across generations to provide adequate income for lower income individuals and share economic gains with older age cohorts.

Increasing saving for retirement will not necessarily increase net national saving. But a shift from saving for college, for example, could affect how long consumption is deferred and over what period saving is available for investment.

- When the government runs surpluses, it adds to public retirement saving. But national saving does not increase if new spending, whether for emergencies, to subsidize retirement savings, or other purposes, or new tax cuts, to encourage private retirement saving or for other purposes, offset surpluses.

Similarly, shifting from taxable to tax-advantaged saving does not increase national saving. Nor would net saving increase if new borrowing offsets retirement saving.

Social Security Reform Proposals

This analysis is based upon a comparison of the five Social Security proposals listed below. (See Appendix I for a side-by-side comparison of these plans.) There are many other proposals before Congress, but these illustrate the range of reform options currently under discussion.

- H.R. 874, Individual Social Security Retirement Accounts (ISSRAs), sponsored by Representative John Porter;
- Social Security Guarantee Accounts (SSGAs), proposed by Representatives Bill Archer and Clay Shaw Chairmen of the House Ways and Means Committee and its Social Security Subcommittee;

- H.R. 1793, 21st Century Retirement Act, sponsored by Representatives Jim Kolbe and Charlie Stenholm;
- President Clinton's FY 2000 budget request; and
- Two economists, Henry Aaron and Bob Reischauer, have authored a plan to maintain the structure of the current Social Security System.¹⁰

Plans are more Alike than Different

Despite appearances, these proposals are very similar.

- All seek to strengthen retirement income security by increasing retirement savings.
- None proposes to raise payroll taxes.

All propose to capture rates of return associated with investments in private equities and bonds. Historically, private investments earn 6 to 7 percent more than the rate of inflation compared to the trust fund's projected 2.8 percent earnings (after inflation) from its U. S. Treasury obligations.

Capturing increased investment returns is vastly more politically attractive than raising taxes or cutting benefits. This approach is appealing because it is apparently painless, it uses Social Security surpluses to help "pay" for Social Security benefits, and it takes advantage of a robust stock market.

As with most apparently painless remedies to otherwise painful problems, there is a fly in this ointment. All of these plans propose

¹⁰ See Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform: The Great Social Security Debate*, 1998. Both are widely respected experts on Social Security and U.S. economic policy. Bob Reischauer is a former director of the Congressional Budget Office and current member of the Committee for a Responsible Federal Budget Board of Directors.

to increase government borrowing compared to current law. The Social Security system might reap higher returns, but government (i.e., taxpayers) would foot the bill in the form of increased interest payments.

Proponents argue that increased investment returns would more than offset higher interest costs. Given the higher levels of risk involved, however, many experts dispute that assertion. Moreover, many analysts ask, if government can recognize real gains through arbitrage, why not employ this technique to finance the defense department, education, or other government services?

Fundamental Differences Remain

Details vary among Social Security proposals, but the most significant differences among plans can be described as follows:

- Some plans cut current law benefits. Others actually promise benefit increases, compared to current law. Needless to say, there is a direct correlation between benefit promises and the amount of government borrowing that would be necessary to fund each proposal.
- Some plans would channel funding for private investments through individual accounts. Workers would exercise limited investment choices and restricted withdrawal options even upon retirement. Others would purchase stocks and bonds centrally. The Social Security Trustees could manage purchases directly or a new, independent investment board could be created for that purpose.

The most important differences are benefit differences. Benefits determine the cost of any proposed reform. The more generous the benefits, the more taxes must go up or the more government must borrow.

Proponents of individual accounts argue that this approach would “privatize” some or all of Social

Security. As discussed later, public v. private is less of an issue than the debate would make it appear. Instead, the consequences of individual versus central account purchases of private investments are more significant. Individual accounts are more costly to administer. In addition, investment risks are individualized rather than shared. On the other hand, the public and many politicians remain highly skeptical that the government can meet the fiduciary test of managing assets solely in the interests of beneficiaries.

Budgetary Impacts

All of these plans would affect the budget and the economy significantly and in ways no one can predict accurately. The full impact

of most plans would not develop fully for several decades. Budget estimates generally cover five to ten years. Analysts can simulate multi-decade estimates. But those simulations cannot provide the certainty decision-makers want and expect as the basis for major public policy change. (There are no official budget estimates for any of these plans¹¹.)

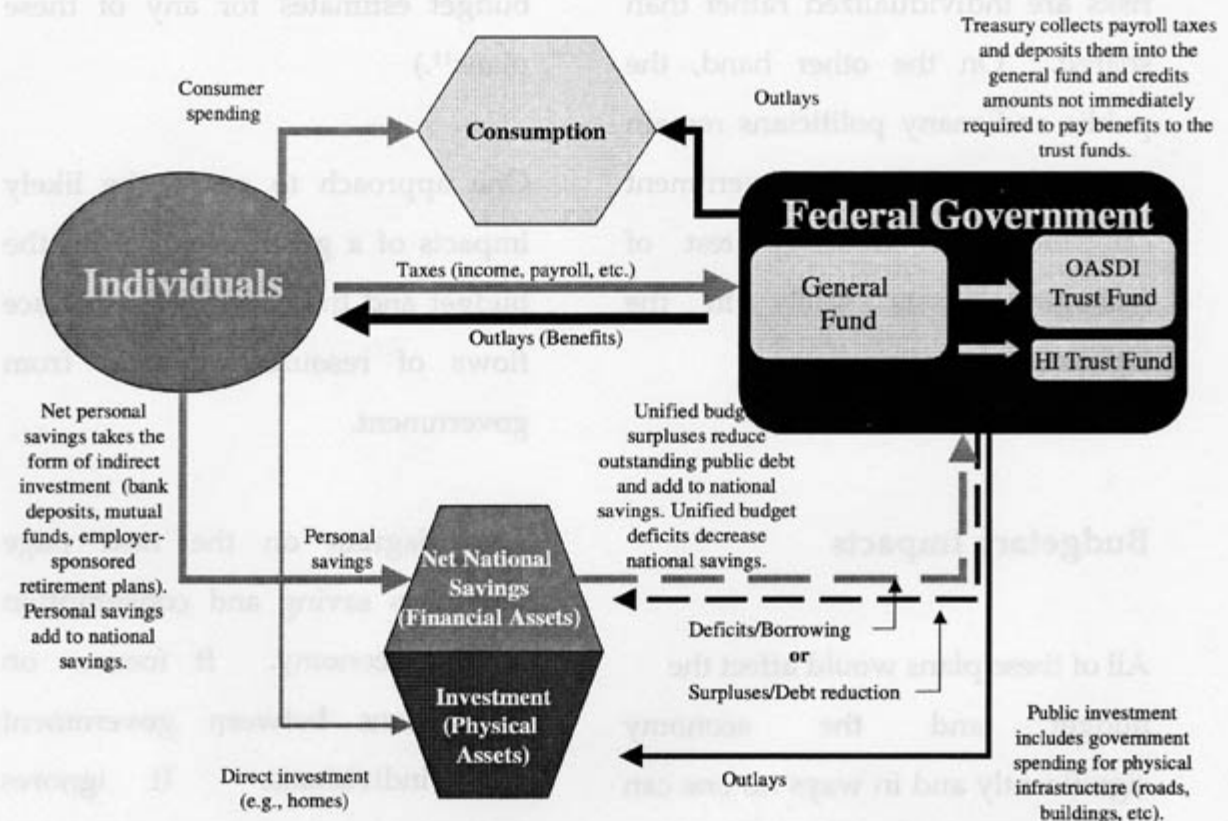
One approach to assess the likely impacts of a given proposal on the budget and the economy is to trace flows of resources to and from government.

The diagram on the next page illustrates saving and consumption in the economy. It focuses on transactions between government and individuals. It ignores businesses and foreign transactions.

¹¹ Social Security reform presents a major analytical challenge for budget estimators. Proposed reforms would produce major fiscal policy implications that would not become fully developed for several decades. Budget estimates normally cover five to ten years. Analysts could simulate long-term budget effects, but, at present, they cannot provide multi-decade budget estimates with anywhere near the level of certainty lawmakers might expect of such estimates.

This will be the starting point for our comparison of the five reform proposals we discuss in detail in this report. The diagram makes clear that government has only two

sources of revenue: taxes and borrowing. The resources government uses are not available for private use. The budget documents government's use of resources.



Unless the budget is as comprehensive as possible, voters will not be able to hold elected officials accountable for their decisions to use resources.

If it Walks, Talks, and Acts like a Duck, it must be a Duck

Budget analysts must answer two questions to determine a proposal's potential impact on the budget.¹²

1. Should individual accounts be classified as public and included in the budget; and
2. If so, what is the best way to account for those impacts?

It is not always easy to decide such issues. First, politicians like to "have their cake and eat it too". They embrace fiscal responsibility and

simultaneously exploit opportunities to "bring home the bacon" to constituents. "Bacon" may take the form of program benefits or tax cuts. Getting around budget and accounting rules and concepts is the key to having it both ways.

Second, creative approaches to public policy challenge existing budget and accounting concepts.

New ideas force rethinking of what is "public" and what is "budgetary". ("Budgetary" refers to actions and policies that affect government revenues and outlays). Health care reform challenged such concepts a few years ago, and Social Security reform is repeating the experience.

Technical" considerations can play an important role. "Big government" is out of style. "Private control" and "choice" are appealing.

¹² For lengthier discussion of these issues, see the Committee for a Responsible Federal Budget report, *Social Security Reform: Economic, Budget Concepts, Enforcement, and Scorekeeping Perspectives*, December 1998. This report reflects Committee conclusions based upon consultations with leading budget and economic policy experts.

Sound budget analysis goes beyond labels to determine whether and how a proposal would change the role of government.

The objective is clarity. Politicians and voters need to understand real costs and benefits. Illusory outcomes can lead to unsustainable reforms. The goal must be informed choice leading to lasting change.

Privatize

Definition: to make private, i.e., transfer ownership to private individuals or entities, as distinct from government control or ownership.

The major alternative to Social Security's current pay-as-you-go structure is to create a system of individual accounts, commonly referred to as "privatization." This implies a shift in responsibility from government to individuals—from a publicly owned, controlled and

funded system to private ownership, controls and funding.

However, these plans propose such significant levels of government involvement and control that it is difficult to describe the individual accounts as private.

Most, if not all, of the following features are common to all individual account proposals:

- Mandatory participation and compulsory contribution rates implemented through payroll withholding;
- Absolute prohibitions against withdrawals of account balances prior to retirement for non-retirement purposes, except the account could pass to the worker's estate in the event of death prior to retirement;
- Strict limitations on withdrawals and distributions once an individual reaches retirement age generally require phased withdrawals or purchase of an annuity;
- Strictly limited investment options and choices;

- Little or no control over account management;
- Government guaranteed minimum benefit levels.

Proponents liken individual accounts to tax advantage retirement accounts, e.g., individual retirement accounts (IRAs) and 401(k) plans. But participants would exercise far less control over the proposed accounts.

Individuals would have greater choice over how account balances are invested than they do under Social Security. They also would receive periodic account statements explicitly identifying their contributions and investment earnings¹³. But the government would control everything else associated with the accounts. That is because, without

the restrictions listed above, individuals left to their own discretion would be unlikely to preserve designated resources for retirement.

Government guaranteed benefits offer further compelling evidence that the proposed systems are essentially public. Indeed, the government guaranteed benefit would constitute the largest share of the retirement income most lower- and middle-income workers would receive under proposed individual accounts systems for many decades to come.

There is very little “private” or individual about most of these proposed accounts, except for the paperwork.

¹³ The Social Security Administration provides a Personal Earnings and Benefits Estimate Statement (PEBES). The PEBES reflects earnings and payroll tax history and projects retirement, disability and survivors’ benefits.

Few workers would recognize the difference between compulsory payroll withholding for these accounts and Social Security taxes. Individuals would exercise very little control over even the most "private" of these accounts.

The budget should reflect receipts at the time individuals (and employers on behalf of individuals) contribute to the accounts.¹⁴

The accounts themselves could be considered public or private.

Eventual individual account distributions would be functionally equivalent to Social Security benefit payments. It would be possible to rewrite the Social Security benefit formula to change it from its current defined benefit basis to a defined contribution approach as envisioned under these plans. That approach most likely would be easier to understand and less costly to administer.

Accounts should be classified as "private" if government must exercise taxing authority to control the balances. The budget would show account contributions as federal receipts and payment into individual accounts as outlays. That simultaneous "in and out" activity would have no impact on annual deficits or surpluses.

¹⁴ There is on going discussion among budget analysts about how government purchase of private investments should be reflected in the budget.

- Some believe that such purchases represent an exchange of assets (cash for stocks or bonds). Under this approach, no outlays would take place when the investment takes place, but receipts or outlays would occur subsequently as the portfolio's value increased or fell.
- Others believe the purchase of financial assets should be handled in the same way as purchase (or acquisition) of physical assets. Outlays would take place as equities and bonds are purchased. Receipts would be scored as investments are redeemed to pay benefits.
- Finally, some argue that stock and bond purchases should be treated differently. Because bonds are similar to loans, they should be scored under credit reform procedures. Government would show outlays equal to the subsidy provided when bonds are purchased. Assuming the government buys bonds at market price, there would be no subsidy, and therefore, no outlays.

Under any of these approaches, debt held by the public would be higher than if non-private investment took place. That is because resources that would have gone to pay down publicly held debt would be used instead to purchase stocks and bonds.

If balances revert to government, if benefit payments actually come from government, or if the amount of tax-financed government benefit payments varies based on payments from the accounts, the accounts properly should be classified as public. These conditions apply in most individual account proposals. Outlays would occur when benefits are paid. The mismatch between the timing of income and outlays would be similar to current surpluses and future Social Security benefits.

To classify transactions associated with individual account proposals, as "private" would vastly understate the government role and substantial governmental financial responsibility for future benefits. Substantially similar individual account proposals should all be treated similarly to avoid exaggerating relatively small differences.

Picturing Reform

The simplified flow charts on pages 55-63 illustrate ways in which a "private" designation would obscure similarities between reform proposals. They diagram the President's plan, the Archer-Shaw Social Security Guarantee, the Aaron-Reischauer plan, the Kolbe-Stenholm plan, and the Porter plan.

Differential impacts on national savings constitute the most significant differences between and among proposals. Proposals that cut benefits likely have a more benign impact on national saving than proposals that promise benefits equal to or greater than the existing Social Security program.

The President would establish tax-subsidized proprietary accounts for low-income individuals and recycle part of the proceeds from the sale of Treasuries to Trust Funds to increase balances in the Social Security and

Medicare funds. That would extend the solvency of those two funds beyond current law projections. The Administration proposal also would invest part of the Social Security Trust Fund balances privately.

The Archer-Shaw proposal would create individual accounts and use tax credits to fund them. SSGA balances would be invested 60 percent in stocks and 40 percent in bonds. At retirement, balances would be annuitized and transferred to the Social Security Administration. Social Security would "top up" each annuity payment to equal current Social Security benefits and send a check to the beneficiary. If the annuitized payments from the individual account exceed current Social Security benefits level, the beneficiary would receive the balance left over in the individual account.¹⁵

The two diagrams of Archer-Shaw illustrate how different the picture looks, when such accounts are classified as "private" and excluded from the budget, compared to treating them as governmental.

Current law requires payroll tax and interest earnings not needed to pay benefits to be invested in U.S. Treasury obligations. In the decade, the average rate of return on these investments was 7.3 percent. The tables on the next page illustrate rates of return for different kinds of assets since the 1920's..

Aaron and Reischauer propose to invest a portion of the social Security Trust Fund in private equities.

Investment earnings would accrue to government in the form of Social Security Trust Fund receipts. Aaron and Reischauer do not intend or claim to privatize any part of the

¹⁵See appendix for a more detailed description of this proposal.

Social Security System. Indeed, it might be argued that they want to publicize a greater part of economic activity, by capturing stock market gains to help finance Social Security benefits. But Aaron and Reischauer do propose significant benefit cuts thus the amounts needed to finance future Social Security benefits would be less under their proposal than under current law.

Critics of this approach, and of the President's proposal, express concern that politicians would turn public investment in private markets into a kind of industrial policy. They argue that political leaders would insist on politically popular and "socially useful" investments and refuse countenance investments in "bad" companies or industries.

Further complicating any analysis of divisions between public and private activity, the critics say that government investments would be so large as to dominate financial markets.

Supporters of public investments in private debt and equities say that they can protect against politicization of investment decisions by establishing an independent board to hire and oversee private companies that would make specific investment decisions. In this fashion, they argue that the public and private aspects of such plans can be kept separate and distinct from each other.

The following pages contain comparisons of the five Social Security reform proposals discussed in this report. Do not feel slighted, if the proposal you prefer is not included in this comparison, it is not intended to be definitive. Indeed, this is intended more to illustrate similarities and differences between and among approaches to reform than the specific named proposals.

Having observed that the Social Security reform debate is more mature than the debates on Medicare or tax reform, we nonetheless remain

convinced that the final version of reforms that ultimately will be enacted has not yet taken shape. That is because, as we have said often throughout this volume, the debate so far does not disclose clearly the tradeoffs between maintaining or expanding benefits and raising taxes or diverting resources from other public policy priorities to fund benefit costs.

This report will be most useful, therefore, if it helps to focus on the essential elements of various approaches to reform:

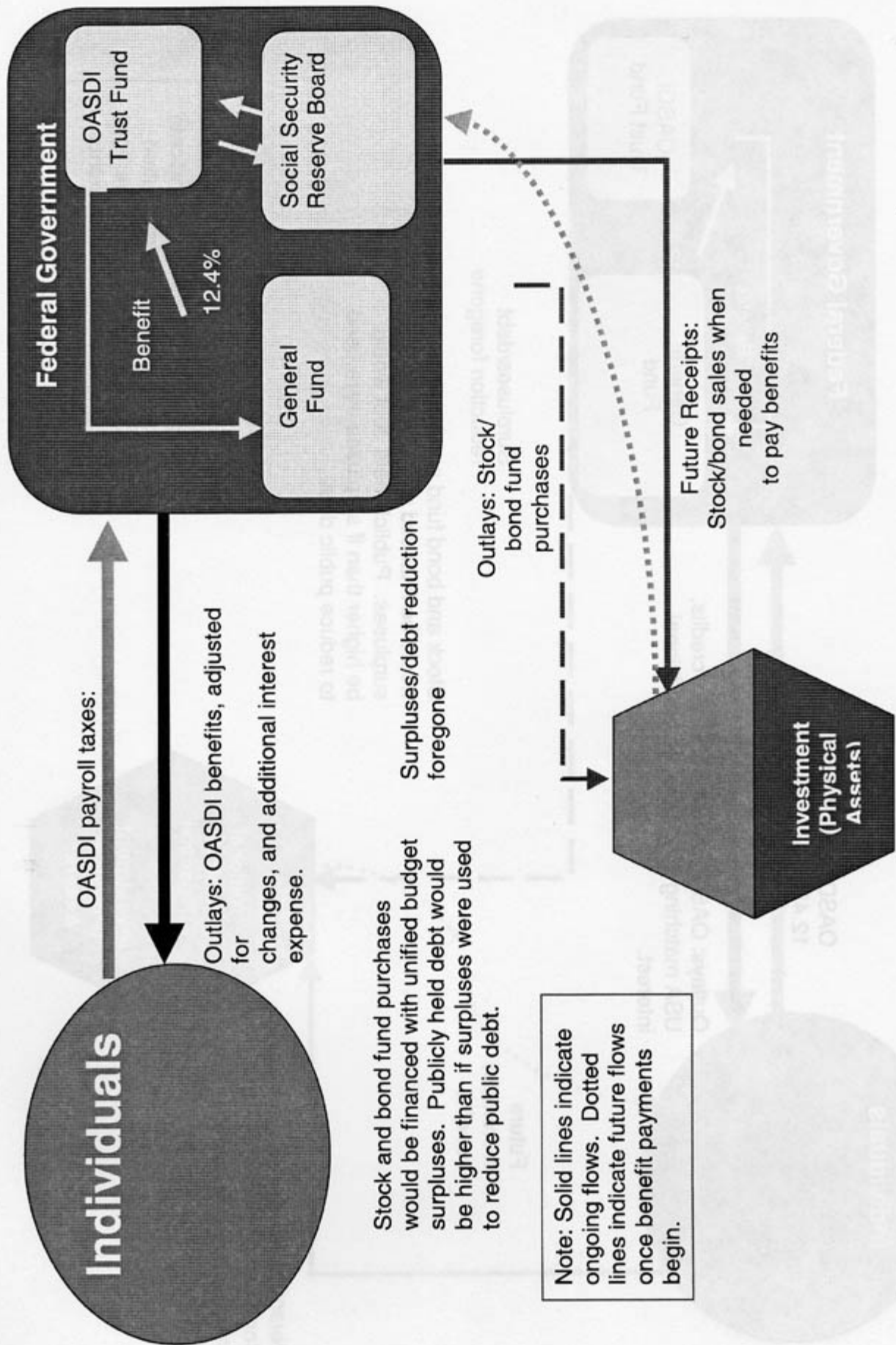
- Does a plan propose to reduce benefits and if so for whom?
- If it does not propose to reduce benefits sufficiently to keep costs consistent with projected revenues from dedicated payroll taxes, who would pay the excess costs and how would they be funded?
- Perhaps most importantly, would the plan likely increase or diminish saving?

Individual or private accounts might be a useful level to encourage middle and upper income earners to give up some future benefits. But money diverted to private accounts will not be available to pay tax financed benefits. Thus tax financed, guaranteed benefits must go down by more than the amounts that would be used to fund private accounts or total program will costs go up. If program costs go up, taxes almost certainly must go up.

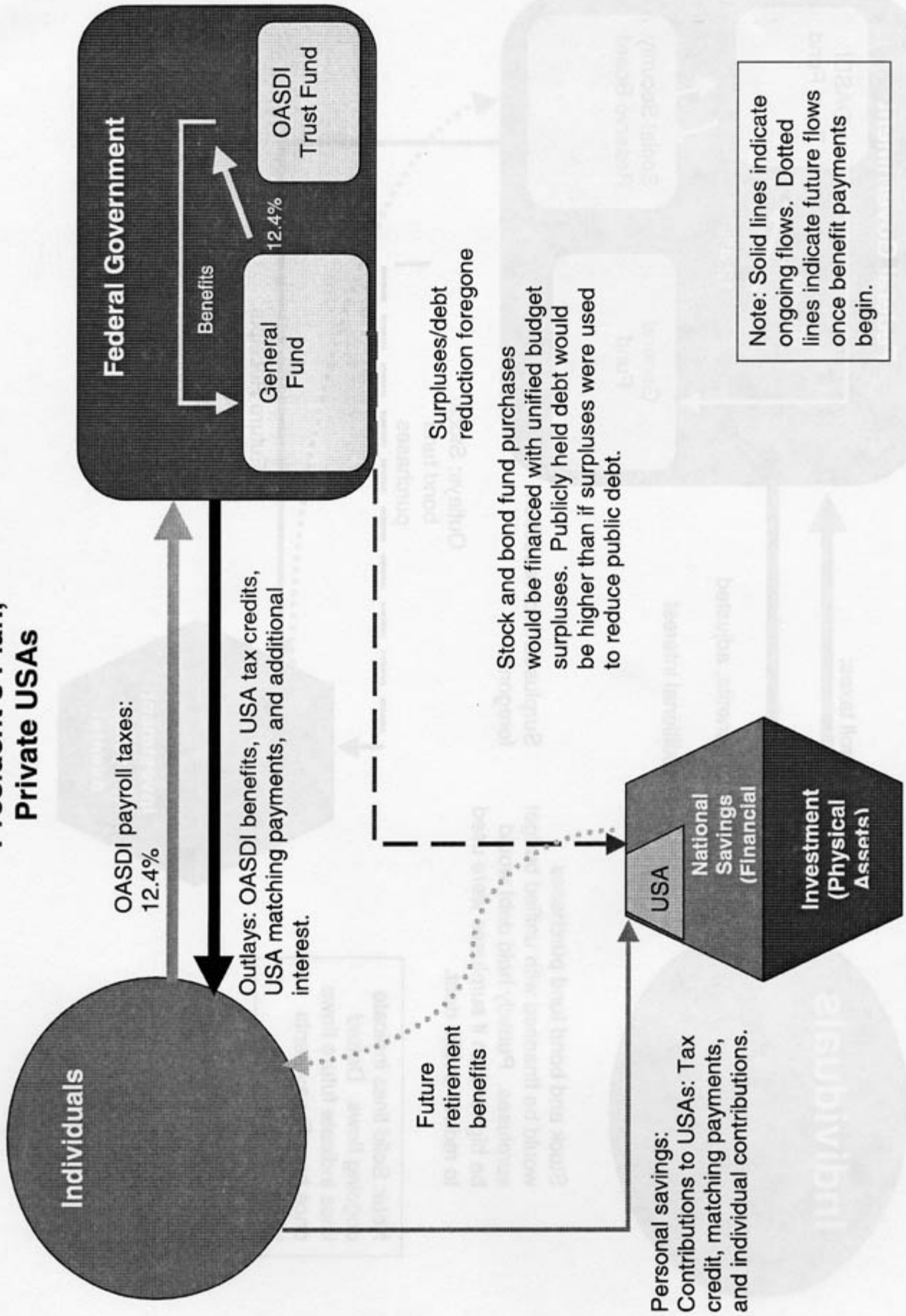
Deficit financing, or the use of surpluses to cover some costs, is an interim measure. Eventually taxpayers must cover the cost of government programs.

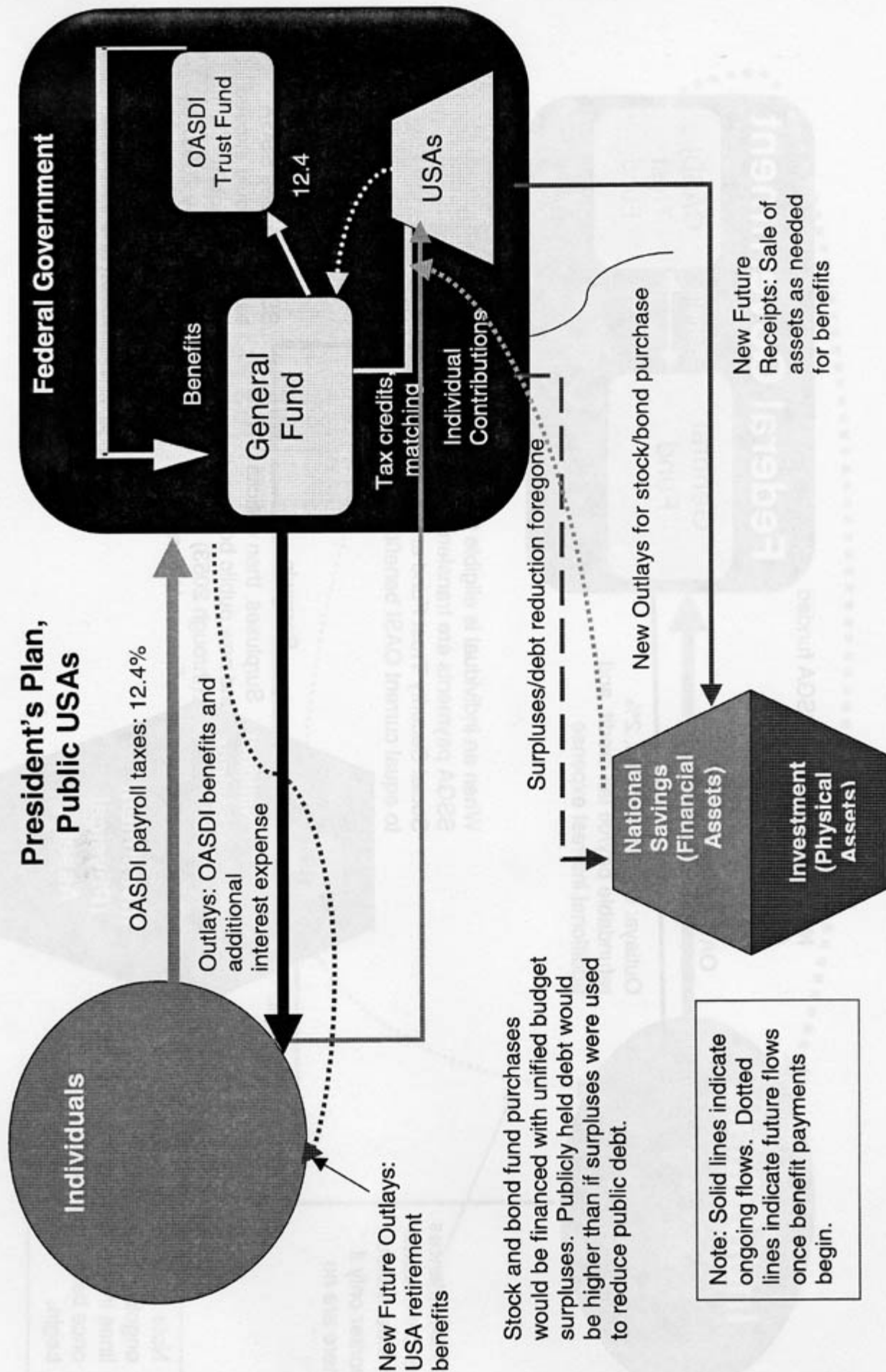
The following comparisons begin with the Aaron-Reischauer Plan, because that is the only one included here that makes no claim to "privatize". Thereafter, we illustrate first "private", then "public" treatment of each of the remaining plans.

Aaron-Reischauer Social Security Reserve Investment Plan



President's Plan, Private USAs

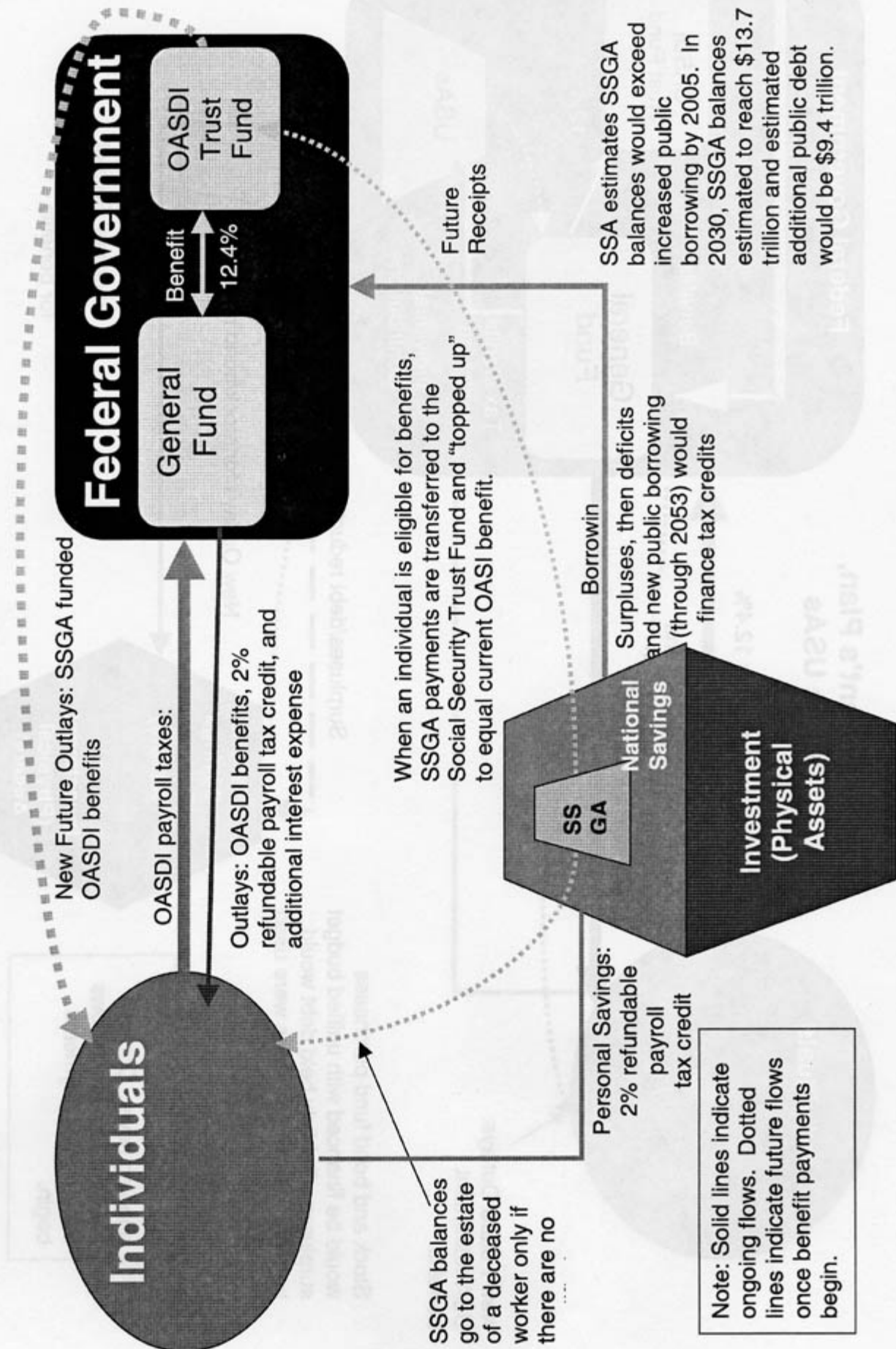




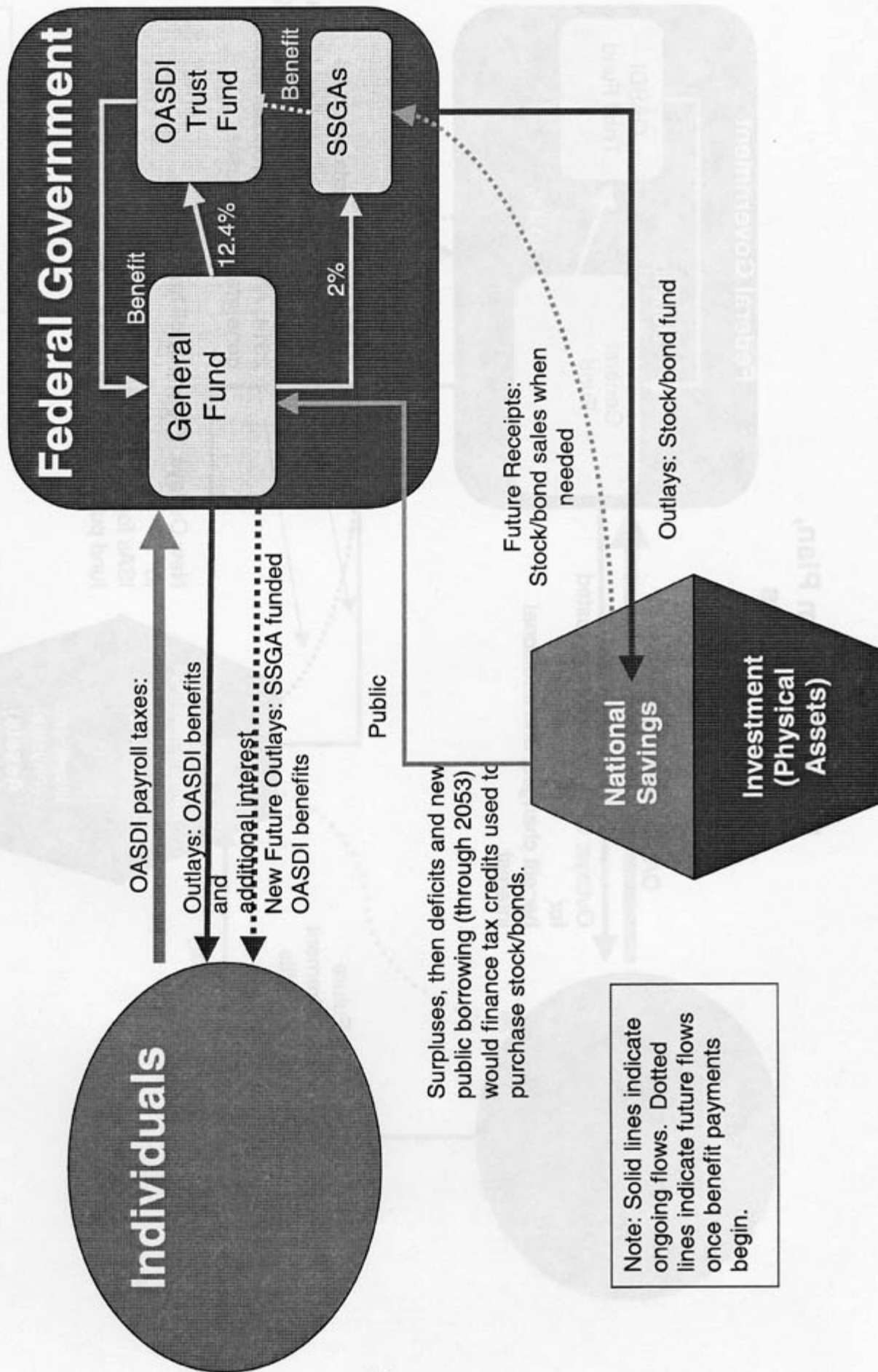
Archer-Shaw

Social Security Guarantee (SSG)

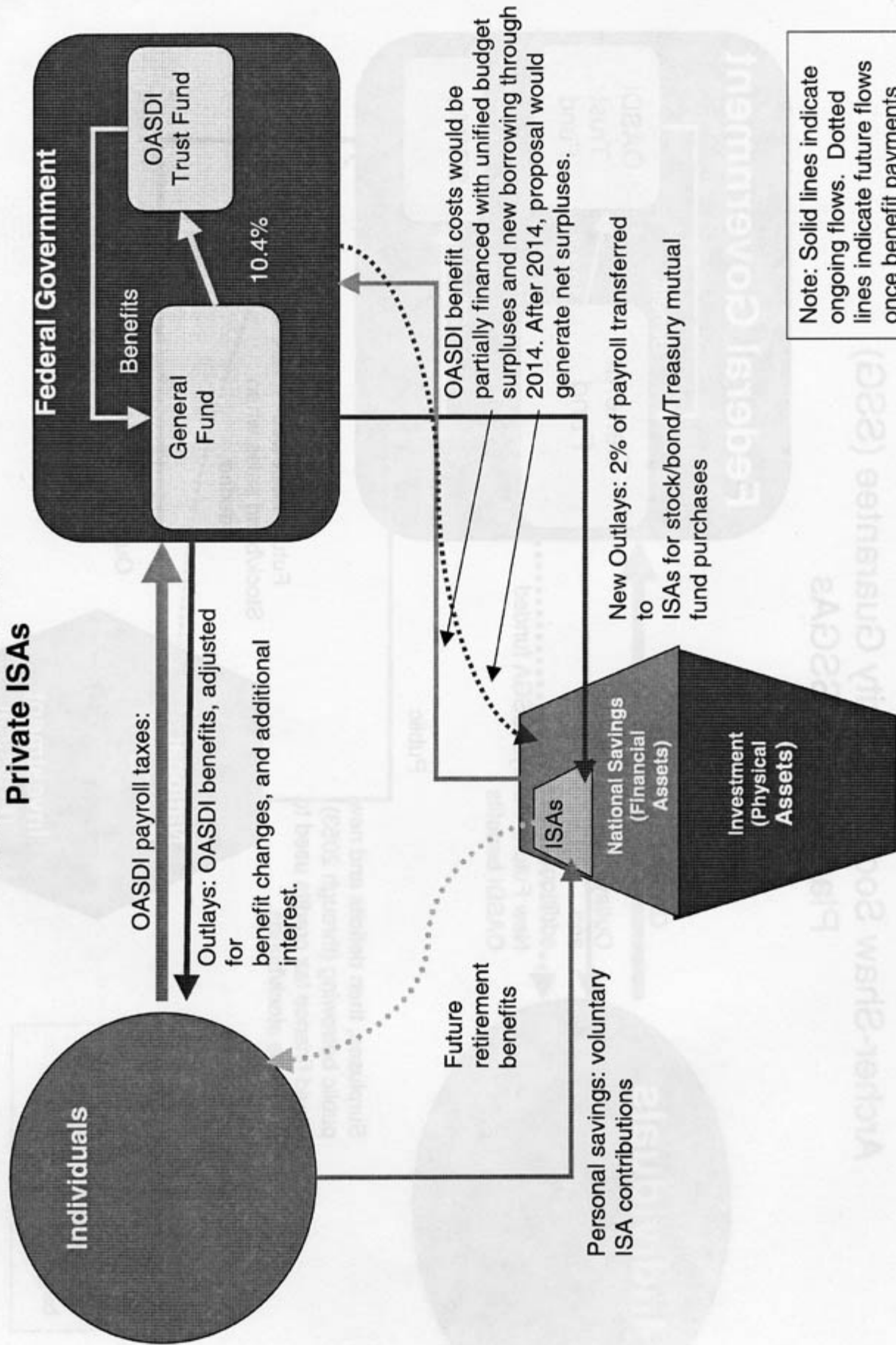
Plan: Private SSGA's



Archer-Shaw Social Security Guarantee (SSG) Plan: Public SSGAs

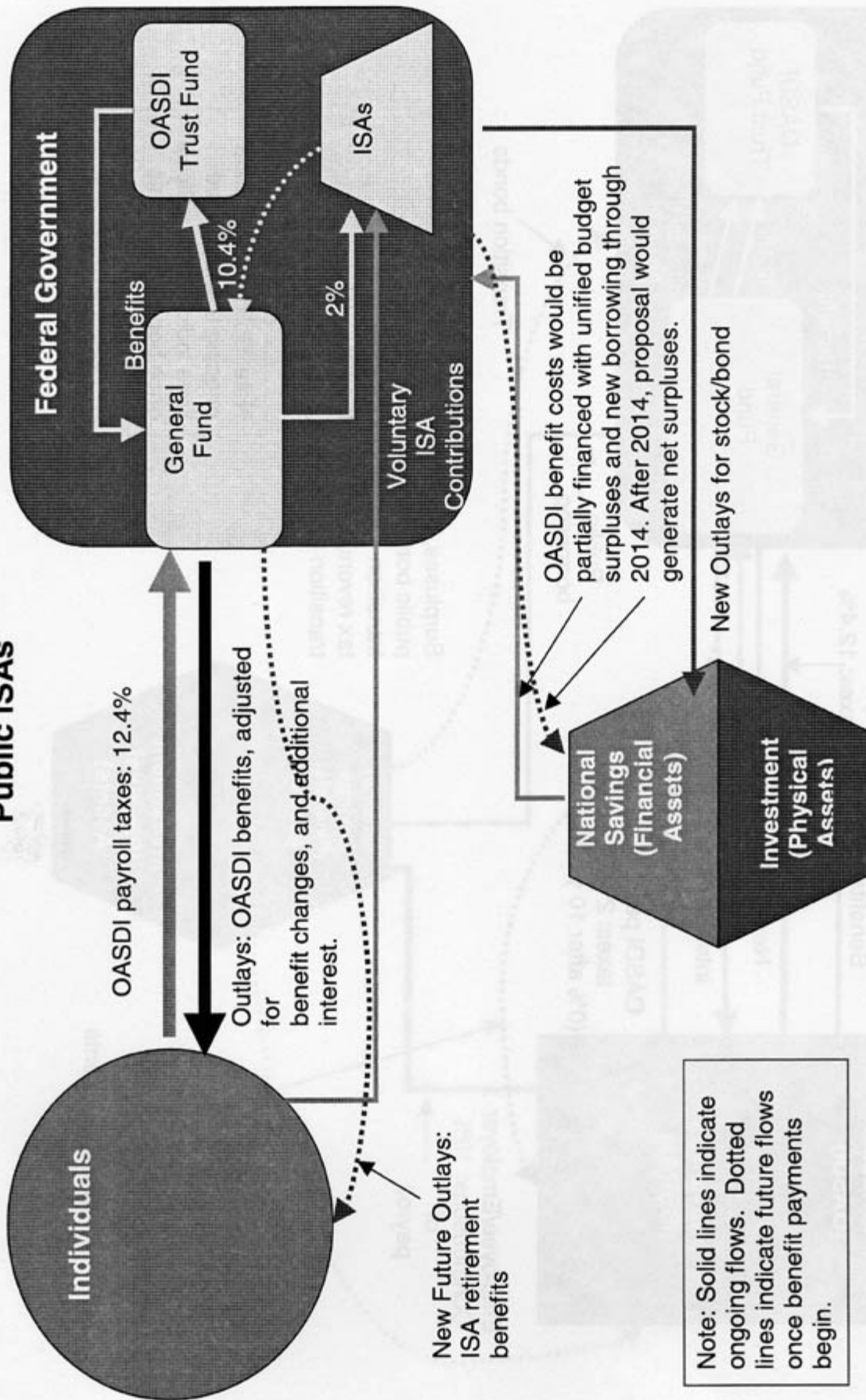


Kolbe-Stenholm Plan, Private ISAs

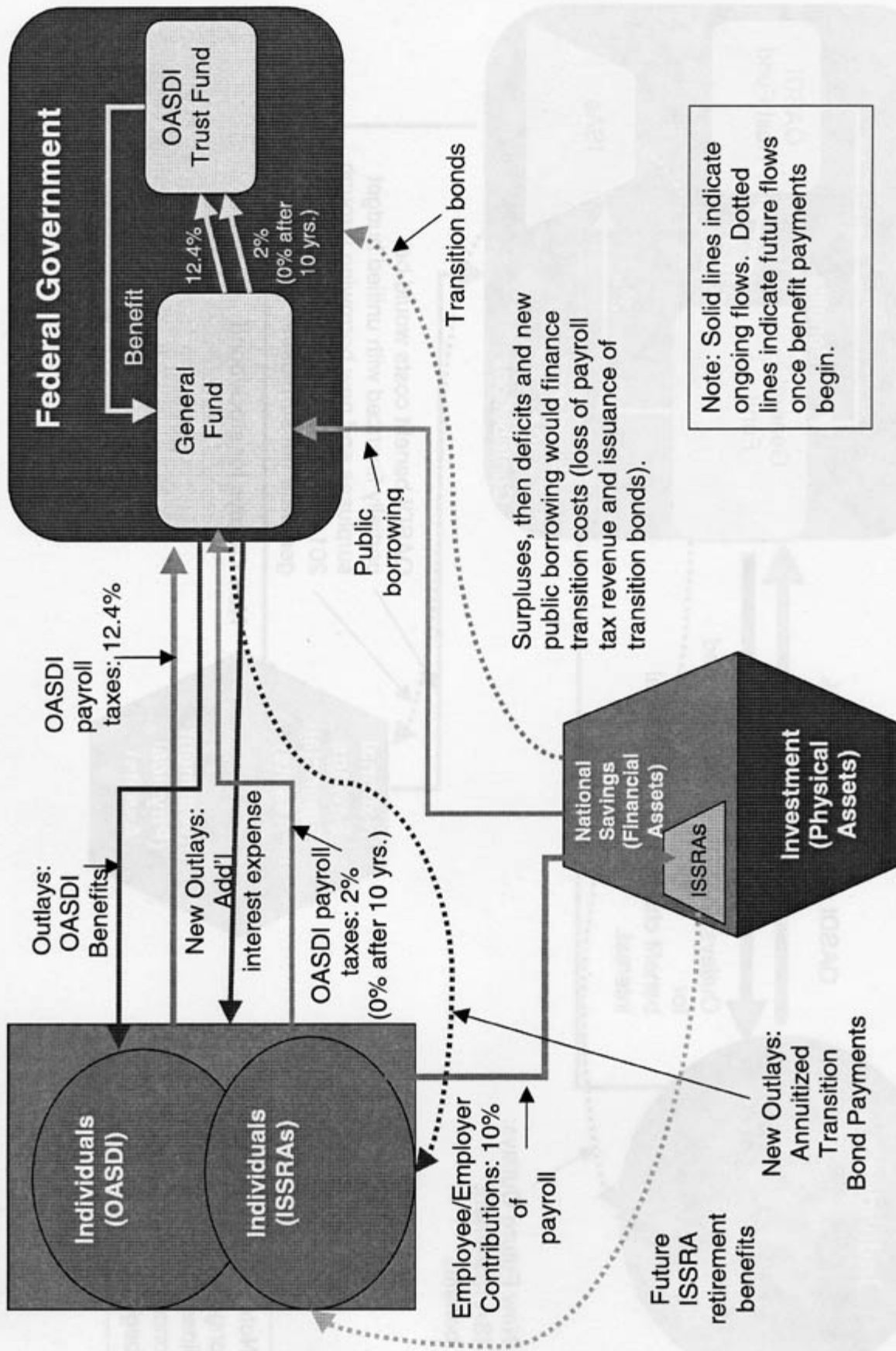


Note: Solid lines indicate ongoing flows. Dotted lines indicate future flows once benefit payments begin.

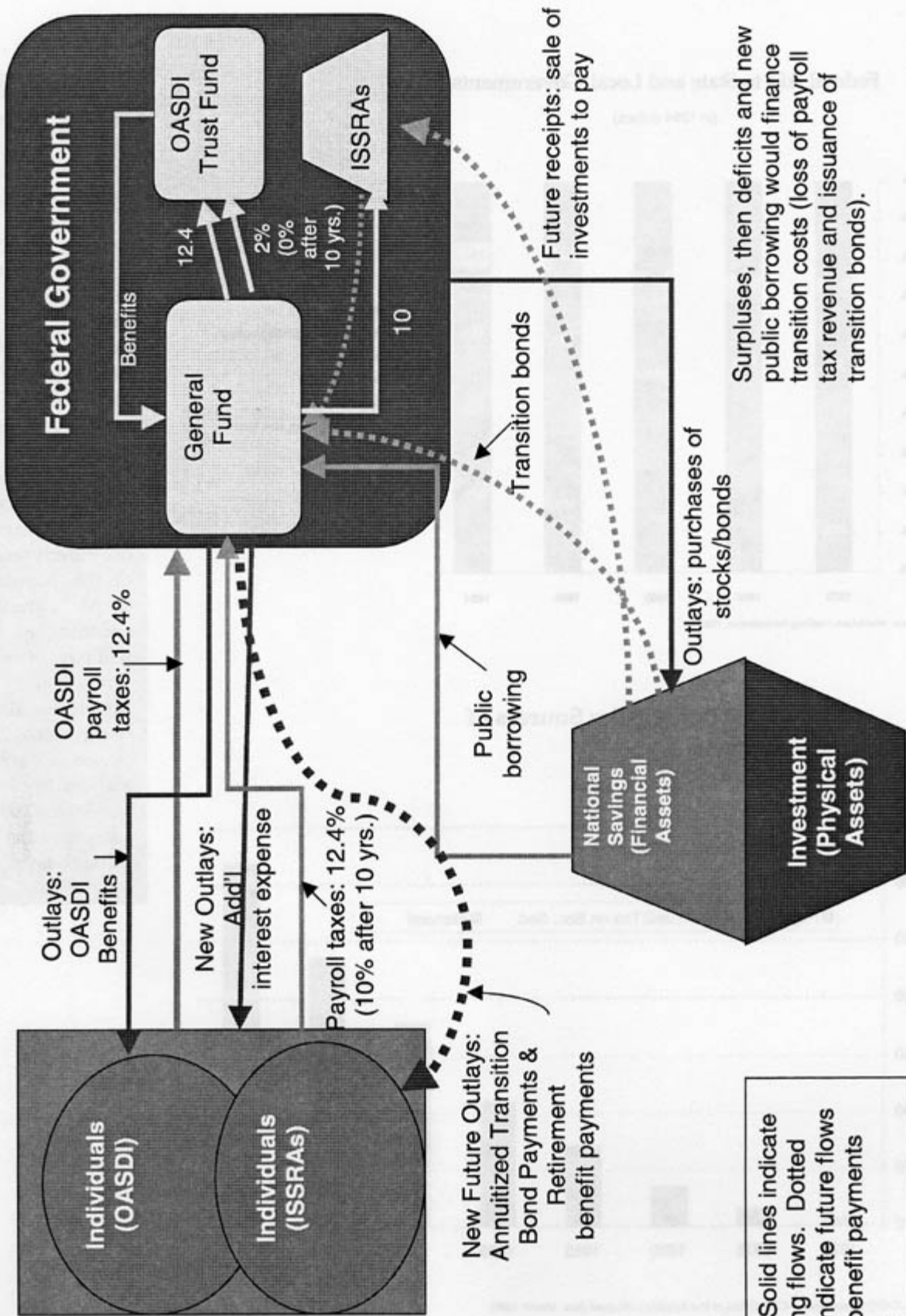
Kolbe-Stenholm Plan, Public ISAs



Porter Individual Social Security Retirement Account Plan: Private ISSRAs

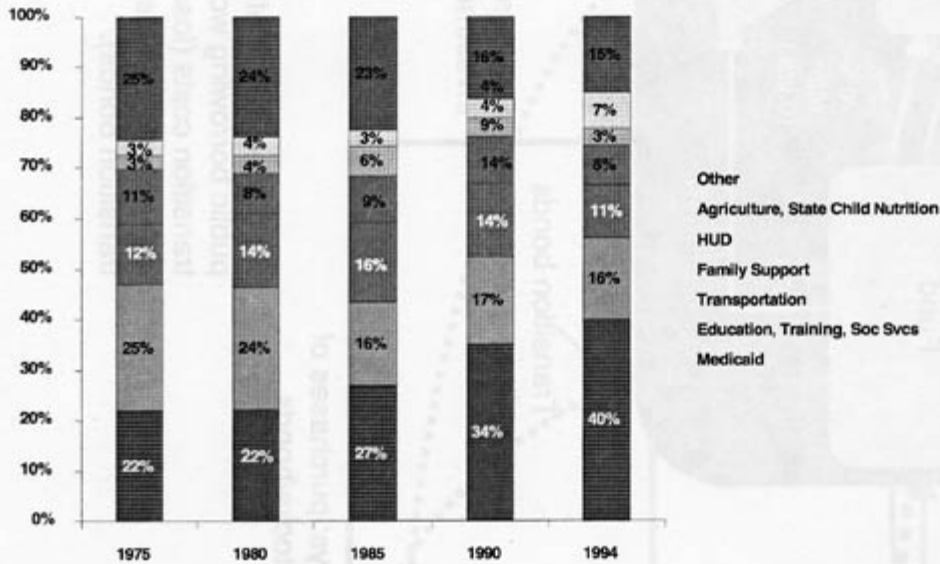


Porter Individual Social Security Retirement Account Plan: Public ISSRAs



Federal Aid to State and Local Governments

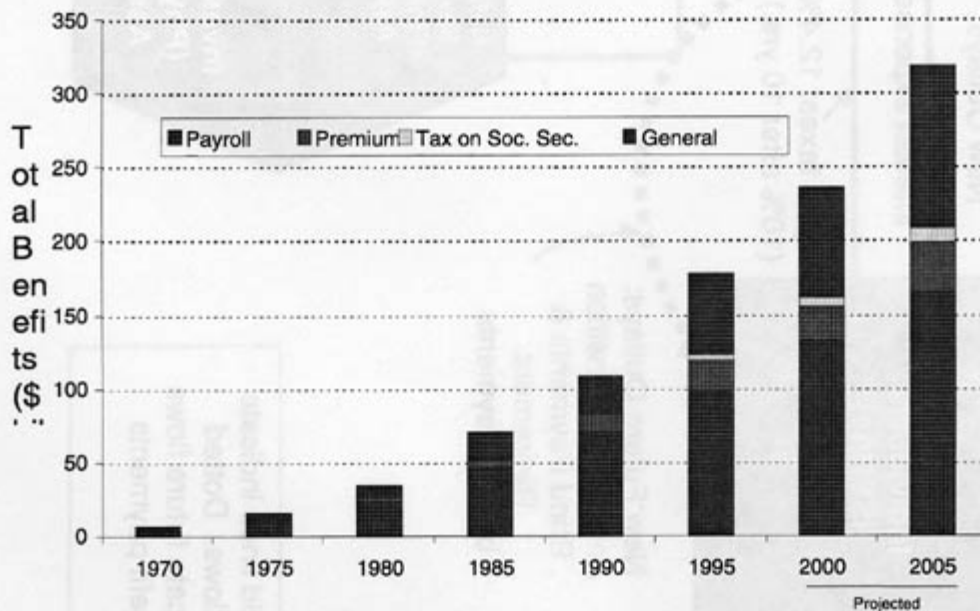
(in 1994 dollars)



Source: Health Care Financing Administration, 1996.

Medicaid is the fastest growing category of Federal financial assistance to states and localities. It is by far the fastest growing program in State budgets. In the 1980's and early 1990's Medicaid spending accounted for more than 100% of the increase in total state spending. Medicare is the fastest growing Federal program. The question is: how to meet the health care needs of the elderly and the rest of the population and keep health care spending at levels we will pay (directly in the form of insurance premiums, deductibles, co-payments, uninsured personal expenditures and indirectly through employers as part of compensation or through taxes).

Medicare Benefits by Sources of Financing



Source: CRFB based upon HCFA Office of the Actuary published data, March 1999.

Medicare

Medicare is the primary health insurer for virtually all of the population age 65 and older. The program also covers another 5 million people below age 65 who are disabled or who have end-stage renal disease. Today, Medicare pays for over 20 percent of the nation's health care bills. Under current policies and as the number of older Americans increases, Medicare will pay a larger and larger portion of the nation's health care. Efforts to address gaps in Medicare coverage would make the program even more expensive.

Policy makers eventually will have to choose between limiting federal financing for Medicare, thereby rationing the amount of care the program can provide, or increasing revenues to support its rising costs. There are no easy answers.

If they choose rationing, they must decide whether how explicitly to ration care. Should they means test benefits, or should they allow costs to shift to beneficiaries, which will make some services unaffordable for individuals with lower incomes. Reducing payments to providers eventually will affect the availability of services.

If they chose to add more resources, they must decide who should pay. Raising payroll taxes places the burden on workers and has a greater impact on lower income workers than their higher income counterparts. Raising premiums places the burden on beneficiaries, most of who have modest incomes. Cutting other federal programs to allow more general revenue support affects other priorities and constituencies. Borrowing shifts costs to future taxpayers.

Medicare Reform Goals

The goal of Medicare reform is twofold: contain cost and expand coverage. There are promising signs that fewer individuals will suffer chronic (and expensive) disabilities as they age. A healthier population would reduce per capita costs. But the rapid increase in health care costs appears to be driven by expensive new technology. Aging baby boomers are not likely to deny themselves the benefits of such potential quality of life enhancing developments.

Policy makers can find ways to promote more efficient delivery of health services. However, those approaches invariably restrict beneficiaries' choice of providers and limit access to care. Even if health outcomes are not impaired and may even improve, policy makers are reluctant to limit choice and access.

In addition to providing health insurance to older individuals and people with disabilities, Medicare also subsidizes physician training and "safety net" hospitals located in low income or rural areas. Reform raises the question of whether these social policy objectives should remain in Medicare, be eliminated, or transferred to another part of the budget.

Medicare Costs More

Until recently, overall health care spending grew faster than the overall economy. spending has moderated. Today, health spending is 14 percent of GDP. However, the slowdown in cost growth is expected to be temporary. Indeed, there are already signs that cost growth again is picking up.

Until this year, aggregate Medicare spending has grown faster than private health spending. The number of Medicare beneficiaries is increasing faster than the rest of the population. But more important, health expenditures increase with age. Medicare spends over \$5,000 per beneficiary compared with \$3,800 per person under the age of 65. In 1998, Medicare spending growth slowed to only 1.5 percent. In 1999, Medicare spending may actually decline. The slowdown in Medicare cost growth also is expected to be temporary.¹⁶

CBO projects that annual Medicare spending will grow an average of 7 to 8 percent through 2009, causing Medicare spending to double over the next 10 years. In 2009, Medicare

spending (net of premiums) will reach \$389 billion, 16 percent of projected total federal spending, compared with 12 percent in 1999.

Increases in Medicare spending put pressure on other parts of the budget. According to the latest Medicare Trustees report, the Hospital Insurance Fund (Part A) will remain "solvent" until 2015. Solvency is not an issue for the Supplementary Medical Insurance Fund (Part B). It has unlimited access to general revenues. Trust fund solvency implies that the program is self-supporting. Medicare benefit expenditures, however, already exceed the payroll taxes, taxes and Social Security benefits, and premiums designated to support them. (See chart page 66.)

¹⁶ CBO attributes the slowdown to a number of factors. The 1997 Balanced Budget Act (BBA) made a number of changes and produced savings estimated as \$112 billion over the 1999-2003 period. In addition, better compliance with program regulations, anti-fraud and abuse efforts, and slower claims processing times contributed to the spending slowdown. Some health policy analysts argue that the BBA cuts were too deep and cut more than policy makers intended. Others argue that other factors were responsible for the slower than anticipated growth in spending.

As baby boomers become eligible for Medicare, costs will grow even faster than designated revenues. The Medicare Chief Actuary projects that spending will grow from 2.5 percent of GDP to nearly 5 percent in 2030. In 2030, current law payroll taxes and beneficiary premiums will add up to less than 2 percent of GDP. The difference — 3 percent of GDP — will have to come out of general revenues, or benefits will have to be drastically reduced.

The growth in Medicare costs also affects beneficiaries. Under current law, on average, beneficiaries now pay about 21 percent of Medicare-related costs. By 2025, each beneficiary's share will increase to 26 percent, doubling from approximately \$1,500 to over \$3,000 (1998 dollars).¹⁷ Health care costs are rising so rapidly that increasing beneficiary contributions to cover an additional 4% of actuarial costs would double the per capita cost to participants in dollar terms. (See charts page 68.)

But Medicare Buys Less

Although Medicare spending growth has outpaced overall health spending, its benefit package has not kept up with private coverage. To a large extent, Medicare still reflects the type of indemnity coverage for inpatient hospital and acute care services prevalent at the time the program began in the mid-1960s. Traditional Medicare reimburses health providers for eligible services. This approach allows beneficiaries wide choice of providers, but they are limited to covered services. Because of the program's focus on acute and post-acute care, coverage for preventive and chronic care needs is limited. Notably, the program provides only limited skilled nursing care coverage and does not cover long-term care and outpatient prescription drugs. In addition, unlike most private plans, Medicare has no "stop loss" protection to cap exposure to out-of-pocket spending.¹⁸

¹⁷ Marilyn Moon, *Growth in Medicare Spending: What Will Beneficiaries Pay?* May 1999.

Health policy experts worry that traditional Medicare affects health outcomes and promotes inefficient use of health services. Individuals who can't afford out-of-pocket costs may delay seeking treatment, experience discontinuities in treatment, and end up with more serious and expensive conditions. The program limits payments, but not the volume of services delivered.

Medicare was enacted to provide insurance for older Americans because private options were inadequate in the 1960s. The system was designed to provide the same type of coverage as private employment based plans. Although years ago, it has not adjusted to changes in the delivery of services. More care is delivered in non-hospital settings.

Prescription drugs have become increasingly important in the treatment of chronic conditions. Other new technologies may change the way medicine is practiced even further. But these developments may not be fully accessible if traditional Medicare remains an acute care, largely hospital-based benefit package.

Affordable Reform

Despite coverage limits and exposure to high out-of-pocket costs, traditional fee-for-service Medicare offers beneficiaries greater choice of health care providers and fewer restrictions on the use of covered services. These are attractive features. Almost 85 percent of Medicare beneficiaries remain in traditional Medicare.

¹⁸ About 85 percent of elderly beneficiaries have some protection against coverage gaps. Over half have supplemental coverage (employer-sponsored retiree health insurance or individually purchased Medigap policies). Another 14 percent are enrolled in Medicare + Choice plans, which provide more comprehensive coverage in exchange for less choice of providers, and 12 percent are enrolled in Medicaid, which covers costs depending on income eligibility.

CBO projects, however, that the percentage of beneficiaries enrolling in Medicare + Choice (capitated) plans will almost double, reaching 31 percent in 2009.

By comparison, three-fourths of privately insured Americans are enrolled in some form of managed care. These plans limit access to health care providers and use incentives to encourage more efficient delivery of services.

Health care needs are hard to anticipate and plan for in advance. Through insurance, individuals can protect themselves against high medical costs by pooling their risks with large numbers of others. Over 70 percent of working age people obtain insurance through employer-sponsored plans.¹⁹ Employer plans create insurance pools and provide individuals coverage at lower cost

than if they had to purchase insurance on their own. Favorable tax provisions make employment-based coverage even more attractive to workers.

Traditional Medicare directly insures older Americans. It defines a set benefits, manages claims, and pays providers.²⁰

One side of the Medicare reform debate believes the federal government would do a better job of balancing the need to control costs and increase coverage if it continued in this traditional role.

The other side believes that the government should focus instead on providing financial subsidies, which beneficiaries would use to purchase insurance, and rely on market competition to produce the best coverage at lowest cost.

¹⁹ 72 percent of workers age 1864 were covered by employer-sponsored plans in 1997. This percentage has been relatively steady since 1992, but represents a decline from the 76 percent covered in 1987. (Paul Fronstin, *Sources of Health Insurance and Characteristics of the Uninsured*. EBRI, December, 1998.)

²⁰ Private insurance contractors handle the processing of claims on behalf of Medicare.

Thus, at present, there are only three reform approaches on the table.²¹ (The table at Appendix II compares these approaches.)

1. Incremental reform. This option would maintain Medicare as older Americans' primary insurer. Some changes would modernize benefits and the administration of the program.

Others would focus on improving the program's financial status (increasing revenues and controlling costs). The incremental reform option would preserve fee-for-service Medicare, while continuing to develop the Medicare + Choice option.

2. Premium support.²² Senator John Breaux and Congressman Bill Thomas have proposed to change Medicare into a program that pays a set portion of beneficiaries' health insurance costs. Individual premiums would be established through a competitive market process. All participating plans would provide a statutorily defined core package of benefits.

3. President Clinton's Proposal.

The Clinton Administration proposes to use short-term budget surplus—and thus explicitly earmark Social Security and income tax receipts—to extend the life of the Medicare Trust Fund.

²¹ Other approaches include vouchers and advance funded medical savings accounts. A voucher approach would provide a fixed contribution to subsidize beneficiaries' insurance purchases. Unlike the premium support approach, a voucher system would not include a standardized benefit package. Medical savings accounts would mandate individual contributions. Birth cohorts would form insurance pools. Contributions would be invested. Upon retirement, the approach would function like a catastrophic insurance policy.

²² Ten of 17 members of the National Bipartisan Commission on the Future of Medicare chose this approach, but they fell short of the eleven votes needed to recommend the option the President and Congress.

The Administration also proposes to expand Medicare prescription drug coverage. And they have proposed limits on provided payments (beyond those in current law). But the Administration has not articulated a proposal to reduce benefits or raise taxes enough to continue Medicare as we know it after the baby boom generation retires. One might deduce from the proposals described above that the President would either cut other programs to free up income tax receipts to help pay for Medicare—or raise income taxes to continue Medicare. But the Administration has not made such a proposal and we do not presume to read their minds.

The extent to which any of these approaches would reduce Medicare cost growth depends on the generosity of benefit packages and beneficiary cost-

sharing requirements. The Medicare Commission staff estimated the Breaux-Thomas proposal would reduce Medicare costs by 2 percent of GDP in 2030 relative to current law. That would be an improvement, but Medicare would still cost more than the revenues to support it. Proponents of this approach did not endorse specific revenue raising measures. The proposal failed to attract sufficient bipartisan support even with an enhanced benefit package that included outpatient drug coverage and “stop-loss” protection from out-of-pocket costs.

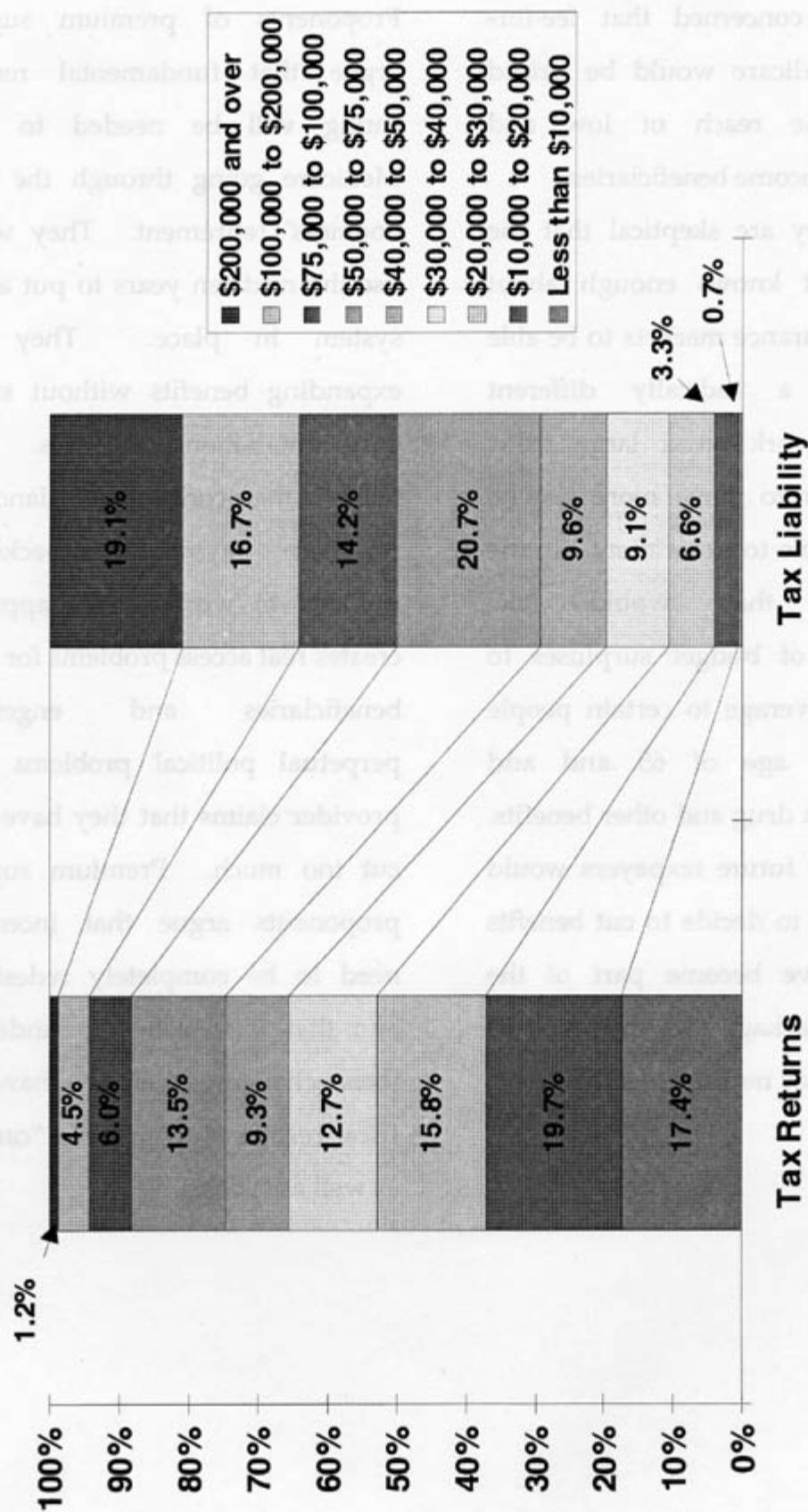
Proponents of incremental reform fear the premium support plan’s fixed federal contribution would add a whole new set of statutory restrictions on that would shift too much of the risk of increasing health care costs to beneficiaries.

They are concerned that fee-for-service Medicare would be priced out of the reach of low and moderate-income beneficiaries.

Finally, they are skeptical that the government knows enough about private insurance markets to be able to make a radically different approach work on a large scale. They prefer to move more slowly, allowing time to experiment. In the meantime, they would take advantage of budget surpluses to broaden coverage to certain people under the age of 65 and add prescription drug and other benefits. They know future taxpayers would be unlikely to decide to cut benefits once they've become part of the Medicare package and, thus, will be willing to pay more.

Proponents of premium support argue that fundamental restructuring will be needed to keep Medicare going through the baby boomers' retirement. They would use the next ten years to put a new system in place. They fear expanding benefits without strong cost containment measures. They believe that continued reliance on provider payment cutbacks is unlikely to work. This approach creates real access problems for some beneficiaries and engenders perpetual political problems with provider claims that they have been cut too much. Premium support proponents argue that incentives need to be completely redesigned and that it is better to undertake these changes when we have the fiscal resources to provide "carrots" as well as "sticks."

Percent of Total Federal Taxes Paid Compared to Distribution of Tax Returns by Income Classes



Source: Joint Tax Committee, US Congress, 1997.

Tax Reform

Since 1965, there has been a very significant change in the composition of Federal revenues.

FICA taxes (dedicated to pay for Social Security and Medicare) are up more than 3% of GDP over the last 20 years. Total Federal revenues have risen almost 2% of GDP over the same period. *Ipsa facto*, the Federal government collects 1.7% less than in 1965 (as a share of the total economy) to pay for all other programs and services, except Social Security and Medicare.

To fund current law Social Security and Medicare benefits, FICA taxes would have to continue to grow as a share of GDP, and as a percent of total Federal revenues, through the middle of the 21st century. Either FICA taxes continue to impinge on government's ability to raise revenue from other sources, or other receipts must be used to help fund promised

benefits. The only other options are benefit restraints consistent with current law payroll tax receipts, or very large deficits or tax increases equal to about 5% of GDP, Five percent of GDP is about \$400 billion this year, and even more in future years.

Nobody in Washington today argues we should raise taxes \$400 billion per year!

There are as many reasons to undertake tax reform as there are proposals to change the current system.

There is a broad and deep consensus in public opinion that the current tax system is too complicated and is unfair lends urgency to the current tax reform debate. The goals of simplicity and fairness may, however, conflict as some complexity

in current tax law was designed to make it more "fair".

The current debate focuses on maintaining budget balance and cutting taxes. Should there be a tax cut? If so, how big should it be? Should the goal be tax relief for middle income families, capital or increased saving and investment?

Big government and spending increases are generally less popular than tax relief. Thus many proposals to expand the size and scope of government and/or increase Federal spending for specific purposes masquerade as tax cuts.

We should insist on clarity above all else in the tax reform debates. There should be no doubt whether tax receipts would go up or down. Who stands to benefit and who would pay more?

Beyond the current debate, however, there is growing sentiment for broader tax reform. Some want to abolish the IRS entirely. Some seek a

system consistent with filing tax returns on a post care. Those may sound like extremes but there is a great deal of frustration with the current system. Tax reform could be a major topic of campaign rhetoric and debates for many elections to come.

Tax cut fever is rampant in Washington. For over a decade, conventional wisdom held that a combination of spending cuts and revenue increases would be needed to balance the Federal budget. Republicans argued they could cut spending, cut taxes and balance the budget. And Republicans took control of Congress. Republican control of Congress changed dramatically the revenue debate in Washington. We no longer talk of raising revenues. The debate is about whether or not, and how much, we can cut taxes, meet high priority needs and maintain budget balance.

Congress and the President almost certainly will not raise revenues this year -- and probably not next year.

The aversion to tax increases may or may not apply to selected tax expenditures and user fees. Only time will tell. Later, when Congress and the President turn to tax reform, some taxes almost inevitably will go up -- even as others go down.

Almost by definition, those who did well in past debates about tax policy (individuals, industries and economic activities that enjoy preferential treatment under current tax laws) will be most disadvantaged by any substantial change.

The tax reform debate seems centered on two major options: Flat Taxes and Consumption Taxes.

You may be excused, if you are confused, because all of the flat tax proposals currently in play are consumption tax plans.

This is a good example of the confusion that arises when we fail to separate "base" issues from "rate"

issues in tax reform.

Clarity must be the hallmark of any tax reform debate. This best can be accomplished if we discuss first what we ought to tax (the base), and then debate the rate structure. Shifting back and forth between the two sets of issues is confusing. Doing so may mask both similarities and fundamental differences between proposals.

Within each category, there are a variety of alternatives.

House Majority Leader Richard Armey (R-TX) is the leading proponent of one Flat Tax proposal. Steve Forbes made a big splash in Republican Presidential primaries and he focused almost exclusively on a flat tax proposal. House Minority Leader Richard Gephardt (D-MO) has authored another.

The Majority Leader's proposal is "flatter"; the Minority Leader's is intended to be more progressive.

Senate Budget Committee Chairman, Pete Domenici (R-NM) and former Senator and Armed Services Committee Chairman, Sam Nunn (D-GA), authored the Unlimited Savings Allowance (USA) Tax—a consumed income tax proposal. Their bill is designed to be the progressive approach to taxing consumption. It would not alter the percentage of total taxes paid by each income group. The USA tax bill would add up all income received, subtract all saving and investment, and tax the balance.

House Ways and Means Committee Chairman Bill Archer (R TX) has is interested in a National Sales Tax or a Value Added Tax (VAT).

These approaches to consumption based taxation are criticized as regressive.

Opponents say poor people must spend almost all their incomes for necessities (food, housing, medical care, etc.) thus sales taxes and VATs are unfair. One approach to redress regressivity in VAT and sales taxes

would exclude food, housing and pharmaceuticals from the tax base. However, that is about half the total tax base. Some suggest increasing grants to poor families, instead, in order to make a consumption based tax system "fairer."

Another option to shift the emphasis in Federal taxes from incomes to consumption would increase energy taxes. The Joint Tax Committee reports that energy is so large a part of everything we consume that a broad based energy tax would be the functional equivalent of a broad-based consumption tax. In addition, some argue that higher energy taxes would have ancillary benefits, i.e., promote conservation, reduce air pollution and reduce the trade deficit.

Policy options that are part of current tax reform debates can be briefly described as follows:

Should other issues such as Social Security and Medicare reform take precedence over tax cuts?

To meet those challenges should we focus on debt reduction instead of tax reduction; or

Can we reform Social Security and Medicare without raising taxes?

If it will be necessary, eventually, to raise taxes to pay for Social Security and/or Medicare reforms, does it make sense to cut taxes before we solve those longer-term challenges?

Some argue that the President and Congress must cut taxes today—even if they have to raise them again in the future—because the money otherwise will be frittered away.

As we noted earlier, the tax reform debate is much less mature than discussions around Social Security Reform.

And tax reform has in common with Social Security and Medicare reform one characteristic, which may make it difficult to reach consensus for years

to come. Far too little candor and much too much wishful thinking underlie all of these debates.

There can be no free lunch. In tax reform, as in entitlement reforms, major public policy change will require hard choices. If we want lower tax rates, we will have to forego some popular deductions (Getting rid of unpopular deductions for “special interests”, i.e., deductions that benefit someone else, simply will not offset the revenue loss from broad rate reductions.)

Do we value simplicity or do we want more deductions for more health care benefits, education costs or for other purposes? If we must choose, is it more important to increase savings or to make the tax system progressive? We probably will not see major tax reform enacted until we can agree on such goals as these—and there is no clear consensus around questions such as these today.

Appendix I
Side by Side Comparisons
of
Approaches to Social Security Reform

Comparison of Social Security Plans

Current Law		Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R.1793	President	Aaron- Reishauer
Description	Public social insurance (pay-as-you-go) system funded by payroll taxes.	Transition to "private" individual retirement accounts.	Keeps current system, but adds individual accounts. Tax credit (advance) funded individual accounts become base funding mechanism, supplemented by payroll tax financing.	Keeps current system (with modifications), carving out 2% payroll tax to fund individual accounts.	Keeps current system, but adds tax credit funded individual accounts and invests trust fund assets into private equities and bonds.	Keeps current system with benefit modifications. Increases revenues by investing trust fund reserves in private equities and corporate bonds.
Plan Components						
OASDI Trust Fund	Yes: Ongoing	Yes, but expected to whither away as younger workers opt out..	Yes: On-going	Yes: On-going	Yes: Ongoing	Yes: Ongoing
Individual Accounts	No	Yes: Optional Individual Social Security Retirement Accounts (ISSRAs). ISSRA participants ineligible for	Yes: Mandatory Social Security Guarantee Accounts (SSGAs)	Yes: Mandatory Individual Security Accounts (ISAs)	Yes: Optional Universal Savings Accounts (USAs) for those meeting income and other restrictions.	No

Current Law	Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R. 1793	President	Aaron-Reishauer
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traditional
Social
Security.

Financing

Trust Fund	Employers withhold payroll tax of 12.4% (split evenly between employee and employer) on taxable wage/ salary income. Taxable maximum indexed. Treasury collects taxes and credits trust fund with the revenue.	ISSRA participants pay 2.4% payroll tax (split between employee and employer) up to taxable maximum for 10 yrs. Non-ISSRA participants pay 12.4% (same as current law).	Same as current law. Rate drops to 9.9% in 2050 and 8.9% in 2060.	Same as current law. In addition, general fund transfers \$2.3-trillion to OASDI trust fund over next 15 years. Trust fund earns additional revenues from private investments.	Same as current law. Trust fund earns additional revenues private investments.
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Individual Accounts	Not applicable	Employers withhold 10% payroll tax contribution and distributed to account managers.	Treasury general fund transfers tax credit equal to 2% of taxable wage/salary income to a central agency that would pool credits and transmits them to mutual	Treasury collects payroll tax and credits 2% to ISAs. Additional, voluntary contributions up to \$2,000/yr. (including IRAs).	Tax credits and matching sums total \$500 billion over next 15 yrs. paid from Treasury general fund.
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Current Law		Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R. 1793	President	Aaron- Reishauer
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fund managers.

Investment of Plan Assets

OASDI Trust Fund	Limited by statute to investment in special Treasury obligations, yielding average return for all outstanding Treasuries.	No change	No change	No change	Gradual investment of \$600 billion in trust fund in stocks. By 2014, est. 15% of trust fund assets invested in private equities and 85% in special Treasury obligations.	Keeps 1-1/2 years' worth of benefits in special Treasuries. Remainder split 50-50 between private equities and corporate bonds.
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Individual Accounts	Not applicable	Individuals choose among broad investment options similar to IRA rules.	Account must remain invested in 60% stock index funds, 40% corporate bond fund prior to and after retirement. Individuals chose among qualified mutual funds to manage their entire SSGA. May change once/yr.	Individuals allocate account to a stock index fund, bond index fund, and Treasury securities fund similar to Fed. Retirement Thrift Savings Accounts. (Options to be expanded over time.) Other restrictions to be determined.	Individuals choose from a basic set of government-administered investment funds.	Not applicable
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Management of Private Investments

Not	ISSRAs held as	SSG Board	Individual	Federal	Social
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Current Law	Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R.1793	President	Aaron- Reishauer
applicable	trust by gov't. approved private trustees (banks or others) who have fiduciary responsibility for accounts (as under ERISA).	(appointed by Social Security Trustees) supervises private mutual fund account managers.	Security Fund Board within Social Security Admin. (similar to Fed. Retirement Thrift Savings Board).	government to administer accounts. Private investment manager accounts to be explored.	Security Reserve Board (similar to Federal Reserve Board).

Current Law		Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R.1793	President	Aaron- Reishauer
Benefits						
OASDI	Price-indexed retirement, spousal, survivor, and disability benefits. Benefits reflect earnings history (highest 35 years), marital status, dependents. Progressive benefit structure: higher replacement rate for low-income workers. Early retirement age of 62. Normal retirement age 65, rising to 66 between 2003 and 2009, and rising again to 67 between 2021 and 2027.	For individuals remaining in OASDI: Gradually raises retirement age to 70 for individuals born between 1938 and 1967 and thereafter. Reduces COLAs by reflecting changes in wages. Over time, OASDI expected to whither away as younger workers opt for ISSA tax cut (after 10 years) and better benefits (higher income workers, especially).	Guarantees current benefits. (No reductions) Repeals earning limits.	Guarantees minimum benefit equal to poverty level for workers with 40 yrs. earnings (approx.15% higher than current low-earner benefit). Repeals earning limits	Acknowledges need for, but does not propose, changes to current program.	Raises benefits for surviving spouses from 67% to 75% of couples combined benefit. Reduces spousal benefits from 50% to 33% of worker's benefits. Speeds up increase in normal retirement age, reaching 67 in 2011 instead of 2027 and index to longevity. Increases early retirement age to 64 by 2011 and index to longevity. Includes highest 38 years of earning. Reflects more accurate CPI in COLAs.
				Reduces replacement rates for middle- and upper-income workers, adjusts benefits for increase in longevity, adjusts COLAs to reflect more accurate CPI, includes all earnings years, and other changes. Speeds up increase in normal retirement age, reaching 67 in 2011 instead of 2027, and index to longevity. Expands coverage to all new State		

Current Law	Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R.1793	President	Aaron- Reishauer
Up to 50% of benefits taxable for singles (income \$25,000 to \$34,000) and couples (income \$32,000 to \$44,000). Up to 85% of benefits taxable if income, plus tax-free interest, plus 50% of Soc. Sec. benefits exceeds \$34,000 (singles) and \$44,000 (couples).			& local gov't. workers. 2010-2019: Gradually recaptures revenue from taxation of Soc. Sec. benefits from HI trust fund. (HI projected to receive \$11 billion in 2009.)		Expands coverage to all new State & local gov't. workers. Taxes all Soc. Sec. benefits the same as private pension income.

Current Law		Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R.1793	President	Aaron-Reishauer
Individual accounts	Not applicable	Guarantees minimum benefit equal to lesser of 40% of avg. pre-retirement income or 95% of expected Soc. Sec. benefits. Must wait until age 62 before taking any ISSRA distributions. ISSRA trustees must purchase private disability and pre-retirement survivors insurance from ISSA account balances.	Guarantees minimum benefit equal to Soc. Sec. benefit. (If necessary, SSGAs amount topped up to reach the minimum.) No withdrawals prior to retirement. Retirement age same as current law Soc. Sec. Tax credits flow from Treasury to central authority for distribution to individual's chosen mutual fund.	Individuals would have non-forfeitable property right to contributions plus accrued earnings. No withdrawal prior to retirement. On retirement, individuals must buy an indexed annuity sufficient to provide income "comfortably above" the poverty level when added to Soc. Sec. benefit.	\$300/person tax credit for tax filing couples with income under \$40,000. (Phases out between \$40,000 and \$80,000) Federal match: income under \$40,000--100% up to \$350/individual or \$700/couple. Phases down to 0% for family income greater than \$100,000. No withdrawals prior to retirement. Does not have to be annuitized.	Not applicable.
		No withdrawals permitted prior to retirement (age 59-1/2) or death of account holder. At retirement, account can be annuitized, or ams. can be withdrawn periodically as long as	At retirement, SSGA balances annuitized and sent to Soc. Sec. Admin. SSA issues benefit check. Prior to retirement, SSGA balances go to estate	Integrated with 401(k)s. Individual 401(k) contributions eligible for match if income eligible.		

Current Law	Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R. 1793	President	Aaron-Reishauer
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account balance is sufficient to finance minimum monthly benefit. Account balances remaining at worker's death go to estate.	of deceased worker if there are no surviving spouses, divorced spouses or eligible dependents. After retirement, SSGA balances go to account of surviving spouse/divorced spouse of deceased worker. After survivor(s) death(s), remaining balances go to SSA.
Workers converting to ISSRAs age 30+ receive recognition bonds to compensate for OASDI taxes already paid. Bond can be used to supplement monthly benefits.	

Budget Impacts

Short Term	Payroll tax revenues exceed outlay until 2014. Social Security surpluses account for	Tax credit transfers to SSGAs (plus interest) would use up 50% of projected unified budget surpluses	Diversion of 2% of payroll tax into individual accounts and private investment would reduce projected surpluses by over \$600 million, or	USAs and private investment of trust fund balances reduce budget surpluses and result in higher levels	Investment of trust fund in private stocks and bonds decreases budget surpluses relative to the baseline.
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Current Law	Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R.1793	President	Aaron- Reishauer
56% of projected unified budget surpluses over the next 15 yrs.	private investment likely to use up projected unified budget surpluses and could result in new deficits.	(2001-2009). Publicly held debt would be \$1.3 trillion higher in 2009 than under current law.	25% (2001-2009). Publicly held debt would be \$600 million higher in 2009 than under current law.	of publicly held debt than under the baseline.	By 2015, publicly held debt could be \$1.4 trillion higher than under current law.
	Publicly held debt would be higher than under current law.				
	Recognition bonds would increase public-debt levels further.				
Long Term	OASDI trust fund exhausted in 2034, when tax revenues sufficient to cover 71% of benefits. 75-yr. actuarial deficit equals 2.07% of taxable payroll. Benefit cost increase from 4.45% of GDP in 1999 to	Unknown: Gov't would pay transition costs: net residual benefits (benefits less tax contributions from individuals staying in traditional program and the 2.4% transition tax from ISSRA participants); and payments	Transfers to SSGAs exceed transfers back to Soc. Security until 2031. Including interest, would reduce unified surpluses and increase deficits through 2053 Publicly held debt would be \$16.4 trillion higher in 2054	Unknown: Depends whether savings realized from reductions in basic benefits, net of higher minimum benefit and additional interest costs from higher publicly held debt levels, are sufficient to offset long term financing shortfall.	Cost of USAs adds to current law OASDI costs. Private investment would eventually increase governmental receipt, but no estimate available on net impact.
	Changes more than sufficient to resolve Social Security's long-term actuarial deficit. No estimate available for impact on overall budget.				

Current Law	Porter: H.R. 874	Archer-Shaw	Kolbe-Stenholm: H.R.1793	President	Aaron- Reishauer
6.84% in 2030.	to amortize recognition bonds that begin when ISSRA workers retire. Additional continuing costs to fulfill minimum benefit guarantee for ISSRA retirees.	than under the baseline.			

Appendix II
Side by Side Comparisons
of
Approaches to Medicare Reform

Comparison of Medicare Reform Approaches

Current Law	Incremental Reform (Illustrative)	Breux-Thomas Premium Support	President's Proposal
<p>Description</p> <p>Government (Health Care Financing Agency-HCFA) run insurance program. Approximately 85% of beneficiaries are enrolled in the traditional fee-for-service program; 15% in private Medicare+Choice plans.</p>	<p>HCFA continues to administer Medicare program.</p>	<p>New Medicare Board oversees program and negotiates with private plans and government-run fee for service plan.</p> <p>Private plans compete on a local, regional or national basis for enrollees based upon premiums, cost-sharing requirements, and quality of service.</p>	<p>HCFA runs fee-for service (traditional Medicare) plan. Plan would receive same capitated payment as private plans but must compete on a national basis for enrollment. HCFA granted greater management authority (e.g., flexible purchasing authority, enhanced demonstration authority, ability to competitively bid contracts, ability to selectively contract with providers).</p>

Current Law		Incremental Reform (Illustrative)	Breaux-Thomas Premium Support	President's Proposal
Benefits	<p>Part A: Hospital Insurance -- inpatient hospital, skilled nursing facility care, home health care associated with covered hospital or nursing home stay, and hospice care.</p> <p>Part B: Supplemental Medical Insurance -- ambulatory services including physician services, outpatients services at hospitals, lab and other diagnostic and screening tests, mental health services, home health services not covered under Part A, physical therapy, speech therapy, certain medical appliances and durable medical equipment.</p>	<p>Combine Parts A and B with a single deductible and uniform co-payments across services. Provide a comprehensive benefit package, including outpatient prescription drug benefit and cap on out-of-pocket costs.</p> <p>Could provide a new long-term care benefit.</p>	<p>All plans must offer a standardized core benefit package at least equal to the benefits covered under current Parts A and B. (Actual value must be \pm 10% of the actuarial value of standard package.) Plans also must offer a high option that includes outpatient prescription drug benefits and cap on out-of-pocket costs. Plans can add benefits, but federal subsidy based on cost of standard benefit package.</p> <p>Government-run fee-for-service program offers standard (current Parts A and B benefits) and high (prescription drug benefits and stop loss protection) option plans.</p>	
Eligibility	<p>Part A: Participation is mandatory for those working in covered employment.. Automatic coverage for individuals and spouses w/ 40 qtrs. of employment in covered positions who are at least 65 yrs. old, and are citizens or permanent residents .Younger individuals qualify if they have worked sufficient time in Medicare covered jobs,</p>	<p>Same as current Part A.</p> <p>Could conform eligibility age to scheduled increases in normal Social Security retirement age.</p> <p>Could allow buy-in by early retirees.</p>	<p>Same as current Part A, except would conform eligibility age to scheduled increases in normal Social Security retirement age. Two-yr. waiting period waived for those who became disabled between ages 65 and 67 and reduced for those who became disabled between ages 63 and 65.</p>	

Current Law	Incremental Reform (Illustrative)	Breaux-Thomas Premium Support	President's Proposal
have received Social Security disability benefits for 2 year or have end stage renal disease.			
Part B: Voluntary. (Over 95% of Part A enrollees also enroll in Part B.) Must be eligible for Part A and pay a monthly premium.	Not applicable. Part B folded into Part A. Participation is mandatory for those working in covered employment.	Proposal implies combination of Parts A and B in gov't. run fee-for-service plan.	

Current Law		Incremental Reform (Illustrative)	Breaux-Thomas Premium Support	President's Proposal
Financing	Part A: Hospital Insurance Trust Fund-2.9% payroll tax credited to trust fund (split between employees and employers). Excess funds invested in Treasury obligations and earn interest at the Treasury rate. Those 65 and older who did not work in covered employment may buy-in.	Direct 2.9% payroll tax plus beneficiary premiums into a single (combined) trust fund.	On average, beneficiary premiums equal 12% of standard option plans.	
	Part B: Supplemental Medical Insurance Trust Fund- Beneficiaries pay monthly premium (\$45.50 in 1999). Premiums pay 25% of estimated program costs. General revenues pay 75%.	Could increase premiums uniformly or vary premium by beneficiary's income. (Current Part B premium will cover 12% of combined Part A and Part B costs once 1997 changes fully phased-in.) Could convert from payroll tax to general revenue financing. Could permanently fix Part B premium at 25% of costs. (After 2002, premium will be indexed to CPI.)	<ul style="list-style-type: none"> Standard plans at or below 85% of national weighted average: federal government pays 100% of premiums. For plans with premiums between 85% and 100% of the national weighted average, government pays \$1 for every \$3 paid by beneficiary. Plans above 100% of national weighted average: beneficiary pays full amount of premium above 100%. <p>Government's payments would be risk adjusted to reflect plan's enrollment (e.g., demographic characteristics, health status, and geographic location).</p>	
Beneficiary Cost-Sharing Requirements	Part A: Beneficiary pays co-pays and deductibles (varies by service and number of days).	Implement unified cost sharing structure (single deductible and uniform co-payments across services).	Private plans: co-pays and deductibles vary. Gov't. fee-for-service plan: Single \$400 deductible indexed to growth in Medicare costs. 10% co-pay on all services except inpatient hospital care.	
	Part B: \$100 deductible, and co-pays (varies by service)	Could index deductible to increases in health costs.		
Low Income Beneficiaries	Medicaid pays co-pays, deductible, and Part B premiums for individuals eligible for both programs (16 % of Medicare beneficiaries are "dual eligibles") or who incomes	Shift resources from Medicaid to Medicare trust fund to provide better coordination of coverage for low income individuals.	For beneficiaries with incomes up to 135% of poverty level: gov't would pay 100% of premium of high option plans at or below 85% of national weighted average.	

	Current Law	Incremental Reform (Illustrative)	Breaux-Thomas Premium Support	President's Proposal
	below poverty but do not qualify for Medicaid (Qualified Medicare beneficiaries - QMBs). Medicaid pays Part B premiums only for beneficiaries with income under 120% of poverty (Specified low income Medicare beneficiaries - SLMBS). Others with incomes up to 175% of poverty may apply to have Medicaid pay all (up to 135% of poverty) or some (up to 175% of poverty) of their premiums (qualifying individuals - QI-1s and QI-2s).			
Cost Containment	Relies on controlling payments to health care providers. Provider payment have gradually shifted to set payment rates from reimbursement for "reasonable" costs.	Limit participation to the most efficient providers and allow HCFA to negotiate more favorable payment rates for services.	Relies on competition to constrain costs. Would provide HCFA with additional flexibility so it could compete more effectively with private plans. Would eliminate first dollar coverage in Medigap plans to improve beneficiaries' cost-consciousness.	

AFTERWORD

The Committee for a Responsible Federal Budget and Oklahoma State University jointly convened a symposium in Tulsa, Oklahoma October 26, 1999, to release the draft version of this report.

The University and that meeting were crucial to the completion of this work. A number of people contributed generously of their time to participate in that event. They provided invaluable insights, based on substantive and political knowledge and experience and we are very grateful for their contributions.

More than 100 people participated. They included—

- Dr. James Halligan, President, Oklahoma State University, Dr. Gary Trennepohl, President, Oklahoma State University Tulsa, Dr. Gerald Lage, Interim Dean, College of Business Administration, Oklahoma State University, other faculty and students representing the university community;
- The Honorable Henry Bellmon, former Governor of Oklahoma, former United States Senator and founding co-chairman of the Committee for a Responsible Federal Budget;

- The Honorable Robert S. Kerr, Jr. and Mrs. Kerr, representing the Kerr Foundation which sponsored the event (Mr. Kerr is a Member of the Board of the Committee for a Responsible Federal Budget);

- A very diverse cross section of individuals from the public and private sectors in Tulsa and the State of Oklahoma.

Two people with vast experience in the political world and the issues addressed in this report highlighted the morning session—

- Senator Nancy Kassebaum Baker, former Chairman of the United States Senate Committee on Health and Human Resources; and
- The Honorable Leon Panetta, former White House Chief of Staff, former Director of the Office of Management and Budget and former Chairman of the House Budget Committee.

Dr. Alice Rivlin was the keynote speaker at lunch. Dr. Rivlin has served as Vice Chairman of the Board of Governors of the Federal Reserve System, Director of the Office of Management and Budget, and Director of the Congressional Budget Office.

The afternoon featured Dr. William Niskanen, for Chairman of President Reagan's Council of Economic Advisers and the Honorable David Walker, Comptroller General of the United States and a former Public Trustee for the Social Security and Medicare systems.

Dr. Niskanen currently is Chairman of the Cato Institute and a leading advocate for "privatization".

Mr. Walker presented the data disclosed in his agency's long term projections and urged early action to address the Social Security and Medicare issues before they truly threaten the nation's economy.

Dr. Walker suggested that Social Security reform can be a "win win" issue for politicians, because current beneficiaries will not be cut and younger folks will know the reformed system will be solvent for them. Medicare will be much more difficult, however, according to Mr. Walker.

Mr. Walker also suggested that some form of individual accounts may be a part of Social Security reform but stressed that solving the problem would require benefit reductions and/or tax increases compared to current law.

Dr. Niskanen describes his privatization proposal as follows—

- Set the tax rate to finance transition;
- Maintain benefits for existing retirees;
- Provide a safety net for poor retirees;
- Regulate private funds to ensure safety of investments; and
- Compel future retirees (who opt for the new system) to purchase annuities with values in excess of safety net guarantees.

Dr. Rivlin offered a generally optimistic outlook for the future. She said we need to do five things to prepare for the future—

- Preserve the Social Security surplus;
- Fix Social Security *and* encourage private saving;
- Make school improvement a major priority for everyone at every stage of life;
- Lengthen productive working lifetimes and mitigate the rush to early retirement; and
- Reconfigure cities to accommodate older populations, restructuring housing in particular.

Mrs. Kassebaum Baker and Mr. Panetta offered surprisingly similar assessments of the challenge and prescriptions for solving the problems we face—

- The biggest problem is that politicians instinctively seek partisan political advantage; and
- These issues require bipartisan solutions.
- Both said that strong leadership is the only thing that will break up partisan gridlock. Both implied that such leadership can come only from the White House. Both, therefore, suggested that nothing substantive will occur until after the 2000 elections.

The audience offered a number of valuable suggestions and provided incisive thoughts about the report.

Unfortunately, their contributions are too numerous to list here. Suffice it to say that the symposium—and all participants made this a better product that it otherwise would have been.

The conference closed with several participants committing to take the materials and the discussions back to their communities and thus multiply the education impact of the meeting.

All agreed that more and better public education will be needed to solve the challenges we face. But everyone also agreed that the United States is a very strong and wealthy nation and we ought to be able to solve these problems.

The Exercise: Participating Organizations

American Business Conference
American Council of Life Insurance
American Savings Education Council
Brookings Institution
Cato Institute
Center for Strategic and International Studies
Center on Budget and Policy Priorities
Chamber of Commerce of the U.S.A.
Citizens for Tax Justice
Committee for Economic Development
Concord Coalition
Economic Policy Institute
Economic Security 2000
Employee Benefit Research Institute
Heritage Foundation

International Association for Financial Planning
National Association of Counties
National Association of Manufacturers
National Association of Negro Women
National Association for the Self-Employed
National Commission on Retirement Policy
National Governors Association
National League of Cities
Progressive Policy Institute
Public Forum Institute
The Business Roundtable
Third Millennium
2030 Center
Urban Institute

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For more information about the *Building a Better Future: An Exercise in Hard Choices* project or the Committee's other activities, you may contact us at (202) 547-4484 or at CRFB@aol.com.

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